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The University of Manchester

TRADE SUSTAINABILITY IMPACT ASSESSMENT (SIA) OF THE ASSOCIATION AGREEMENT UNDER NEGOTIATION BETWEEN THE EUROPEAN COMMUNITY AND MERCOSUR

SECTOR STUDY: FINANCIAL SERVICES

FINAL REPORT

Consultation Draft

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Interested Parties are invited to comment on this Consultation Draft:
email address: sia-trade@man.ac.uk

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ABBREVIATIONS

BHU	Banco Hipotecario Uruguay
BNDES	Banco Nacional de Desenvolvimento Econômico e Social
BROU	Banco de la Republica Oriental del Uruguay
CCA	Causal Chain Analysis
CGE	Computable General Equilibrium
EC	European Commission
EFC	Economic and Financial Committee
EU	European Union
GATS	General Agreement on Trade in Services
IRB	IRB-Brasil Resseguros S.A.
IRB	internal-ratings based
M&E	Mitigation and Enhancement
MEA	Multilateral Environmental Agreement
NBC	Nuevo Banco Comercial
SIA	Sustainability Impact Assessment
SME	Small and Medium Sized Enterprises
TPR	Trade Policy Review
WTO	World Trade Organisation

EXECUTIVE SUMMARY

This report presents the results of a sustainability impact assessment (SIA) study undertaken for the European Commission to assess the economic, social and environmental impacts of the Financial Services component of the proposed trade agreement between the EU and the Mercosur trade area, composed of Argentina, Brazil, Paraguay and Uruguay (with the inclusion of Venezuela since 2006). It expands on the findings of the project Inception Report and Mid-Term Report, presents proposals for mitigation and enhancement measures, and summarises the overall conclusions from the study. The results are intended to provide information for the trade negotiations and for the development of parallel policy measures to enhance the beneficial impacts of the trade agreement and to avoid or mitigate adverse ones. The principal findings of the study are presented in this Executive Summary, together with recommendations for negotiators and policy-makers in the EU and Mercosur countries.

The methodology used in the SIA is summarised in the second section of the report, after an introduction to the background and objectives of the study. The trade and negotiation issues covered by the study are described in the third section. The fourth section summarises three case studies on which much of the detailed analysis and recommendations are based. These are presented in full as annexes to the report. The sections which follow describe the impact assessment analysis and the proposals for mitigation and enhancement measures. The overall conclusions are presented in the last section and are reproduced below.

Principal findings

The static welfare gain from financial services liberalisation is small in both Mercosur and the EU, but other effects are potentially much larger. EU providers of financial services stand to gain from increased market penetration, while in the Mercosur countries the main economic benefits are expected to come from long term dynamic effects on economic growth. This is expected to make a significant long term contribution to reducing poverty. Social impacts in the EU are small but also beneficial.

A short term decline in domestic financial services output is expected in all the Mercosur countries, but except in Paraguay the impact is small and likely to countered in the longer term as domestic providers become more competitive. The decline in output projected for Paraguay is large enough to be of major significance to the small domestic financial services industry.

The principal environmental impact of financial services liberalisation comes indirectly from the expected increase in economic growth. This would intensify the need for change in unsustainable patterns of consumption and production. No significant direct environmental impacts are identified in either direction.

The potential benefits of liberalisation could be considerably more than outweighed by increased risks of financial instability. Unless countered by effective mitigation measures this could result in major adverse effects in all the Mercosur countries and, to a lesser extent, in the EU.

Recommendations for negotiators and policy-makers

The SIA study is not intended to make specific recommendations for the negotiating positions of the EU or Mercosur countries. However, negotiators are encouraged to take account of the impacts discussed above, in developing their positions and throughout the ongoing negotiations. In particular, they should note the potentially adverse effects on financial stability.

The recommendations for enhancing the potentially beneficial impacts and mitigating or avoiding adverse ones are presented in three categories:

- Mitigation of adverse environmental and economic impacts
- Enhancement of economic benefits
- Avoidance of adverse impact on financial stability

Mitigation of adverse environmental and economic impacts

Financial services liberalisation is not expected to have any significant direct environmental impacts. However, if the liberalisation measures succeed in accelerating economic growth they will intensify the need for change in unsustainable patterns of consumption and production in both the EU and Mercosur. The issues of greatest concern relate to climate change and biological diversity. We therefore recommend:

1. Enhanced cooperation between EU and Mercosur government to reinforce their efforts to strengthen Multilateral Environmental Agreements (MEA) and associated governance mechanisms which effectively address climate change and declining global biological diversity, including the Framework Convention on Climate Change and the Convention on Biological Diversity.

The assessment has indicated the possibility of major adverse adjustment impacts for Paraguay's small financial services sector. In the longer term, domestic providers are expected to benefit from competitive pressures for greater efficiency and productivity. We therefore propose that consideration be given to:

2. Support from the Government of Paraguay to assist the country's financial services providers enhance their competitiveness in services that are complementary to those offered by EU providers.

Enhancement of economic benefits

The assessment of impacts on Small and Medium Sized Enterprises (SME) suggests that liberalisation may have relatively little effect, except perhaps in Brazil where small firms already make greater use of bank finance. The case study for SMEs has identified needs for improved credit rating expertise among service providers and for fuller evaluation of the suitability of collateral. The first of these is likely to benefit from an increased presence of EU providers with greater credit rating experience. The second is likely to remain a barrier for both domestic and EU providers. We therefore recommend consideration of:

3. Technical assistance from the EU for the development of improved systems for evaluating the suitability of collateral offered by SMEs

Avoidance of adverse impact on financial stability

The assessment indicates that financial services liberalisation could have severe adverse effects on financial stability in the Mercosur countries, and to a lesser extent also in the EU, unless accompanied by action to strengthen both regions' regimes for regulation and supervision. Similar needs have also become apparent as a result of the current global financial crisis. It is therefore considered vital that the negotiations on EU-Mercosur liberalisation should take full account of the evolving international dialogue on strengthening the global financial system, and that specific mitigation measures associated with EU-Mercosur liberalisation should be based on those agreed internationally.

A number of specific measures have been identified in the assessment that would contribute to avoiding adverse impacts on stability of further financial services liberalisation. These measures are included in the following recommendations, along with others related to wider international action.

4. The EU-Mercosur Association Agreement on financial services should not be finalised until a reasonable international consensus has emerged on actions to be taken in response to the current global financial crisis.
5. The Association Agreement should include specific actions to be taken by both parties to ensure that the liberalisation measures do not adversely affect stability in either region, based on an international consensus on appropriate mechanisms for strengthening global stability.
6. Fuller implementation of the Basel Core Principles for Effective Banking Supervision in both Mercosur and the EU.
7. Full implementation in both Mercosur and the EU of any revisions to the Basel principles that may be agreed in response to the current global crisis.
8. Joint EU-Mercosur development of fuller guidance on implementation of the Basel principles.
9. Implementation within Europe of the European Commission's Economic and Financial Committee (EFC) recommendations for strengthening international and cross-sector co-operation, particularly in monitoring cross-border financial institutions.
10. Joint action on extending and adapting the EFC recommendations to apply to cooperation between the EU and Mercosur.
11. Strengthening of supervisory institutions and systems in both the EU and Mercosur to provide greater transparency, increased financial and human resources, greater autonomy for supervisors, and the ability of supervisors to enforce regulations.
12. Technical assistance from the EU in providing better training of regulators and supervisors in Mercosur, particularly for the enhancement of monitoring and enforcement capabilities.

Overall conclusions of the Financial Services SIA study

Five broad conclusions are drawn from the SIA study:

1. Further liberalisation of financial services between the EU and Mercosur offers potentially significant economic benefits in both regions. The expected contribution to economic growth in Mercosur countries would have significantly beneficial social impacts in the long term.
2. Adjustment impacts are relatively small except in Paraguay, whose small financial services sector is vulnerable to increased competition.
3. Environmental impacts are limited mainly to the indirect effects of greater economic growth.
4. Unless liberalisation is accompanied by stronger regulation and supervision it would significantly increase the risk of financial instability. This would carry corresponding risks of severe adverse economic and social impacts in both the short term and the long term, that could considerably outweigh the benefits of liberalisation.
5. An EU-Mercosur agreement on financial services liberalisation should not be finalised until a reasonable international consensus has emerged on actions to be taken in response to the current global financial crisis. The agreement should fully incorporate any actions that are agreed internationally.

Further consultation

The results of the SIA will contribute to refining the EU's position in the ongoing negotiations and in the design of its development assistance programmes. They are also expected to be taken into account by policy-makers in the Mercosur countries. Comments and suggestions on all aspects of the SIA report will be greatly appreciated. They should be sent to the project email address:

sia-trade@man.ac.uk

1. INTRODUCTION

Since 1999 the European Commission has been engaged in an ongoing programme of Sustainability Impact Assessment (SIA) studies of all EU trade negotiations. Within this programme a series of SIAs has been commissioned for the current negotiations for a trade agreement between the EU and the Mercosur trade area composed of Argentina, Brazil, Paraguay and Uruguay (with the inclusion of Venezuela since 2006).

The Trade SIA programme applies a standard approach in conducting impact assessments. This framework has two complementary elements:

- a balanced and integrated analysis of potential economic, social and environmental impacts;
- consultation with and dissemination of results to partners and key stakeholders as an integral part of the assessment process.

The first phase of the EU-Mercosur SIA programme consisted of a Preliminary Overview SIA together with three sectoral studies (for Agriculture, Automobiles and Forests). The Preliminary Overview SIA identified a number of other sectors and issues worthy of further study in the final phase of the programme. Following consultation on the findings of Phase One, Financial Services and Trade Facilitation were selected for two further sectoral studies in the final phase, alongside a Final Overview SIA.

The sectoral SIA for Financial Services assesses the potential economic, social and environmental impacts of the proposed trade agreement in Mercosur and EU countries, and identifies measures for avoiding, preventing or mitigating adverse impacts and enhancing beneficial ones. This Final Report presents the results of the study and it conclusions.

An overview of the Financial Services sector in the EU and Mercosur was presented in the Inception Report for the final phase of the EU-Mercosur SIA programme[1], along with a review of the status of financial services liberalisation, and a discussion of the issues to be addressed in the sectoral study. This provided the basis for an initial assessment presented in the Mid-Term Report for Financial Services[2]. Three case studies providing more detailed analysis have been undertaken in the final stage of the study, along with further analysis of potential impacts and the development of proposals for mitigation and enhancement measures.

There are six sections in the report, including this introduction. Section 2 describes the SIA methodology, with particular reference to refinements and adaptations for the assessment of the financial services sector. Section 3 gives an outline of financial services in the EU and Mercosur and of trade in the sector, and summarises the current status of the EU Mercosur negotiations. Section 4 summarises the three case studies, which are presented in full as Annexes. Section 5 presents the impact assessment analysis, and Section 6 describes proposals for measures to enhance beneficial impacts and avoid or mitigate adverse ones. Section 7 presents overall conclusions.

[1] IARC (2008a)
[2] IARC (2008b)

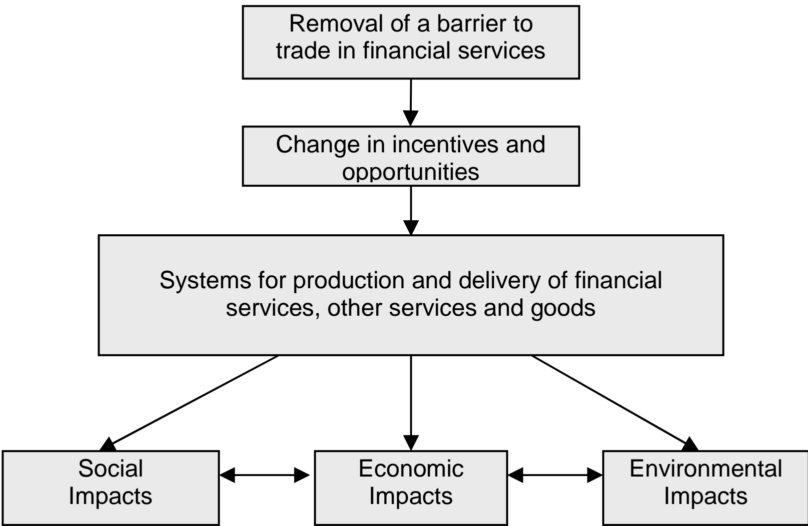
2. METHODOLOGY

2.1. Methodological framework

The methodological framework for Trade SIA is described in the EC's Handbook for Trade Sustainability Impact Assessment[3], and its application to the EU-Mercosur negotiations is described in the Final Report for the Final Overview SIA[4]. Causal chain analysis (CCA) is the cornerstone of the SIA methodology, and is used to identify the significant cause-effect links between the proposed trade measure and its eventual economic, social and environmental impacts. The evidence that is used within the causal chain analysis is derived from theoretical reasoning, economic modelling, other quantitative analysis, the results of prior studies and expert opinion from key stakeholders.

As applied to the financial services sector the causal chain analysis can be represented in the form of a causal chain diagram showing each of the main linkages in their logical order of causality (Figure 1).

Figure 1: Causal Chain Analysis of the Impact on Sustainable Development of Financial Services Liberalisation



The removal of a trade barrier will alter the structure of incentives and opportunities for service users and suppliers in the markets that are directly affected by the measure. The new structure of incentives and market opportunities will induce a change in the economic behaviour of enterprises (service producers or consumers) and of households (consumers). Changes within the financial services sector will in turn affect incentives and opportunities in other economic sectors that use financial services, with potentially significant effects across the entire economy. These changes in the system of production and delivery of goods and services will have impacts on each of the three dimensions of sustainable development (social, economic and environmental), with further impacts arising from interactions between the three dimensions.

Figure 1 is a simplified illustration of the causal chain approach which is used in SIA to assess significant linkages and final impacts on sustainable development. It does not convey the full complexity of the linkages between each stage in the causal chain or of the cross-

[3] EC, 2006
[4] IARC (2008c)

linkages between the social, economic and environmental impacts. Further, the direct and indirect impacts from individual trade liberalisation measures may have cumulative impacts, which need to be considered in the appraisal of the trade agreement as a whole. The mechanisms through which these cause-effect relationships operate may be numerous and complex.

The effects illustrated in Figure 1 are essentially dynamic in nature. They do not occur instantaneously or simultaneously, and the speed of adjustment to a liberalisation measure will vary in different parts and at different stages in the causal chains. For financial services liberalisation there may also be long term dynamic effects that continue beyond the period of adjustment, resulting from structural changes in the entire socio-economic-environmental system. These dynamic effects within the intermediate and subsequent stages of the cause-effect relationships will influence the nature and magnitude of both short term and long term impacts on sustainable development.

2.2. Indicators

The impacts of financial services liberalisation are assessed by evaluating the significance of the linkages from the removal of a trade barrier to the changes in enterprise and household behaviour, and to the consequent impacts on the economic, social and environmental dimensions of sustainable development. For this purpose the sectoral study uses the set of nine core indicators defined in the SIA methodology (Table 1).

Table1. Core Sustainability Indicators

Sustainability dimension	Core indicator
Economic	Real income Fixed capital formation Employment
Environmental	Biodiversity Environmental quality Natural resource stocks
Social	Poverty Equity Health and education

These core indicators (or themes) are used to guide the assessment process and to summarise the impact of the trade measures on each of the three dimensions of sustainable development. The SIA methodology also allows for the development of second tier indicators for each SIA study, to describe results at a lower level of aggregation than the core indicators. These second tier indicators measure the significance of specific impacts within each of the nine core themes. For financial services they are identified through the causal chain analysis described in the subsequent sections of the report.

In addition to the nine core indicators for sustainability outcomes, the methodology also allows for two process indicators which influence the long term economic, social and environmental impacts of trade liberalisation:

- Consistency with sustainable development principles
- Institutional capacity for effective sustainable development strategies

The inclusion of process indicators allows for the assessment of impacts on the key procedures, processes and practices that are needed for longer-term advancement of sustainable development.

2.3. Impact significance

The methodology defines the significance of an impact in terms of greater or lesser significance:

- lesser significant impact – marginally significant to the negotiation decision, and if negative, a potential candidate for mitigation
- greater significant impact – significant to the negotiation decision, and if negative, merits serious consideration for mitigation.

In evaluating the significance of impacts the financial services SIA takes account of the following factors as defined in the SIA methodology:

- The extent of existing economic, social and environmental stress in affected areas;
- The direction of changes to base-line conditions;
- The nature, order of magnitude, geographic extent, duration and reversibility of changes;
- The regulatory and institutional capacity to implement mitigation and enhancement measures.

2.4. Scenarios

Two scenarios are used in assessing the potential impact on sustainable development of the financial services negotiations:

- Base scenario: no change in the current negotiated trade measures affecting EU and Mercosur trade, including no agreement on the trade liberalisation measures being discussed within the WTO Doha Development Agenda negotiations. The baseline scenario assumes, therefore, no change to the commitments on financial services that have been made by each of the partners within existing WTO agreements, and a continuation of existing trends in financial services trade.
- Further liberalisation scenario: this represents the strongest probable implementation of the trade negotiations, including economic modelling of removal of all barriers to cross-border trade in financial and other services (mode 1). Negotiating options for the actual trade agreement cover a range of intermediate scenarios, involving different degrees of liberalisation for each component of the financial services sector.

2.5. Assessment of impacts

A fundamental difficulty in studying of the impact of liberalising trade in financial services is a shortage of reliable data on trade and financial flows attributable to the sector. This limits the statistical basis upon which the economic impact of further liberalisation can be modelled. The assessment of the further liberalisation scenario includes quantitative estimates for Mode 1 liberalisation only, obtained from an integrated CGE model[5]. Further quantitative information on the potential magnitude of impacts is derived from the causal chain analysis using baseline data and from other studies reported in the literature. However, the lack of trade data and the diverse nature of the financial services sector are such that much of the assessment of economic, social and environmental impacts is based on qualitative analysis.

[5] The EU-Mercosur CGE model is described in the Final Report for the Final Overview SIA.

The main focus of the SIA is on the potential impacts at the regional level (EU and Mercosur). However, the SIA also provides information on potential impacts at the individual country level, where it appears that a particular country may be disproportionately affected (positively or negatively), or where countries are likely to respond in different ways. Equally, social and environmental impacts may vary significantly at the country or intra-country level. Factors taken into account include:

- The level of economic development in each of the countries;
- The specific financial services activities in which liberalisation is proposed;
- The timescale over which further liberalisation would be implemented;
- Current degree of access for foreign-based providers of the financial services concerned;
- The existing balance between domestic and foreign-owned providers of the services;
- The existing importance of the services in the national economy, including the proportions of employment and capital investment which they represent;
- The nature of financial services regulation in the national economy;
- The capacity of the economy to absorb further financial services liberalisation in the short and medium term.

The potential positive and/or negative impacts identified in the assessment are highlighted in impact summary tables using the following symbols:

-	Impact assessed to be non-significant compared to the base situation
↑	Positive greater significant impact
↓	Negative greater significant impact
↑↓	Greater positive and negative impacts likely to be experienced according to context
⇧	Positive lesser significant impact
⇩	Negative lesser significant impact
⇧⇩	Lesser positive and negative impacts likely to be experienced according to context
? or ?	Impacts uncertain

2.6. Mitigation and Enhancement

The SIA methodology allows for the assessment of possible preventative, mitigation or enhancement measures, subsequent to the assessment of potential impacts. These measures will be categorised in the same way as for the Final Overview SIA:

- Trade-related measures, which can be integrated into the trade agreement
- International and regional measures to improve the policy environment and strengthen national regulatory capacity
- National sectoral policy measures to remedy or regulate market imperfections
- National policy measures to mitigate adjustment costs.

2.7. Consultation

Consultation is a key part of the SIA methodology, and is being conducted as described in the Final Report for the Final Overview SIA. Consultees on financial services have been targeted as part of the overall consultation programme. Their contributions have been taken into account in the preparation of this report, as described in the final report on the Overview SIA.

3. TRADE AND NEGOTIATION ISSUES

3.1. Financial services liberalisation by mode of service supply

Article 5 of the financial services Annex of the General Agreement on Trade in Services (GATS) defines financial services as insurance and insurance-related services, and banking and other financial services (excluding insurance). Insurance and insurance-related services include direct insurance (including life and non-life, and co-insurance); reinsurance and retrocession; insurance intermediation (such as brokerage and agency); and services auxiliary to insurance (such as consultancy, actuarial services, risk assessment and claim settlement services). Banking and other financial services cover all other financial service activities and auxiliary services related to them.

The EU-Mercosur negotiations aim for additional commitments for services trade liberalisation beyond those that have been made through the WTO under GATS. Services liberalisation measures negotiated through the WTO follow a positive list approach, whereby countries undertake commitments to national treatment and market access by specifying the type of access or treatment offered for particular financial services or suppliers of financial services in scheduled sectors. Sectors not included in a country's national schedule are not subject to commitments. The EU-Mercosur negotiations follow a similar positive list approach, aiming for further commitments beyond those that have been agreed multilaterally.

The modes of service supply set out in GATS are:

- Mode 1: cross-border trade
- Mode 2: consumption abroad
- Mode 3: commercial presence in the territory of another country
- Mode 4: presence of natural persons (representing a foreign-based service provider).

For financial services there is often considerable overlap between the four modes. GATS distinguishes between services provided *from* the country of the service supplier (Mode 1) and those provided *in* the country of the service supplier (Mode 2). For financial services the dividing line between these two modes of supply is not always clear. Because financial services are intangible, assigning a geographic location to their provision across borders can be difficult. For this reason some analysts combine modes 1, 2 and 4 into a single category of cross-border trade, defined as "the provision of financial services by a financial firm located in one country to a customer residing in another country without the establishment of a commercial presence" [6]. The country where the firm is located need not be where it is headquartered, but may be a third country where it has a subsidiary or branch office. Mode 3 is clearly distinguished from the other three modes in that it does require a commercial presence.

Mode 3 liberalisation also differs from the other three modes in the implications for regulation and for capital transfers. Cross-border trade in financial services (particularly Mode 1) typically requires a higher degree of capital account opening than commercial presence. Commitments to Mode 3 liberalization require only the liberalisation of capital inflows related to the foreign investment, whereas Mode 1 requires liberalisation of both inflows and outflows[7].

[6] OECD (1999)
[7] Contreras and Soonhwa (2004)

Cross-border trade also generates needs for a higher degree of regulatory symmetry than may be necessary for Mode 3[8]. Foreign financial institutions established with a commercial presence normally have to abide by domestic regulations, usually on a national treatment basis, whereas for cross-border transactions it may not be clear which of the home and host country regulation and supervision systems apply. The cost of complying with different regulations may put either domestic or foreign suppliers at a competitive disadvantage with respect to the other. At least as importantly, asymmetries in regulations or any uncertainty in their applicability may hamper supervision and monitoring and hence increase systemic risks. The development of effective regulatory mechanisms is therefore a key factor in financial services liberalisation, particularly for Modes 1, 2 and 4.

3.2. Financial Services in the EU

Strengthening the convergence of supervisory practices between Member States is the overarching objective of internal EU policy for the financial services sector. The White Paper on Financial Services of December 2005 set out the Commission's objectives in financial services policy for the period to 2010[9], with emphasis on financial integration and increased coherence and consistency in regulation and supervision. A review of progress towards achieving these objectives was undertaken in 2007[10].

Integration of EU financial services markets is progressing across the board, but at a very different pace for different products and end-users. Wholesale markets are generally characterised by a high level of integration, while retail financial markets remain nationally fragmented. The financial integration review report recognises that greater integration can strengthen competition and offer better opportunities for financing and risk diversification, but identifies risks associated with corresponding structural changes in the financial system. In parallel with measures for increased convergence within the EU, it therefore calls for the development of adequate safeguards to ensure financial stability.

The EU policy also recognises ways in which financial instability can be transmitted internationally, and seeks to strengthen regulatory and related dialogue with the EU's main trading partners. These include the United States, Japan, and emerging financial services markets in China, India, Russia and elsewhere. This dialogue is expected to be a significant factor in the negotiation of a joint EU-Mercosur agreement on liberalisation of financial services.

The current world financial crisis has led to reduced liquidity in the interbank market and forced the emergency resolution of major financial intermediaries, to deeply disrupt structured credit markets and necessitate repricing of risk across a broad range of instruments[11], The crisis has reinforced the needs identified in the 2007 integration report, which confirmed the need for the ongoing revision of prudential frameworks, and stressed the importance of dialogues on financial services regulation between the EU and its major financial partners.

3.3. Financial Services in Mercosur

During the past decade the Mercosur countries have suffered from several financial crises. These crises have had significant consequences for their financial systems, which vary from

[8] Contreras and Yi ibid
[9] Commission of the European Communities (2005)
[10] Commission of the European Communities (2007)
[11] IMF (2008a)

country to country. The following review summarises the situation in each of the Mercosur countries.

Argentina

The crisis that affected Argentina between 2001 and 2002 ended a period of liberalisation in certain sectors of the economy. Regarding the financial sector, the advantages, inter alia, that were lost may be mentioned here: the elimination of exchange control; exporters had no longer the obligation of sending the convertible currency back to Argentina; firms were able to have access to medium term loans both through local and foreign financial markets, and could thus equip and modernise their production lines; Argentine banks had access, through their correspondents, to credit facilities at very competitive interest rates.

The strong devaluation that became inevitable when the crisis exploded brought very traumatic consequences, both social and economic. Here we shall only refer to those related to the financial system.

1) Dollar deposits were confiscated, and were later restored in (devaluated) Argentine pesos by means of an interest rate established by the government, for those who accepted this option. Other clients decided to legally demand that their deposits were restored in the original currency (dollars).
2) On the other hand, firms and individuals with loans in US dollars were able to cancel these obligations in Argentine pesos, by means of an index established by the government. This situation, called asymmetric devaluation, created serious problems regarding banks' book values and annual balance of assets, a state of affairs that still exists.
3) In view of the fact that the State had declared the non payment of the external debt, followed by its renegotiation, a number of banks stopped complying with their obligations vis-à-vis banks and financial institutions abroad. Within the foreign trade sector, this was the first time that Argentine banks did not repay loans made by their foreign correspondents regarding export pre-financing or did not cancel letters of credit.
4) The Central Bank again enforced the rule that exporters had to send their convertible currency back to Argentina; in case of non compliance exporters are subjected to the exchange penal system.
5) There also exists a reserve ratio of 30 percent for all financial loans coming from abroad.
6) Regarding Argentine exports of capital goods, there are no mechanisms that allow the exporter to give long term credit facilities to their clients, as occurs in other countries (Eximbank in the US, Hermes in Germany, Coface in France, etc.).

In view of the foregoing, added to the legal insecurity thus created, we can briefly state the following:

1) At present there are exporting and importing sectors that have ready access to credit facilities either directly from abroad or from their own suppliers. These are the big firms such as grain exporters, automobile companies, oil firms, etc.
2) Exporting SMES, however, face huge difficulties in order to obtain credit facilities locally for their working capital needs (pre-financing) or post-shipment invoice discounts (international factoring), when they are not covered by financial instruments

that in turn cover the risk related to the foreign buyer, such as letters of credit, bank letters, etc.

3) Within the Argentine financial system there are no possibilities of obtaining financing in order to support medium or long range plans with a view to increasing production capacity, infrastructure, logistics, etc.

Brazil

Even if in the late nineties Brazil had been unable to maintain its rate of exchange (January 2001), the consequences of its devaluation were not as traumatic as those in Argentina (in 2002). It should be borne in mind that the background of Brazil as an exporting country is essentially different vis-à-vis Argentina, its most important Mercosur partner. We may here mention some of the differences between the two countries in this respect:

1) Brazil has adhered to a coherent policy regarding foreign affairs. It has maintained clear trade rules with those countries that constitute its traditional export markets, especially as far as the US is concerned. This differs from the situation in Argentina, where the relationship with the US was given top priority during the nineties, while today two trade partners have established very close ties with Argentina: Bolivia and Venezuela.
2) In Brazil there exists lasting cooperation between the business community and the public sector in order to develop and carry out the country's export policies, and even to carry out business operations.
3) Argentina, as has been already mentioned, has limited financial instruments supporting capital goods exports. Brazil has the National Development Bank (BNDES[12]) that shows an active participation side by side with exporters.
4) Brazil has also a law dealing with Trading Companies. Through these export engines, small and medium sized producers – of Brazil's internal regional economies - are allowed to sell their own products benefiting from the same tax advantages as if they were themselves actually exporting. These trading companies are important firms with access to credit facilities in both the local and the foreign financial market.
5) Apart from being among the world's leading exporters, Brazil has the advantage of having a significant domestic market. Both these markets – domestic and foreign - create a level of demand that allows business to operate at competitive production levels, which is in turn a dynamic factor associated with business opportunities for their industries and one that offers a more attractive scenario for banks when it comes to evaluating credit requirements.

These factors give an indication of the importance Brazil grants to those financial services related to foreign trade.

Even if in the late nineties devaluation had its negative consequences – some banks simply disappeared and others were forced to reposition themselves. Today the following positive aspects may be mentioned:

1) Most banks are already beyond the emergency state and actively take part in foreign trade financing.
2) However, it is fair to point out here that there also are difficulties when it comes to evaluating credit risk regarding SMEs, owing (as is the case in Argentina) to their inability to show their repayment capability.

[12] BNDES = Banco Nacional de Desenvolvimento Econômico e Social

3) With a positive interest rate - 11 percent against a 3 percent rate of inflation - there is a considerable flow of foreign capital for both commercial and financing loans; in Brazil there is no such thing as a 30 percent reserve ratio as in Argentina, where the interest rate is negative. According to non-official figures, in 2007 there were over 30 billion US dollars of foreign capital flowing into Brazil.
4) There is a policy geared towards supporting first level Brazilian companies seeking to acquire firms in Argentina, Paraguay and Uruguay, in sectors such as steel, cement, meat, oil and other significant sectors of the other three Mercosur Member Countries. This is also true in the banking sector, such as the case of Brazil's Itaú, which acquired an Argentine bank (Banco del Buen Ayre) and is actively participating in the Argentine domestic market.
5) There is a flow of banks and funding institutions coming into Brazil. These institutions too, have an active participation as far as Brazilian foreign trade is concerned.

Uruguay

Being quite a small country both in square miles and in number of inhabitants, when compared with neighbours such as Brazil and Argentina, and having also suffered political, economic and financial difficulties, Uruguay is to be credited with having solved the above problems without the traumatic consequences that afflicted Argentina.

The financial system has always held a relevant position within the Uruguayan economic scenario, and the administrations that successively led the country were always very careful when it came to announcing their programmes regarding the financial system. The signals sent – always clear - spoke of trust and seriousness, the basic elements as far as financial services are concerned.

Some of the following characteristics confirm the above:

1) As from 1974 there are no restrictions regarding the flow of capital, either inbound or outbound.
2) Maintenance of bank secrecy is sacred.
3) Income tax: if a company operating in foreign trade has its domicile in Uruguay, but actually trades with other countries (except Uruguay), they pay no income tax. This rule allows the functioning of financial investment corporations. This has been a legal form very much in use by foreign companies to this date, but which will be legally discontinued as from 2010.
4) Local Free Trade Zones: this has been an extremely important instrument used by Uruguay and Brazil as far as foreign trade is concerned; the possibility of importing goods from abroad, adding value to them and re-exporting the product with costs well bellow those that would result from operating in the national territory, or the opportunity to store merchandise that can be warranted in favour of a financial institution, thus obtaining financing, are some of the advantages the local free trade zones in Uruguay offer, and which turn them into very competitive trade platforms.

In view of the foregoing, we consider the Uruguayan financial system to be firmly established, and benefiting from a considerable flow of capital, especially coming from Argentina and Brazil. All this said, it is important to point out that in Uruguay banks – as far as foreign trade is concerned - are oriented to supporting the big firms, especially those multinational companies that operate in Argentina and Brazil, but which have an operational office in the Uruguay. These firms, however, have access to credit facilities through other

banks or funds abroad. These circumstances turn the Uruguayan financial marketplace into a rather competitive scenario.

And here again, exporting SMEs are afflicted by their own balances and financial statements, which render assistance by banks always a difficult endeavour.

Paraguay

Traditionally, Paraguay has been an agricultural and cattle-raising country, plus one involved in the production of wood products; the extent of their forest area is a measure of the country's commitment to this particular field. Regarding agriculture, in recent years, soybean has become a significant component of its exports.

Paraguay suffered two crises – in 1995 and in 1998 - which had a significant effect on its economic activity, owing to the plunge in deposits and the tardiness regarding loan repayment. The Central Bank had to actively intervene in the case of a number of banks, exchange companies, credit cooperatives, etc., and not a few of these institutions had to stop operating altogether. The consequences of both these crises were felt during the following years. However, little by little, the financial system grew stronger owing to the participation of foreign banks plus the controlling activity brought to bear by the Central Bank.

But in 2002 the crisis that shook Argentina also had its impact upon the Paraguayan financial system. The economy deteriorated, inflation grew, the *guaraní* (Paraguay's local currency) was devaluated and fiscal unbalance increased. These were all factors which triggered massive withdrawal of deposits by the public, created a flight of capital to other countries and were responsible for the fall of one of their most important institutions, the German Bank.

The Government turned to the IMF, requesting a stand-by loan of 200,000,000 US dollars. The loan was granted on condition that a certain law was enforced (Law Nº 2334); which was in fact enforced in December 2003, and deals with two key issues: deposits guarantee and financial agents' regulations. This law gave Paraguay's Central Bank the legal support needed in order to apply a more firm control over the financial system's institutions. This in turn contributed to restoring the financial system's solidness. Today the system is normalised.

It is worth expressing that also in Paraguay multinational exporting firms have access to foreign credit facilities.

3.4. Status of Financial Services Liberalisation

Barriers to trade in financial services are typically those defined in GATS Article XVI:

- limitations on the number of service suppliers;
- limitations on the value of service transactions or assets;
- limitations on the number of service operations or quantity of output;
- limitations on the number of people employed in a particular service;
- measures which restrict the types of organisation that may supply a service;
- limitations on the participation of foreign capital, in terms of a limit on foreign shareholding or the total value of individual or aggregate foreign investment.

As noted in the previous section the integration of EU financial services markets has been progressing across the board, but with significant residual constraints on trade between

Member States as well as on inputs from third countries. A similar situation applies in Mercosur.

The foreign investment regimes of the Mercosur countries have been significantly liberalised in the last 15 years, and are now considered to be conductive to attracting large foreign investment. Significant constraints do however remain in place, for instance in Brazil, where restrictions to foreign investment apply in a number of areas. Also, commercial presence of foreign entities or individuals is restricted in financial services, where the establishment of new financial institutions is subject to case-by-case approval. In Argentina, in the setting of a steadily growing economy, a degree of political interference has to some extent conspired against foreign investment flows during 2007. Other significant financial services issues include:

- Lack of financing for project development;
- Lack of private sector banking owing to a number of causes
- Bureaucratic inefficiency associated with the leading role of public banking institutions in agreements
- Lack of management and management training

In addressing these issues, the experience in the EU of cooperation between regions, provinces or municipalities may hold useful lessons for Mercosur.

The EU-Mercosur negotiations aim for additional commitments for financial services liberalisation beyond those that have been made through GATS. Table 2 presents the GATS commitments made by Argentina, Paraguay and Uruguay as summarised in WTO Trade Policy Reviews (TPR).

Table 2. Summary of specific commitments under the GATS

	Market access				National treatment			
Modes of supply:								
Cross-border supply	1				1			
Consumption abroad		2				2		
Commercial presence			3				3	
Presence of natural persons				4				4
Commitments (■ full; ◨ partial; □ no commitment; - does not appear in the Schedule)								
Argentina								
A. All insurance and insurance-related services				□				□
(a) Life insurance services	□	□	◨	□	□	□	■	□
(b) Non-life insurance services	□	□	◨	□	□	□	■	□
Maritime transport insurance services	■	■	◨	□	■	■	■	□
(c) Reinsurance and retrocession	■	■	◨	□	■	■	■	□
B. Banking and other financial services				□				□
(a) Acceptance of deposits and other repayable funds from the public	□	■	■	□	□	■	■	□
(b) Lending of all types by financial institutions, and financing of commercial transactions	□	■	■	□	□	■	■	□
(c) Financial leasing services	□	■	■	□	□	■	■	□
(d) All payment and money transmission services	□	■	■	□	□	■	■	□
(e) Guarantees and commitments	□	■	■	□	□	■	■	□
(f) Trading for own account or for account of customers, whether on an exchange, in an over-the-counter market or otherwise, the following: money market instruments; foreign exchange; derivative products; exchange rate and interest rate instruments; transferable securities; other	□	■	■	□	□	■	■	□

	Market access				National treatment			
Modes of supply:								
Cross-border supply	**1**				**1**			
Consumption abroad		**2**				**2**		
Commercial presence			**3**				**3**	
Presence of natural persons				**4**				**4**
(g) Participation in issues of all kinds of securities and provision of services related to such issues	□	■	■	□	□	■	■	□
(h) Money broking	□	■	■	□	□	■	■	□
(i) Asset management	■	■	■	□	□	■	■	□
(j) Settlement and clearing services for financial assets	■	■	■	□	□	■	■	□
(k) Advisory and other auxiliary financial services	□	■	■	□	□	■	■	□
(l) Provision and transfer of financial information	□	■	■	□	□	■	■	□
New financial services	□	□	□	□	□	□	□	□
Paraguay								
A. Insurance								
(Excluding reinsurance and retrocession)	□	□	■	◨	□	□	■	◨
Reinsurance and retrocession	■	■	■	◨	■	■	■	◨
B. Banking								
Acceptance of deposits and other repayable funds from the public	□	□	■	◨	□	□	■	◨
Lending of all types, including consumer credits, mortgage credit, etc.	□	□	■	◨	□	□	■	◨
Other services auxiliary to financial intermediation	■	■	■	◨	■	■	■	◨
Uruguay								
A. Insurance and insurance-related services								
a. Direct insurance								
Life insurance and personal insurance	–	–	–	–	–	–	–	–
Motor vehicle insurance	□	□	◨	□	■	■	■	□
Transport insurance	□	□	◨	□	■	■	■	□
Freight insurance	□	□	◨	□	■	■	■	□
b. Reinsurance and retrocession	–	–	–	–	–	–	–	–
c. Insurance intermediation	–	–	–	–	–	–	–	–
d. Services auxiliary to insurance								
Insurance and pension consultancy services	■	■	■	□	■	■	■	□
Actuarial services	■	■	■	□	■	■	■	□
B. Banking services								
a. Acceptance of deposits and other repayable funds from the public	■	■	◨	□	■	■	■	□
b. Lending of all types								
Personal instalment loans	■	■	◨	□	■	■	■	□
c. Financial leasing with purchase option	■	■	◨	□	■	■	■	□
d. All payment and money transmission services								
Credit card services	■	■	◨	□	■	■	■	□
e. Guarantees and commitments	–	–	–	–	–	–	–	–
C. Securities	–	–	–	–	–	–	–	–

Source: Trade Policy Reviews, WTO, 2005, 2006, 2007

General information on Brazil's GATS commitments is given in the 2004 TPR for Brazil (WTO, 2004). Most commitments are in mode 3 (commercial presence), with no commitment in mode 1 (cross-border supply). Horizontal market access limitations have been scheduled regarding commercial presence (mode 3), the movement of natural persons (mode 4), investment and subsidies. For mode 4 market access is guaranteed only to specialised staff working under temporary contracts, and special conditions apply to the appointment of managers to affiliates of foreign companies. Brazil has also retained the right

to require foreign service suppliers to be organised as legal entities under Brazilian law. The installation of new financial institutions is subject to case-by-case approval. The participation of foreign capital in financial institutions is subject to conditions of national interest, international agreements and reciprocity, failing which the establishment of new branches of financial institutions or an increase in foreign participation is not allowed. Cross-border supply of insurance services is not allowed, although the purchase of insurance from outside Brazil may be authorised under special conditions.

In Argentina legislation is governed by the principle of national treatment for foreign capital (WTO, 2007). Significantly more commitments have been made under GATS than in the other Mercosur countries. Uruguay has a relatively liberal financial system but has included numerous limitations in its GATS schedules, including quantitative limits for several types of financial service (WTO, 2006). Paraguay's commitments on financial services under GATS include commercial presence for savings and loan banks, and modes of supply 1, 2 and 3 for financial consultancy services, loan intermediation and foreign exchange (WTO, 2005).

As noted in the Phase 1 SIA report Mercosur has offered more 'new' sectors in the EU-Mercosur negotiations than the EU, but since there is no free provision of services between Mercosur member countries this offer is less attractive that it otherwise would have been. Pena (2005), summarizing the services proposals, states that the value of the Mercosur offer is concentrated in the value of the Brazilian contribution, especially in telecommunications and financial services. The offers made by each country for financial services are summarised in Table 3.

Table 3. Comparison of specific commitments and offers for financial services liberalisation

Argentina			Brazil			Paraguay			Uruguay			EU		
UR	Doha	M/ EU	UR	Doha	M/ EU	UR	Doha	M/ EU	UR	Doha	M/ EU	UR	Doha	M/ EU
20	20	21	11*	11*	35*	5	5	10	3*	3*	26*	22	22	22

UR: Uruguay Round, Doha: Initial offers presented in Doha Negotiations, M/EU: offers presented at the bilateral process
* The countries did not undertake their commitments according to the classification of W/120, thus comparison can not be made between commitments of various countries.
Source: Pena, 2005

The overall preliminary trade SIA undertaken in the Phase 1 study concluded that financial services liberalisation offers the potential for significant economic benefits in both the EU and Mercosur countries, but needs to be coupled with strengthened regulation and supervision in order to achieve those benefits. Such action is also essential to avoid the potential pitfalls. In consequence both the EU and Mercosur countries are expected to adopt a cautious and sequenced approach, in which the benefits would be realised incrementally over a phased programme of selective liberalisation.

4. CASE STUDIES

4.1. Credit Markets for SMEs In Mercosur[13]

Regional banking context

Following the various financial crises of the 1990s most Latin American countries restructured their banking systems. Banks were closed, merged and/or recapitalized, liquidated or privatised. In many countries, the restructuring of the banking market led to a boom in foreign participation (mostly European). Between 1995 and 2004, foreign banks' participation in Brazil increased from 10% of bank assets to 20%. In Argentina, foreign holdings of bank assets rose from 19% in 1995 to 58% in 2002, and then fell back to 23% in 2004 following the 2001-2002 crisis.

In Brazil a comprehensive restructuring programme resulted in 52 banks being liquidated, reorganised or placed under temporary administration between July 1994 and December 2000. Most state banks were privatized and the regulatory framework substantially tightened. In Uruguay, over the same period, insolvent banks were liquidated, access to IMF credit lines restored and a liquidity crisis overcome. In Argentina, the influence and market share of foreign banks grew dramatically after the 1995 Tequila crisis, spurred on by the currency board regime. By mid-1997, only one of the 10 largest private banks was still in Argentine hands. Similarly, the number of public banks fell from 33 in 1994 to 12 in 2007, while cooperative banks almost completely disappeared. Meanwhile, financial reform in Paraguay after 1989 led to incautious bank lending and resulted in over half of them being closed following the 1995 Tequila crisis.

The *Brazilian* financial sector today is fairly concentrated, with the 10 largest institutions accounting for over 65% of financial sector assets. Lending by the large banking institutions is focused on the largest companies. Three federally owned banks (Banco do Brasil, Caixa Econômica Federal and BNDES) still play a prominent role in the financial system. In an effort to prevent future problems on the part of these federal banks, the government now requires that social lending programs run by government-owned banks be supported with explicit government guarantees.

In 1991 *Argentina* pegged its peso to the U.S. dollar and adopted far-reaching market-based policies, including the dismantling of a web of protectionist trade and business regulations and the implementation of an ambitious privatisation program. Argentina subsequently received among the highest FDI flows in Latin America through most of the 1990s. While convertibility defeated inflation, Argentina's export competitiveness declined and led to persistent deficits in the balance of payments and massive borrowing. The Asian financial crisis of 1998 precipitated capital outflows and a four-year long recession that culminated in a financial crisis in November 2001. In January 2002, the government ended convertibility and defaulted on roughly US$82 billion in privately held debt and over US$6 billion in obligations to official creditors. Argentina subsequently posted real GDP growth of over 8 percent each year from 2003 to 2007, partly due to favourable international commodity prices. In 2007 the ratio of private bank non-performing loans fell to a historic low of some 2.5 percent, and profits for the overall banking system reached their highest levels in over a decade. However, lending is mostly short-term. In September 2008 Argentina paid off its defaulted debt with the Paris Club (some US$6.7 billion) using the reserves held by its Central Bank.

[13] This section presents a summary of the case study by Pedro Regina presented in Annex 1.

Paraguay's financial system comprises one state owned bank and 12 private ones, 5 of which are foreign institutions, 4 are majority foreign owned and 3 are majority locally owned. As of July 2007, the top eight private banks had 86.8 percent of the US$ 3,541.6 million total assets of the local private banking system. Also, there are 14 financial credit agencies, 2 savings and loan institutions that offer credit for housing and 35 insurance companies. The financial and insurance system suffered great volatility and erratic growth between 1997 and 2006, reflecting the different financial crises that took place in 1995, 1998 and in 2002. A clear effect of these crises was the migration of deposits from local banks to foreign resident banks, which has since been reversed. There are no formal restrictions on foreign investment in Paraguay. Equal treatment of foreign investors is guaranteed by Law 117/91, as is the full repatriation of capital and profits by Law 60/90. In 2007 the United States was the largest foreign investor in Paraguay, with US$ 617 million, followed by Brazil with US$ 231 million, and the Netherlands with US$ 130 million.

Since the restructuring of *Uruguay's* banking sector in 2002, there has been significant bank consolidation. The banking sector currently encompasses two state-owned banks, Banco de la Republica Oriental del Uruguay (BROU) and Banco Hipotecario Uruguay (BHU), 13 private banks, including Nuevo Banco Comercial (NBC), and a number of credit cooperatives. NBC has the most extensive branch network among private banks and is the only one with a truly national reach. BROU is Uruguay's largest bank (with some 40% of all private deposits). The mortgage bank, BHU, is the leading supplier of housing loans. During the banking crisis, the government transferred BHU's dollar-denominated time deposits to BROU. Insurance provision was a government monopoly until the mid-1990s. Offshore financial institutions operate with limited functions - e.g. they may neither accept resident deposits nor offer checking account services.

<u>SMEs and credit</u>

Mercosur's SME sector is estimated to account for upwards of 90% of non-agricultural firms in the region. The region's SMEs also account for between 44% and 65% of formal jobs. The relative share of SMEs in total output and exports is generally much smaller, i.e., one third or less. Between 1998 and 2002 SMEs Argentina experienced a drop in the number of SMEs, although in most of the Mercosur economies SMEs flourished. The SME sector in Brazil expanded twice as fast as the economy as a whole. In Brazil 82% of all firms are incorporated, whereas most Latin American entrepreneurs opt to run firms as sole proprietorships, and mix personal and business financial affairs.

A 2006 survey of Argentine SMEs showed that only 8% of their investment expenditures were financed with bank credit, while financing from retained earnings accounted for 83%. In Brazil, SMEs accounted for half of non-state banks' commercial credit operations in 2006 and 2007 and close to 60% during the first half of 2008. Bradesco, Itaú, ABN Amro and Unibanco loaned some R$ 100 billion to Brazilian SMEs in 2007, or 25% more than 2006. Growth at HSBC and Santander banks is believed to have been similar. Banco Itaú puts growth in commercial credit for micro, small and medium enterprises at 18.5% in 2007.

Although growth in credit – both commercial and retail – rose in Brazil for several years, it grew more rapidly for the SME sector from 2005. By early 2008, banks' commercial loan portfolios were probably evenly split between SMEs and large firms. This interest in promoting SME activity is expected to continue, in spite of the global credit crisis and a feared economic slowdown.

Real interest rates in Brazil were slashed by half between 2005 and 2008, and this has provided banks with the impetus to broaden their commercial loan portfolios. As returns on government bonds fell, banks were compelled to extend more credit to SMEs. From the banks' perspective, the recent credit expansion has a very real downside: an increase in non-performing loans, which rose by 5% in 2006 and by 7% 2007. Non-performing loans were up 4.7% in the first quarter of 2008 year on year, significantly less than the expansion of credit in the same period. Banks are now strengthening their credit departments and improving their data collection to aid credit analysts.

Conclusions

Credit rating/scoring has not been a prominent feature of Mercosur's banking practice, historically. The situation improved – out of necessity – after liberalization in the region (excepting Uruguay), but is still in its infancy. The situation in Brazil was typical – its much vaunted credit information system worked adequately when applied to the largest firms and borrowers, but was of no use to smaller borrowers. Bank analysts could give detailed information of their largest customers, but had neither the time and resources nor the incentive to apply the same methods to assessing potential SMEs.

There is substantial scope for improving credit information. The major challenge is to make information on potential borrowers more readily available to lenders, thus facilitating credit creation. Banks have traditionally maintained a very narrow of interpretation as to what constitutes 'appropriate' collateral (usually land, buildings and deposits), and even then they were very concerned about the legality of the collateral. Land registries are still often fraught with errors, especially in rural areas, and the provenance of the cash to be used as collateral must often be established (a delicate point given the large informal economies in the region). And as for bankruptcy proceedings, they are still lengthy and costly, even if much improved since liberalization.

Financial sector liberalization had been touted as a way for Latin America to avoid being buffeted by international events not of their making. It would recompense virtue and permit the region's lenders and borrowers to plan for the long term, thus employing scarce capital more effectively and efficiently. But the global credit crisis of 2008 demonstrated that the region is not immune from international events. As a result, there is a growing call for mechanisms to regulate short term capital flows**.** For the EU, an increase in Mercosur's capital controls is clearly not a good thing. If the controls are too harsh then flows would dry up and both regions would be penalized; if the holding periods are too long then investment flows will dry up as quickly as portfolio flows. Less likely, but equally worrying, it that by setting up 'mild' capital controls with modest holding periods, portfolio flows may not change much at all, in which case the monetary authorities will deem it an effective tax on financial transactions, raising costs to EU investors with no corresponding benefit to Mercosur's business sector.

The further exposure of Mercosur's financial services industries to foreign entry and competition might result in a short term decline in domestic investment in the sector, but would be mitigated by an expanding commercial presence on the part of EU companies. After any initial decline, domestic investment in financial services provision can be expected to increase, as local firms adapt themselves to the more competitive environment.

4.2. The Brazilian Reinsurance Sector[14]

The case study provides an overview of the liberalising Brazilian reinsurance sector, the largest in Latin America, and examines recent developments and prospects in the regional context. After a brief history of the evolution of the insurance sector in Brazil, if focuses on the liberalisation of the reinsurance sector, including the end of the state-owned monopoly IRB-Brasil Resseguros S.A. European insurance companies, many of which have already undergone competitive consolidation in their own home markets, will have the experience and resources necessary to compete in the liberalized Brazilian market.

Brazil currently represents 40% of the Latin American insurance market and its market looks well placed for growth given the improving economic environment and the deregulation of reinsurance. However, in Brazil insurance penetration is still very low, although it rose to approximately 2.7% of gross domestic product in 2007, up from 1.6% in 2002. In comparison, the average per capita insurance spend in the United States is 9.2% of gross domestic product. Brazil's reinsurance market was constrained by a government-sanctioned monopoly for the past seventy years. Now that this monopoly has ended both domestic and international insurance companies can look forward to participating actively in the sector.

Policy Context of the Insurance Sector in Latin America

Far-reaching policy shifts occurred in Latin America during the 1990s, largely in response to the after affects of the debt crisis of the previous decade. Seeking to stimulate their economies and spurred on by neo-liberal fervour, the countries of the region privatized, liberalized and deregulated in order to strengthen their financial markets, including their insurance markets.

Privatization: Government participation in the economy through state-owned enterprises was scaled back considerably in the 1990s in Mercosur countries. State-owned industrial and financial firms were sold off or opened to competition; the only major state-owned player in Mercosur insurance markets that remained was IRB-Brasil Resseguros S.A. (IRB), Brazil's reinsurance monopoly.

Liberalization: The liberalization of Latin American financial markets (including stock markets) intensified in the 1990s. On the insurance front, liberalization was expected to entice foreign insurers into providing new capital and know-how through innovative and sophisticated insurance products and distribution channels. With reduced entry barriers, many international insurers entered the region's insurance markets. Merger and acquisition activities accelerated and competition intensified. By 2004, the market share of foreign insurers ranged between 30% and 75% in economies within the region's market.

Regulatory Reform: Across the region, alongside privatization and liberalization, advances in securities market supervision, governance and infrastructure accelerated rapidly in the 1990s. The IRB monopoly legally ended in January 2007, although complementary legislation was not effected until early 2008. A series of 'safeguards' in the relevant legislation gives IRB a market reserve (60% for three years, falling to 40% thereafter) in some areas, such as Life and Pensions, and in the market as a whole. To this end, IRB had begun a process of institutional modernization even before its monopoly was broken. Conscious of the need to maintain its competitive position, IRB's board had implemented a series of measures designed to enhance its competitiveness and efficiency.

[14] This section presents a summary of the case study by Pedro Regina presented in Annex 2.

A number of competitors have sought to enter the reinsurance market, including those from Switzerland, Germany, the United Kingdom, the United States and Spain. In addition, local niche insurance companies have made evident their interest in competing in the sector. The prospects for growth are excellent and the general reinsurance market is expected to outpace overall economic growth, with European and other international reinsurers introducing new products and new practices, satisfying segments previously underserved by IRB. During the first half of 2008, SUSEP, the insurance regulator, had authorized ten international reinsurance companies to set up operations in Brazil, and it anticipated authorizing 40 or 50 more by the end of the year.

The current scenario

Supplementary Law 126 of January 2007, which ended IRB's monopoly, allowed for the creation of three categories of reinsurers: local reinsurers headquartered in Brazil and writing only reinsurance; admitted reinsurers headquartered abroad but with a Brazilian representative office; eventual (occasional) reinsurers headquartered abroad with no Brazilian representative office, but with approval to provide reinsurance products within Brazil. Local reinsurers will retain the right of first refusal of 60% of new business until January 2010, as stipulated in the law, and 40% thereafter barring any change in the law.

Current regulations for capitalisation require a rating above investment grade for preferential treatment. This is unlikely to discourage the larger European reinsurers, as they are in any case already rated above investment grade. Smaller European niche players might be put off from entering the Brazilian market, and by extension the other, smaller markets of Mercosur. European firms have led the charge in entering the Brazilian reinsurance market. Swiss Re, the world's largest reinsurer, has been authorized to operate as an admitted reinsurer and believes that increased government investments in infrastructure projects will fuel demand for insurance covering engineering projects such as ports, airports, roads and hydroelectric plants. Other promising areas for insurers and reinsurers over the longer term include agricultural insurance both for crops and livestock, and life insurance, especially individual life policies.

Reinsurance sector prospects

As an arm of the state, IRB traditionally helped smaller insurers through lower prices, but this is likely to come to an end. IRB's customary tariff-based pricing will give way to differentiated underwriting, leading to higher reinsurance rates for small and midsized insurers. Large insurers, however, will increasingly be able to negotiate lower prices with international reinsurers, putting smaller insurers in Brazil at a further disadvantage.

The consolidation of the primary insurance sector, therefore, spells a coming boom in M&A activity over the medium term, both for foreign insurers looking to gain a foothold in the Brazilian market, and for large local insurers looking to expand. European insurance companies, many of which have already undergone competitive consolidation in their own home markets, will have the experience and resources necessary to compete in the liberalized Brazilian market.

In addition to higher reinsurance rates, smaller insurance companies in Brazil face the challenge of coming to grips with new solvency margin rules mandated by SUSEP. Insurance companies could turn to reinsurance to improve solvency margins, but the new capital requirements could also reduce their profitability, limit future growth and convince smaller insurance companies to subsume their operations to the activities of a larger player.

EU-Mecosur negotiations

A number of areas are identified that may be worthy of further progress in negotiations, each with broad scope for policy innovation.

- Emphasis should be on promoting regulatory competence and independence (i.e., freedom from political interference).
- Transparency – prior right notification before the enactment of any proposed measure affecting the sector(s) in question. Lack of transparency is in itself a risk and is priced accordingly by the market; greater transparency of processes and expectations would therefore lead to lower prices and greater efficiency.
- Further financial services liberalization, especially with regard to market reserve issues. While market reserves can help to smooth out transitions and enable small firms to gain critical mass before facing full-on competition, they can also stifle competition and innovation and raise prices if left in place for too long. Clear rules and timetables are therefore essential.

Liberalization of Brazil's reinsurance market should impact the EU positively, albeit modestly. The potential benefits and associated risks are larger in Brazil and, through proximity, the other Mercosur countries. In addition, in the absence of effective strengthening and bioregional coordination of regulatory systems, liberalization of the reinsurance market is likely to be accompanied by increased risks of instability, but in view of the large size of the EU economy and its financial services component the effect on the EU is likely to be small.

In the case of the Brazilian reinsurance market, its exposure to foreign entry and competition is not expected to result in any more than a negligible decline in domestic investment in the sector, accompanied by expanding commercial presence on the part of EU companies. Given the lack of competition in the market until recently and the high prices prevailing even now, the robustness of the sector and its growth is practically assured, even in the short term.

Conclusions

The main conclusions of the case study are that:

- Liberalization and increased competition should fuel the rapid development and sophistication of Brazil's reinsurance market.
- New entrants to the Brazilian reinsurance market will quickly fill niches, offering new products. Established global companies, but new to Brazil, will increase competition and help develop the country's insurance industry, including reinsurance. Driven by falling reinsurance costs, the country's insurance sector will grow, further fuelling growth in the reinsurance sector, in a virtuous cycle.
- Because of this and the country's increasing integration with the global economy, reinsurance in Brazil is poised to become more dynamic, permitting it to adapt more quickly to evolving market conditions. Brazil's general economic growth and relative underinvestment in transport and energy infrastructure practically ensure that it will continue to attract large corporations and large-scale investments. These in turn will further drive the country's already impressive agricultural sector, and also fuel the rapid development and sophistication of its reinsurance market.
- A mass reinsurance market, however, is still in the distant future, and the consensus is that in these early days after liberalization, the focus of the established player and the first movers will be on a relatively small number of high value clients. Over the

medium to longer term, specialist or niche expertise, such as that available to European reinsurers, will offer new products and services that will transform the insurance landscape in Brazil and the region.

4.3. Impacts on the EU Banking Sector[15]

The case study focuses on the potential effects of trade liberalisation on the financial services sector in the EU, with emphasis on the banking sector. Its aim is to assess how the trade aspects of the Association Agreement under negotiation between the EC and Mercosur is likely to affect the EU.

At present, EU financial services, specifically international banking activities, face another major new initiative, Basel II, which proposes a revision of the Basel Agreement on required capital-asset ratios. The case study evaluates the likely impact of this new agreement on international trade in banking and the likely financial service provision and location decisions of international firms operating in Europe and emerging financial markets.

EU Financial Services liberalisation and GATS

The EU financial services sector has been deregulated since the opening of the 'single financial space' in 1993. Further liberalisation of EU financial services is associated with the proposals brought forward by the World Trade Organisation (WTO) in 1995 for the liberalisation of financial services trade as part of the General Agreement on Trade in Services (GATS). In the context of the GATS, financial services are broadly divided into two main categories (Article 5 of the GATS Annex): (i) *insurance and insurance-related services*; (ii) *banking and other financial services*. Each of these two categories includes a more specific list of activities that illustrates, rather than defines, the possible contents of the notion of financial services. The agreement on financial services, as finalised in 1997, required developed countries to implement the GATS within a year, but allowed emerging and developing countries to take exemptions.

The European Single Market, like GATS, was designed to ensure that banks would have rights of entry into domestic markets at no less favourable terms than domestic providers. Given the pre-liberalisation measures of efficiency there was a presumption that there would be both a shake-out as well as a shake-up as a result of market integration. In particular, there was an expectation that the French and Italian markets might see significant entry by the more efficient providers, mainly Belgium, Germany and to a lesser extent the UK and the Netherlands.

This is not what happened. The prospect of the single market provided an impetus for internal bank reorganisation and significant labour shedding in the less efficient markets, rather than provoking widespread take-overs or new entrants. There has been some evidence of joint ventures and buy-ins but interestingly, the level of intra-EU mergers and acquisitions have not been significantly greater than those with banks from outside the EU. Indeed, the level of activity between EU countries is probably less than the level within countries, where smaller banks have frequently merged to compete more effectively with their larger competitors in terms of regional coverage and product range. Levels of efficiency within the EU converged in the wake of the 1992 Single Market, but the impetus for rationalisation and efficiency gains was due as much to the threat of mergers, acquisitions and new competition as to actual outside entrants.

[15] This section presents a summary of the case study by Victor Murinde & Cillian Ryan, Birmingham Business School, presented in Annex 3.

The analysis of GATS and its consequences suggests that where banks have an opportunity to adapt to changes in the competitive environment (i.e. European Single Market), the growth in trade in international banking services will be small. However, where countries experience extreme economic conditions, then changes in the mode of delivery is likely to be much more radical. The main contribution of GATS to this process was that it probably ensured that international banks were already primed to pursue expansionist strategies.

Implications of Basel II

On the basis of the existing evidence on past liberalisation efforts, it appears that trade liberalisation in banking services has not changed the nature of competitive conditions in the banking sector in terms of on-balance sheet service provisions. However, it may be argued that the impact of EU-Mercosur trade liberalisation will be significant in terms of off-balance transactions (e.g. derivatives, hedging, bank trading in foreign exchange and capital market instruments, etc..). The Basel II accord may therefore have important implications.

GATS envisaged that signatories would take steps to ensure that the regulatory and supervisory regime conforms to best international practice, though these requirements need not be specified in the agreement. At that stage this effectively meant conformity with Basel I, a voluntary code with about 100 signatories. The subsequent financial crisis in the Far East appeared to compound the problem with many developing countries arguing that the effect of the GATS would be to leave them susceptible to a similar sort of crash. Ironically, the Asian financial crisis resulted in an expansion of banking activity by international banks, predominantly EU-based banks, in these countries. The Latin-American crisis and collapse of the old Soviet bloc had similar effects.

Strictly speaking, the Basel Agreement is a voluntary agreement covering the members of the Committee on Banking Supervision. This is a committee of the banking supervisory authorities of the 'Group of Ten' (now thirteen) countries, Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. The original Basel I agreement provided for a standard level of capital, 8%, to be held as reserves to cover possible shortfalls in the bank's loan portfolio (the bank's assets) due to failures in repayments (credit risk) or perhaps sudden currency movements or rises in interest rates (resulting in a fall in the asset value of a fixed interest-rate, long-term loan on secondary markets) – so called market risk.

The standard was developed in response to two issues. First, and most importantly for many of the European and US international banks, it was felt that in the absence of such an accord, banks from jurisdictions with loose regulatory regimes faced an unfair advantage in the international market place since they did not have to hold as many costly capital reserves. The European and US international banks thus needed either to establish a badge of quality (to justify their premium rates) or else join the other banks in a race to the bottom by availing themselves of whatever loopholes where available in their domestic supervisory regimes. Second, from the perspective of the international regulatory authorities, there was a realisation that, in the absence of such an accord, competitive pressures could lead to poor holdings of capital reserves and thus, in a crisis, to bank failure followed by contagion. Indeed, it is the fear of contagion as a consequence of bank failures that provides the primary motivation for the unique regulation of this sector.

The original Basel I agreement was relatively crude in its treatment of the credit risk faced by banks. Under Basel I, banks had an incentive to play off their lending strategy against the

rules. Thus, if they were prepared to take more risks, perhaps seeking to gain a competitive advantage on their international rivals, they could focus on high-risk, high-return loans and still remain within the 8% capital-asset ratio band.

As a consequence, in countries where prudential supervision was seen as strict, banks perceived themselves as being at a disadvantage both relative to some of their international competitors and domestic non-bank financial intermediaries who are not subject to the Basel I requirements. Hence there was significant pressure for a modification to the rules from within the Group of Ten. The Basel Committee also had concerns about other aspects of evolving banking practice such as the rise in off-balance sheet activities and the risk to banks as a result of exposed trading positions

Basel II seeks to address all these issues. The proposals are more stringent than Basel I in that banks must assess their risk on a consolidated basis including holding companies and other off-balance sheet activities. However, the proposals are more liberal in the way they treat credit risk, allowing banks to hold reserves supposedly closer to what a 'prudential' bank would voluntarily choose to hold. There are three proposed approaches, a standardised approach, and two variants of what is called the internal-ratings based (IRB) approach. In the standardised approach, banks are now able to classify their sovereign and commercial risks according to a series of 'buckets' with weighting ranging from 0% to 150%, depending on external credit-ratings of the borrower. The alternative IRB approaches go even further and allow banks to adopt more sophisticated risk measurement methodologies. The upshot of these measures is that banks with relatively lower risks will now be required to hold lower capital reserves, thus eliminating the implicit cross-subsidisation of high risk loans associated with Basel I. Thus, banks are being offered an incentive to adopt a more–risk sensitive approach to reserves, while at the same time attempting to maintain the aggregate minimum level of reserves in the system as a whole.

Implications of Basel II for EU trade in Banking Services

It is argued that the big winners in the financial services provisions of GATS would be the existing international banks, as they were best placed to capitalise on their past production-based expertise. The fact that expertise in the IRB approach and the associated data sets are also concentrated in the large international banks suggests that Basel II will also benefit these banks at the expense of smaller banks. In addition, international differences in cost structures are now likely to result from the fact that some countries will be on Basel II while some are still on Basel I, thus inducing greater variance, internationally, in reserves held by banks against specific types of lending.

In so far as lending in developed countries is concerned, international banks employing one of the IRB approaches are likely to enjoy an advantage, but this is a market which is not currently threatened by emerging-country banks. Pre-Basel II, the threat to the large, but regulated, international banks in developed countries was the competition from non-bank intermediaries. The effect of Basel II should be to improve the relative competitiveness of these banks domestically, but this will have few implications for trade patterns. However, the situation in emerging economies is more complex. It is likely that local banks, operating under Basel I, will have lower reserve requirements relative to large international banks and thus may be able to lend more competitively. To do this local banks will need to raise deposits locally (since cross-border funds will probably be priced at higher IRB-determined rates reflecting the higher perceived risk). The lower reserve costs of banks operating under Basel I may also mean that they can offer relatively higher deposit rates. However, local depositors may prefer the apparently safer international banks operating with lower deposit

rates, greater (IRB required) reserve capital and access to international capital in crises. So in emerging countries, Basel II will present depositors with a real option.

Conclusions

Increased market penetration in banking services probably owes more to the special economic events that affected emerging markets than to the GATS initiative. However, the GATS project probably ensured that the large international banks were better geared-up to respond to the opportunities when they arose.

In its analysis of Basel II the case study concludes that the new IRB approaches are likely to reinforce the learning-by-doing expertise available in the larger international banks and further reinforce the benefits conferred by GATS. The concomitant rise in the cost of lending to higher-risk creditors, especially in emerging markets, is likely to reduce such lending and may negate many of the expected benefits of the original GATS proposal to emerging country borrowers. However, from a welfare perspective this may represent an overall improvement in allocative efficiency, at least in global terms, and there are also possible beneficial savings-mobilisation and project-selection advantages to emerging economies. In so far as the larger international banks are perceived as being safer and, as a result, prosper, this is likely to result in more local subsidiary rather than cross-border banking, further reinforcing recent trends.

5. IMPACT ASSESSMENT

Phase 1 of the SIA study identified the following key issues for investigation in more detail in Phase 2:

- influence of liberalisation on the stability of the financial system in both the EU and Mercosur;
- potential costs and benefits to Mercosur industries, particularly exporting industries;
- potential benefits and hazards for SMEs in Mercosur;
- effects of inter-country differences in economic and financial structures;
- needs for regulation, supervision and development of management skills.

After a review of the economic modelling results for financial services liberalisation, the following sub-sections examine each of these issues in the light of the case study findings. The section concludes with an overall assessment of impacts on the core sustainable development indicators.

5.1. Economic modelling results

The immediate effect of reducing a trade barrier will generally be a change in market price, or a change in the availability of a service or its quality. The market response can be modelled in much the same way as for goods, by making assumptions about the demand for services that were not previously available, or whose quality is different from that of a local equivalent. In Computable General Equilibrium (CGE) models that were originally developed for trade in goods, these factors may be allowed for by estimating the tariff equivalents of the qualitative trade restrictions.

The CETM modelling study undertaken in Phase 1 of the SIA indicates that Mode 1 liberalisation of the services sector as a whole would account for about 8% of the projected real income gains from EU-Mercosur trade liberalisation in both the EU and Mercosur[16]. Table 4 shows the total welfare gains in each of the countries and the gain attributable to Mode 1 services liberalisation.

Table 4. Changes in economic welfare from EU-Mercosur trade liberalisation

	Argentina	Brazil	Paraguay	Uruguay	EU15	EU10
Total change (goods, services and trade facilitation)	0.50%	1.50%	10.00%	2.10%	0.10%	0.10%
All services (Mode 1)	0.05%	0.10%	0.19%	0.12%	0.02%	0.01%

The modelling study did not disaggregate the welfare changes for service sub-sectors. However, the contribution from financial services is unlikely to be more than about half the total for the services sector as a whole. The static welfare gain from Mode 1 financial services liberalisation is therefore estimated to be less than a tenth of a percent in any of the Mercosur countries, and less than a hundredth of a percent in the EU. The main economic benefits of financial services liberalisation are expected to come from dynamic effects rather than from the static efficiency gains of traditional trade theory.

There are inherent difficulties in the economic modelling of services trade. Because the barriers to services trade are essentially qualitative in nature, major assumptions and

[16] Mode 1 only was covered in the model estimates

approximations have to be made in order to model their effects. A review by the OECD Trade Directorate concluded that quantitative modelling techniques can be valuable in providing an order of magnitude estimate of the effects, but that the results should not be taken as any more than indicative[17].

This caveat applies to the modelling estimates for changes in sectoral output as well as the net effect on economic welfare. The percentage output changes projected by the CETM model are significantly larger than the welfare changes, particularly in Mercosur countries, where EU-Mercosur trade is a much larger proportion of their total trade. The modelling results are shown in Table 5, indicating a decline in domestic financial services output in all the Mercosur countries. The corresponding increase in output from EU service suppliers is projected to be less than 0.1% of the size of the EU sector, and too small to be significant.

Table 5. Projected changes in Financial Services output in Mercosur countries

	Argentina	Brazil	Paraguay	Uruguay
Change in output %	-2.1	-1.4	-23.1	-0.6

The decline in output projected for Paraguay is large enough to be of major significance to the (small) domestic financial services industry. The result should be treated with caution, however, as the data uncertainties for Paraguay are particularly high. The projections for the other Mercosur countries are large enough to be significant, but at the minor significance level only. However, the indicative nature of the results is such that actual impacts of greater significance cannot be ruled out, particularly for Argentina and Brazil.

5.2. Financial stability

The potential benefits of financial services liberalisation depend strongly on effective regulation[18]. The experience of the Asian financial crisis in 1997 demonstrated the dangers of financial liberalisation which is not supported by a strong regulatory framework. The crisis can be ascribed to liberalising prematurely, long-term foreign borrowing, fragmented financial regulation and supervision, unclear division of responsibilities, and a restrictive regime regarding foreign bank entry. It has been argued that in Africa restructuring was insufficient to change the behaviour of the financial institutions, that uncontrolled fiscal deficits combined with liberalisation to increase public debt, and that regulatory and supervision mechanisms were inadequate to monitor the working of the system[19]. Financial services institutions in Mercosur differ from those in Asia and Africa, but liberalisation in the absence of an appropriate regulatory framework could have broadly similar effects.

The World Bank's report on Finance for Growth[20] cited Argentina as a prime example of where the entry of foreign financial institutions has improved the efficiency of the domestic financial sector, strengthened its stability, and increased access to lending for small and medium-sized enterprises (SMEs). The report was written in 2001, shortly before the Argentinian economic crisis. It has been argued that domination of Argentina's domestic banking industry by foreign ownership, and its reluctance to lend to SMEs, played a major role in the collapse[21]. Domestic banks may be more sensitive than international ones to local cyclical pressures for credit management, and more likely to address gaps in the credit system

[17] Dihel (2002)
[18] Brownbridge and Kirkpatrick 2002
[19] Hodge (2002)
[20] World Bank (2001)
[21] Stiglitz (2002)

for disadvantaged groups and regions. Strong regulation and a controlled pace of liberalisation are likely to be key factors in mitigating potential adverse impacts.

Numerous studies carried out following the financial crises of the late 1990s have concluded that while open and well-developed financial systems can reduce the adverse effects of a financial crisis, liberalisation in the absence of a proper policy framework can exacerbate instability[22]. Measures to promote competitive financial services markets therefore need to be complemented by parallel measures to ensure financial stability[23]. Other key factors include macroeconomic stability, appropriate structural policies and prudential regulation and supervision, without which liberalisation can exacerbate problems in the financial sector or the whole economy[24].

To the extent that financial services trade liberalisation may be associated with a high level of short-term capital flows, the threat to financial stability may be significant. Financial services liberalisation that encourages short term lending can trigger more volatile flows which, in a context of poor macroeconomic management and weak financial systems, can aggravate financial sector difficulties. The Asian and Mexican crises have been attributed to such causes[25]. In a study of 26 banking crises it was found that in 18 cases the financial sector had recently been liberalised. Poorly designed banking systems may have contributed to the link, but dynamic factors may also play a role. Modelling studies have suggested that even if a banking system is well-designed, liberalisation may lead to an initial period of rapid, low-risk growth, followed by a period with an elevated risk of banking crisis[26]. Liberalisation can also do more harm than good if driven by supply rather than demand. When countries suffer from low investment demand, increased capital inflows tend to appreciate the domestic currency and make production in export activities even less profitable[27]. In such circumstances financial liberalisation may fuel a boom in domestic credit, leading to acute balance sheet problems for domestic banks, and exposing the country to a currency crisis in the event of a sudden reversal of capital inflows, which banking weakness may itself trigger[28].

Financial service liberalisation may therefore have severe adverse effects on financial stability in the Mercosur countries unless accompanied by greater international integration, sophistication and complexity of the regulatory regime. Stability in Paraguay and Uruguay is likely to remain strongly dependent on their larger neighbours. Of the two larger economies Argentina may be the more vulnerable. Its economy has been particularly hard hit by the current global credit crisis, with knock-on effects for EU financial services providers. At the end of October 2008 stock markets in Buenos Aires and Madrid fell by 16% and 8% respectively in response to a government move to protect pensioners by nationalising private pension funds[29]. No clear empirical evidence has yet emerged of the extent to which liberalisation may have contributed to the current global crisis or ameliorated its effects. Nonetheless, joint action between the EU and Mercosur to strengthen the financial services regulatory regime will be an essential requirement to reduce the risks associated with further liberalisation.

[22] Finger and Schuknecht (1999)
[23] Key (1999)
[24] WTO (1999)
[25] Contreras and Soonhwa (2004)
[26] Daniel and Jones (2006)
[27] Rodrik (2007)
[28] Bird and Rajan (2001)
[29] Agence France-Presse 23 Oct 2008, http://www.abs-cbnnews.com/print/25051

5.3. Potential costs and benefits to EU and Mercosur industries

Subject to the avoidance of financial crises international financial integration can have a positive influence on economic growth. The presence of foreign banks can help to foster a more efficient domestic banking system, while liberalising restrictions on international financial flows tends to boost domestic stock market liquidity, both of which can have positive effects on productivity and growth[30]. The main economic benefits of financial services liberalisation are therefore expected to come from dynamic effects rather than from static efficiency gains.

The EU and Mercosur countries both stand to benefit. The case study for the reinsurance sector (Section 4.2) indicates strong prospects for EU providers in Mercosur which are likely to be enhanced by further EU-Mercosur liberalisation. The case study for the banking sector (Section 4.3) argues that GATS liberalisation and the Basel accords have both tended to favour larger international banks over smaller local banks. Further liberalisation within the EU-Mercosur agreement is likely to provide further opportunities for EU-based international banks. The potential positive impact in Mercosur is likely to come in the longer term through increased competition from EU service providers, with relatively small adverse effects in the shorter term through loss of market share by domestic providers. In the EU a significant positive impact is expected in both the short term and the long term, through increased market access for European financial service providers.

In the short term domestic financial services output is expected to decline in all the Mercosur countries, particularly in Paraguay, and to a lesser extent in Argentina and Brazil. A corresponding gain will be experienced by users of financial services that choose to switch from Mercosur providers to EU providers with lower costs or better performance.

The competitiveness of firms in open economies is determined in part by access to low-cost and high-quality financial intermediation, and the performance of the financial services sector is an important contributor to sustained economic growth. Comparative studies have indicated that in countries whose financial services and telecommunications sectors are both fully open to international trade, growth has been as much as 1.5% a year faster than in other countries[31]. There is no clear evidence whether openness has contributed to faster growth, or growth has stimulated greater openness, but the availability of efficient financial services has been shown to be a key input to economic advancement[32].

This will be particularly important for exporting industries, in which significant investment is needed in order to achieve the economies of scale that are necessary to compete in world markets. Provided that the stability of the financial system is secured, the greater efficiency resulting from liberalisation of financial services can be expected to make a significant contribution to export growth.

5.4. Impact on SMEs in Mercosur

Small and Medium Sized Enterprises (SMEs) account for a major proportion of production and employment in both developed and developing countries, and are widely believed to be key determinants of economic growth[33]. SMEs contribute about 60 percent of manufacturing production in Brazil and over 30 percent in the other Mercosur countries, except Venezuela,

[30] Levine (2001)
[31] Mattoo et al (2001)
[32] Jalilian, Kirkpatrick and Parker (2006).
[33] World Bank (2004)

where the oil industry is the main producer[34] (Table 6). In all five countries SMEs make an even bigger contribution to employment. In Argentina SMEs provide about 70 percent of total employment[35], while for manufacturing the share ranges from 40 percent in Paraguay and Venezuela to over 65 percent in Brazil (Table 6).

Table 6. Share of SMEs in manufacturing production and employment

	Production %	Employment %
Argentina	35.9	44.6
Brazil	60.8	66.8
Paraguay	31.0	41.0
Uruguay	39.7	57.9
Venezuela	13.8	39.5

Source: Peres and Stumpo (2000)

The distribution between different industrial sectors is shown in Table 7 for Argentina, Brazil and Venezuela. About 20 percent of total SME production is in food and beverages, about 15 percent in chemical products, and about 10 percent in textiles and clothing.

Table 7. Structure of SME industrial production in Argentina, Brazil and Venezuela

	Argentina	Brazil	Venezuela
Food and beverages	21.9	18.7	21.2
Chemical products	13.9	18.9	12.9
Textiles	6.6	7.2	2.6
Garments	3.7	2.7	5.5
Metal products	7.1	9.4	8.0
Nonelectrical machinery	6.7	7.0	4.9
Electrical machinery and equipment	6.0	5.8	3.2
Transport equipment	5.4	3.5	3.0
Plastic products	5.3	4.7	6.8
Printing	4.7	2.5	5.8
Building materials	3.7	4.2	6.5
Paper	3.5	4.3	1.9
Iron and steel	2.5	-	6.3
Furniture	2.2	2.6	3.1
Wood and wood products	2.0	1.5	1.7
Footwear	1.6	1.8	3.4
Leather	1.2	1.8	0.9
Scientific equipment	1.1	1.3	0.8
Tobacco	0.2	0.3	0.1
Others	1.0	1.7	1.4

Source: Peres and Stumpo (2000)

In many countries, including the Mercosur countries, a lack of appropriate finance for SMEs is widely believed to be a serious barrier to their development, and hence to the development of the whole economy[36]. The problem of "credit rationing" can arise when banks have difficulty in distinguishing good risks from bad risks and in monitoring borrowers[37]. The recent sub-prime mortgage crisis may be regarded as an example of the consequences of banks failing to ration credit appropriately in these circumstances. The characteristics of SMEs are such that credit rationing may be more severe than for larger companies.

[34] Peres and Stumpo (2000)
[35] World Bank (2002)
[36] OECD (2006)
[37] Stiglitz and Weiss (1981)

It has been argued that the liberalisation of financial services improves access to finance for SMEs through greater sophistication in the risk management methods of foreign financial institutions[38]. The sub-prime crisis raises doubts about the efficacy of these methods. Changes in international bank policy following the crisis may strengthen the counter-argument that dominance by foreign banks can decrease rather than increase the availability of credit to SMEs[39].

The evidence from past performance in Mercosur countries is inconclusive on whether foreign banks have proved better or worse than domestic banks in providing credit to SMEs[40]. Meanwhile, bank lending may itself be relatively unimportant in most of the Mercosur countries. SMEs throughout the world often obtain funds from informal sources rather than from formal financial markets, whose rates for SMEs are typically higher than those available to larger companies. Common sources include personal savings, internally generated funds and loans from family and friends at lower rates than are commercially available[41]. As noted in the case study (Section 4.1) only 8% of Argentine SMEs are financed with bank credit. Bank loans are a bigger source of SME funding in Brazil, partly because of a higher rate of incorporation and partly as a result of government interest rate policies. A survey conducted in 2002 by the Inter-American Development Bank indicated that 38% of dynamic SMEs in Brazil used bank loans as one of their sources of funding in the launch phase, compared with only 18% in Argentina[42]. As discussed in Section 4.1 the use of bank loans by Brazilian SMEs has risen further since 2005 and is expected to continue to increase. For the other countries in the region it has been argued that SMEs that rely more on personal funds may have better chances of survival than those that rely on banks[43].

Brazil differs from the other Mercosur countries in having a much greater focus on science and technology in its industrial development, including strong governmental support for both large and small enterprises and a national system of business incubators. The vast majority of new ventures in Brazil build upfront relationships with large firms to become part of their supply chains[44]. These relationships are likely to improve the creditworthiness of many Brazilian start-ups, and may in part account for the higher degree of bank lending to SMEs than in the other Mercosur countries.

It may therefore be concluded that financial services liberalisation may have a small but significant direct impact on the performance of SMEs in Brazil if EU providers offer credit on better terms than domestic banks. In the other Mercosur countries the overall impact of liberalisation will be determined primarily by the impact on the economy as a whole rather than through any distinct influence on SMEs themselves.

5.5. Effects of inter-country differences in economic and financial structures

The size of Brazil's economy gives it global significance, with a large population and a higher income per capita than other highly populated countries such as China or India. Argentina also has a relatively large economy in regional terms, with the highest income per capita among the Mercosur countries. Paraguay and Uruguay are much smaller, and differ considerably from each other in economic structure. Uruguay has a fairly diverse economy

[38] World Bank (2001)
[39] Stiglitz (2002)
[40] World Bank (2002)
[41] OECD (2006)
[42] IDB (2002)
[43] Rivera (2007)
[44] Rivera (2007)

with the highest level of urbanisation of the Mercosur countries, whereas Paraguay's population remains largely rural with the lowest per capita income. In Brazil and Argentina, with large domestic markets, international trade contributes a smaller contribution to GDP than in the two smaller countries. The principal economic and related characteristics of the Mercosur countries are summarised in Table 8.

Table 8. Mercosur Economic Characteristics

	Argentina	Brazil	Paraguay	Uruguay
Population (m)	38.4	183.9	6.0	3.4
Population (% rural)	10	17	43	7
GDP ($USb)	486	1483	28	32
GDP growth (%)	9	5.2	2.9	12.3
GDP/Capita (US$)	12723	8297	4868	9465
GDP/Capita growth (%)	8.0	3.9	0.4	11.6
GINI Coefficient	52	59	57	45
Exports (% of GDP)	25	18	36	30
Imports (% of GDP)	18	13	37	28

Source: IARC (2006)

Although Brazil is a large agricultural exporter in global terms, more than 50% of its exports are industrial goods[45]. By contrast, industrial goods contribute only 14.6% of Paraguay's exports. Non agricultural raw materials and fuels account for 34% of exports in Paraguay, but only 11.6% in Uruguay. Exports of agricultural raw materials and food are significant in all the countries, at 48.4% in Uruguay, 42.9% in Argentina, 34% in Paraguay and 22.7% in Brazil.

Of the four countries Paraguay has the greatest need for investment in the diversification of its economy, and stands to gain the most from the potential contribution of an efficient financial services sector. However, many other barriers that have inhibited the country's development in the past will have to be overcome before this potential can be fully realised. The country's own financial services industry is projected to shrink significantly through greater exposure to foreign competition, but it is a small in both national and regional terms. The sector may benefit in the long term through opportunities for greater specialisation.

The more diverse economies of the other three countries are better placed to take immediate advantage of improved financial services provision. Uruguay's small economy is particularly dependent on foreign service suppliers and may benefit from further specialisation both regionally and internationally. The larger economies of Brazil and Argentina are better able to withstand competition across a wide range of services, and to take advantage of liberalisation as a stimulus to their own competitive performance.

5.6. Regulation, supervision and management skills

A need to revise and strengthen the regulation and supervision of financial services in the Mercosur countries had already been identified in the absence of any further liberalisation and before the current global crisis. Five main trends since the early 1990s have contributed to this need: the financial sector has increased in size and depth in most of the countries; banks have been allowed to enter new activities; foreign institutions have become increasingly significant; many small banks have disappeared to leave fewer, larger banks; and capital markets have become more diverse. All these trends have implications for regulation and

[45] IARC (2006)

supervision, including needs for better training of regulators and supervisors and greater support from foreign supervisory institutions[46]. Further liberalisation of the sector, in parallel with the current global financial crisis, would amplify these needs.

The creation of the Mercosur customs union has itself led to a high degree of interdependence between the economies of the region, which has made prudent regulation of external sources of volatility a priority[47]. The creation of a free trade area with the EU, alongside further development of the customs union, will further strengthen this need. Most of the Mercosur countries have performed relatively well in implementing the Basel Core Principles for Effective Banking Supervision, but more remains to be done, and the principles themselves may not be sufficient to deal with the problems revealed by the global crisis[48]. The revised Basel principles (Basel II) [49] were intended to correct problems identified with the original principles[50], but fears have been expressed that they could have a negative impact on developing countries. Additionally, it has been argued that the new system is inherently procyclical[51], which may have exacerbated the depth of the current crisis.

Emerging economies have been relatively resilient to the effects of the crisis so far, including in Mercosur, but dependence on external sources of funding leaves them vulnerable. As noted above, the Buenos Aires stock market fell sharply in response to a move to insulate the country's pensioners from the crisis. The IMF recommends more intense supervision, along with a strict implementation of the Basel II principles and possibly stronger guidance on their implementation. It also recommends that coordination among supervisory bodies should be strengthened[52].

Many of the effects of the recent financial market disruption are still uncertain and many of the currently proposed new regulations are still in a preliminary stage[53]. No liberalisation strategy is universally applicable, and the specific timing and sequencing of reforms needs to be determined by individual country circumstances[54]. Each country's regimes of prudential regulation and supervision might, for example, be subjected to vetting against international norms[55]. However, this could still leave a large gap between formal rules and regulatory practice. The demand for regulatory convergence places a large burden on the governance capabilities of the state, often requiring dramatically enhanced monitoring and enforcement capabilities. The development of international norms needs to take full account of political economy factors that may leave a continued gap between rules and practice[56].

The Mercosur countries differ in the level of development of their supervisory systems, but all can do more in terms of institutional development and greater transparency of regulations. Remedies that have been suggested include increased financial and human resources, greater autonomy for supervisors, and action to bridge the gap between regulations and procedures and the ability of supervisors to enforce them[57]. A supportive international environment is

[46] Stallings and Studart (2002)
[47] Centro de Economica Internacional (2003)
[48] Stallings and Studart (2002)
[49] Bank for International Settlements (2006)
[50] Bank for International Settlements (1997)
[51] Stallings and Studart (2002)
[52] IMF (2008)
[53] Semmler and Young (2008)
[54] WTO (1999)
[55] Cornford (2004)
[56] Walter (2002)
[57] Stallings and Studart (2002)

also seen as essential, and should take account of the different needs of industrial and developing countries.

The European Commission's Economic and Financial Committee has made a number of recommendations for safeguarding financial stability within Europe[58]. These cover: strengthening international cross-sector co-operation; greater exchange of information; strengthening co-operation among supervisors and between supervisors and central banks; and greater convergence of supervisory practices, particularly in monitoring cross-border financial institutions.

Cooperative action of a similar nature between the EU and Mercosur may make an important contribution to ensuring that the further liberalisation of financial services within the EU-Mercosur agreement does not increase the risks of financial instability in either partner.

5.7. Impacts on core sustainable development indicators

Economic indicators

Liberalisation of EU Mercosur trade in financial services is expected to have a small but positive impact in the EU on all three core economic indicators (real income, employment and fixed capital formation). In the absence of effective strengthening and coordination of regulatory systems this would be accompanied by increased risks of instability, but in view of the large size of the EU economy and its financial services component the effect is expected to be small. The potential benefits and associated risks are larger in the Mercosur countries, as summarised below.

Real Income

As indicated by the model results the overall impact on static economic welfare is likely to be positive, but too small to be significant. Larger long term gains are available provided that the opening of services markets is complemented by domestic regulatory reform and effective coordination between Mercosur and the EU. These gains can make a significant contribution to investment, economic growth and real income in the long term. However, the implementation of appropriate and effective regulation would entail both costs and time, which Mercosur governments will have to weigh against the emerging benefits in a carefully phased programme of cooperative reforms.

Fixed Capital Formation

The exposure of Mercosur's financial services industries to foreign entry and competition can be expected to result in a short term decline in domestic investment in the sector, accompanied by expanding commercial presence on the part of EU companies. After its initial decline, domestic investment in financial services provision can be expected to increase, as local firms become more competitive in both domestic and export markets.

Employment

In Mercosur countries there will be small negative adjustment effects on employment in the short-run, partly through a transfer of activity to EU suppliers employing fewer local employees, and partly through competitive pressures for greater efficiency and productivity.

[58] CEC (2001)

Except in Paraguay these adjustment impacts are expected to be small and not likely to be more than minor in significance. The short term impact within Paraguay's small financial services sector is likely to be more siginficant, but is expected to be balanced fairly rapidly by new employment opportunities.

The long term effects on employment in Mercosur are expected to be positive, both within the financial services sector itself, and in other sectors of the economy whose growth is expected to benefit from improved financial services. It should however be noted that if rapid liberalisation were to occur without corresponding strengthening of the domestic and international regulatory regimes, the increased risk of financial instability could result in adverse effects of major significance throughout the region.

Social indicators

The social impacts will be closely linked to the economic impacts. In the EU they are expected to beneficial but small, through indirect effects on poverty and on health and education. Impacts on equity are also expected to be small, and neutral overall. Larger potential impacts are expected in the Mercosur countries.

Poverty

Employment in the financial services sector is primarily of professionals and high skilled workers, with little direct influence on poverty. The short term impact on wage rates in the sector is expected to be fairly neutral, associated with a small decline in employment in local firms and increased demand in international firms.

The main impacts in Mercosur of liberalisation are expected to occur through indirect effects on other economic sectors. Provided that liberalisation achieves the desired effect of stronger economic growth, it can be expected to have a significant long term impact on poverty alleviation. However, if carried out without effective measures to strengthen the regulatory regime, the greater risk of financial instability would carry corresponding risks of severe adverse impacts on poverty in both the short term and the long term.

Health and Education

Impacts on health and education will be similar to those on poverty, occurring indirectly rather than directly. If stronger economic growth is achieved, this can be expected to deliver long term benefits in the provision of health and education services. Conversely, any increase in the risk of financial instability could result in severe adverse impacts on expenditure and hence on the provision of these services.

Equity

The potentially adverse short term effects and beneficial long term effects on employment in financial services will have corresponding effects on female employment, which tends to be relatively high in the sector. The gender effects and other distributional impacts are not, however, expected to be significantly large.

Environmental indicators

No significant environmental impacts have been identified for financial services liberalisation. Most large financial services organisations in the EU have adopted sustainable

development principles in their operations, and the anticipated increase in their activities in Mercosur can be expected to follow these principles. However, the direct environmental impacts of the sector are relatively small, and any difference between the operational characteristics of EU and Mercosur firms is not expected to have significant effects.

Impacts (beneficial or adverse) on long term economic growth may contribute significantly to environmental impacts in either direction, but the impact of the sector itself are relatively neutral for all three core indicators (biodiversity, environmental quality and natural resource stocks).

Process indicators

Consistency with sustainable development principles

The effects of financial services liberalisation are assessed as being neutral, except in so far as they influence long term economic growth. Growth is in principle highly consistent with goals of socio-economic transformation and poverty reduction, while at the same time intensifying the need for change in unsustainable patterns of consumption and production.

Institutional capacity for effective sustainable development strategies

The effects of financial services liberalisation on sustainable development strategies are assessed as being relatively neutral, in that they neither add to nor detract from Mercosur countries' capacity to implement effective strategies. The impact in the EU is also assessed as neutral.

5.8. Summary of principal impacts on sustainable development

The impacts discussed above are summarised in Table 6.

Table 6. Sustainable development impacts of financial services liberalisation

Impact	Countries / sectors affected	Causal factors	Factors affecting significance	Potential significance	
				short term	long term
Economic					
Real income	EU Mercosur	Increased penetration by EU providers Economic growth Risks of greater instability	 Coordinated regulatory reforms	⇧ ?	⇧ ⇧?
Fixed capital formation	Mercosur	Exposure to competition, increased competitiveness		⇩	⇧
Employment	Short term adverse impact in Paraguay. Long term gains in all.	Economic growth, risk of instability	Coordinated regulatory reforms	⇩	⇧?
Social					
Poverty	Mercosur	Economic growth. Risk of instability	Coordinated regulatory reforms	-	⇧ **(↓?)**
Health and education	Mercosur	Economic growth	Parallel policy measures	-	⇧

Impact	Countries / sectors affected	Causal factors	Factors affecting significance	Potential significance	
				short term	long term
Equity	Small impacts, non-significant			-	-
Environmental					
Biodiversity	Neutral impact			-	-
Environmental quality	Neutral impact			-	-
Natural resources	Neutral impact			-	-
Process					
SD principles	Positive for socio-economic change and poverty reduction, adverse for consumption and production, otherwise neutral.	Economic growth	Parallel policy measures, environmental regulation.	-	⇩
SD strategies	Neutral impact			-	-

Legend: 🡅 positive greater significant impact, 🡇 negative greater significant impact, ⇧ positive lesser significant impact, ⇩ negative lesser significant impact, ⇧⇩ positive and negative impacts likely to be experienced according to context (may be lesser or greater as above), **?** or ? uncertain positive or negative impacts of greater or lesser significance, - non-significant impact compared with the base situation.

6. MITIGATION AND ENHANCEMENT MEASURES

6.1. Summary of impacts

The impact assessment described in Section 5 has identified the following potentially significant impacts on sustainable development of liberalising financial services through the proposed EU-Mercosur agreement.

Economic

- small but positive impacts in the EU;
- a potentially significant contribution to investment and economic growth in Mercosur countries;
- a small short term decline in domestic investment in financial services in Mercosur, followed by longer term increase as local firms become more competitive;
- adjustment impacts could be of major significance for Paraguay's small financial services sector;
- potentially increased risk of financial instability that could result in major adverse effects throughout the region.

Social

- significant long term impact on poverty alleviation through stronger economic growth;
- risks of severe adverse impacts on poverty in both the short term and the long term resulting from greater risk of financial instability.

Environmental

- intensified need for change in unsustainable patterns of consumption and production.

As described in Section 2.6, the EC's SIA methodology provides for Mitigation and Enhancement (M&E) measures to enhance the beneficial impacts identified in the assessment and to avoid, reduce or compensate for any adverse ones. The methodology identifies three main mechanisms for implementing M&E measures:

1. modification of the trade agreement
2. action by national governments to enhance positive effects or mitigate negative ones
3. complementary mechanisms to accompany the trade agreement

The following proposals make use of each of these mechanisms as appropriate.

6.2. Mitigation of adverse environmental and economic impacts

Financial services liberalisation is not expected to have any significant direct environmental impacts. However, if the liberalisation measures succeed in accelerating economic growth they will intensify the need for change in unsustainable patterns of consumption and production in both the EU and Mercosur. The issues of greatest concern relate to climate change and biological diversity. We therefore recommend:

1. Enhanced cooperation between EU and Mercosur government to reinforce their efforts to strengthen Multilateral Environmental Agreements (MEA) and associated governance mechanisms which effectively address climate change and declining global biological diversity, including the Framework Convention on Climate Change and the Convention on Biological Diversity.

The assessment has indicated the possibility of major adverse adjustment impacts for Paraguay's small financial services sector. In the longer term, domestic providers are expected to benefit from competitive pressures for greater efficiency and productivity. We therefore propose that consideration be given to:

2. Support from the Government of Paraguay to assist the country's financial services providers enhance their competitiveness in services that are complementary to those offered by EU providers.

6.3. Enhancement of economic benefits

The assessment of impacts on SMEs suggests that liberalisation may have relatively little effect, except perhaps in Brazil where small firms already make greater use of bank finance. The case study for SMEs has identified needs for improved credit rating expertise among service providers and for fuller evaluation of the suitability of collateral. The first of these is likely to benefit from an increased presence of EU providers with greater credit rating experience. The second is likely to remain a barrier for both domestic and EU providers. We therefore recommend consideration of:

3. Technical assistance from the EU for the development of improved systems for evaluating the suitability of collateral offered by SMEs

6.4. Avoidance of adverse impact on financial stability

The assessment indicates that financial services liberalisation could have severe adverse effects on financial stability in the Mercosur countries, and to a lesser extent also in the EU, unless accompanied by action to strengthen both regions' regimes for regulation and supervision. Similar needs have also become apparent as a result of the current global financial crisis. It is therefore considered vital that the negotiations on EU-Mercosur liberalisation should take full account of the evolving international dialogue on strengthening the global financial system, and that specific mitigation measures associated with EU-Mercosur liberalisation should be based on those agreed internationally.

A number of specific measures have been identified in the assessment that would contribute to avoiding adverse impacts on stability of further financial services liberalisation. These measures are included in the following recommendations, along with others related to wider international action.

4. The EU-Mercosur Association Agreement on financial services should not be finalised until a reasonable international consensus has emerged on actions to be taken in response to the current global financial crisis.
5. The Association Agreement should include specific actions to be taken by both parties to ensure that the liberalisation measures do not adversely affect stability in either region, based on an international consensus on appropriate mechanisms for strengthening global stability.
6. Fuller implementation of the Basel Core Principles for Effective Banking Supervision in both Mercosur and the EU.
7. Full implementation in both Mercosur and the EU of any revisions to the Basel principles that may be agreed in response to the current global crisis.
8. Joint EU-Mercosur development of fuller guidance on implementation of the Basel principles.

9. Implementation within Europe of the European Commission's Economic and Financial Committee (EFC) recommendations for strengthening international and cross-sector co-operation, particularly in monitoring cross-border financial institutions.
10. Joint action on extending and adapting the EFC recommendations to apply to cooperation between the EU and Mercosur.
11. Strengthening of supervisory institutions and systems in both the EU and Mercosur to provide greater transparency, increased financial and human resources, greater autonomy for supervisors, and the ability of supervisors to enforce regulations.
12. Technical assistance from the EU in providing better training of regulators and supervisors in Mercosur, particularly for the enhancement of monitoring and enforcement capabilities.

7. CONCLUSIONS

Five broad conclusions may be drawn from the Financial Services SIA study for the EU-Mercosur trade negotiations:

1. Further liberalisation of financial services between the EU and Mercosur offers potentially significant economic benefits in both regions. The expected contribution to economic growth in Mercosur countries would have significantly beneficial social impacts in the long term.
2. Adjustment impacts are relatively small except in Paraguay, whose small financial services sector is vulnerable to increased competition.
3. Environmental impacts are limited mainly to the indirect effects of greater economic growth.
4. Unless liberalisation is accompanied by stronger regulation and supervision it would significantly increase the risk of financial instability. This would carry corresponding risks of severe adverse economic and social impacts in both the short term and the long term, that could considerably outweigh the benefits of liberalisation.
5. An EU-Mercosur agreement on financial services liberalisation should not be finalised until a reasonable international consensus has emerged on actions to be taken in response to the current global financial crisis. The agreement should fully incorporate any actions that are agreed internationally.

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ANNEX 1. A STUDY ON THE IMPACT OF EU MERCOSUR TRADE LIBERALISATION ON CREDIT MARKETS FOR SMES IN MERCOSUR

Pedro Regina

Introduction

This case study focuses on the access and availability of credit to Mercosur's small and medium enterprises (SMEs)[1] and assesses the potential impact that (further) liberalisation of the financial services sector, as part of the EU-Mercosur trade negotiations, might have on the SME sector's access to credit. It comes at an opportune moment, given that SMEs are likely to face ever increasing hardships in the coming months due to the financial crisis of 2008.

> *On August 9th 2007, after an alarming leap in interbank interest rates, the European Central Bank signalled its readiness to provide the banking system with the liquidity it suddenly lacked. What became known, with irresistible alliteration, as the credit crunch had begun* (The Economist, 2008).

What began in August 2007 as a credit crunch developed in to a full-fledged financial crisis by mid-September 2008, involving de facto nationalizations (e.g., Fannie Mae and Northern Rock), de juris nationalizations (e.g., AIG) and managed collapses (e.g., Lehman Bros.). Its longer term implications – both political and commercial – can be expected to reach far beyond the financial markets. Events will continue to unfold in the coming months and more collapses/nationalizations are almost inevitable. The emerging economies of Asia and Latin America initially avoided the fallout of imploding financial institutions, but would find dodging the unfolding global economic slowdown harder to manage. History suggests that the risk of contagion is not easily expunged.

Entering the final quarter of 2008, the wider EU-area and Japan were on the brink of recession, while America's slightly more robust economic figures (as published by its monetary authorities) were raising more than a few incredulous eyebrows. Indeed, American banks – both commercial and investment – had been at the forefront of the previous boom and now were rapidly leading the way down the path to bust.

Central bankers generally proved willing to provide liquidity, to the best of their ability, although this had little impact on international equity markets which suffered numerous significant falls. At least softening of oil prices around the same time helped ease central bankers' concerns over inflation. But, central bankers' firm hands notwithstanding, financial systems around the globe were revealed to be weaker than thought. Regulators came in for particularly harsh criticism, in light of the fact that banks' risks were shown not to have been managed but merely shifted or hidden off balance-sheets.

With a worrying number of financial institutions collapsing or threatening to collapse in September 2008, governments' firm response has been greeted with relief and dismay. In their desire to forestall a systemic crisis in the financial sector and to minimize its impact on the real economy, policymakers have set a dangerous precedent with unknown consequences. If banks and insurers are rescued, ostensibly to protect jobs in the popular perception, then

[1] Here defined as per the Serviço Brasileiro de Apoio às Micro e Pequenas Empresas' (SEBRAE) classification: micro firm (1-19 employees), small firm (20-99 employees), medium firm (100-499 employees), and large firm (500+ employees).

other industries (and their employees) should expect the same sort of treatment; already automobile manufacturers in the USA are openly musing about handouts and rescue packages. Similarly, if nationalization of unviable industries is possible, then so is the re-nationalization of strategic or monopolistic ones (in the latter case, to protect consumers from predatory practices). In Britain, consumers stung by the ever rising price of water and electricity (among the highest in the developed world) are calling for the re-nationalization of utilities; in Brazil, the first mutterings for the re-nationalization of the telephone sector are being aired. For better or for worse, these voices are likely to grow in the wake of events in the financial markets.

In Mercosur countries, initial indications suggest that their financial sectors avoided contagion in the form of capital flight. Moreover, despite an uptick in local interest rates, larger SMEs appeared to encounter little difficulty in securing funds from varied sources (Chevenix-Trench, 2008). Unlike the disruptions to their markets during the Asian (1997) and Russian (1998) crises, which occurred despite their lack of exposure and ties to those regions, the 2008 financial crisis has so far impacted Mercosur in a far milder fashion. However, an extended credit crunch abroad might lead investors to repatriate funds, which would quickly impact Mercosur's growth prospects.

Moreover, bank credit has always been in relatively short supply in Latin America and any tightening of supply is likely to hit SMEs the most. One of the key reasons for the low availability of credit, especially in Brazil, has been that government bonds remain the main assets of banks (as well as pension and mutual funds), but these crowd out or discourage the extension of credit to the private sector. Furthermore, intermediation costs[2] and interest spreads remain high by developed country standards, largely due to difficulties in loan recovery, historic macroeconomic instability, high taxes, restrictive regulatory environments, and high operating costs and interest rates.

Of course, SMEs can and do have recourse to state financing. But if loans are hard to come by, then so is information regarding their availability (which is probably related), especially as regards SME data. Brazil, the only country in the region with an active development bank, is a case in point. Between 1998 and 2006 the Brazilian Development Bank (BNDES) approved 17,509 loans from its Competiveness Promotion Guaranty Fund (FGPC) worth some R$ 3.6 billion (of which R$ 2.6 billion was totally guaranteed, corresponding to an average risk coverage of 73%). The average loan amount was R$ 203,900 over an average of 53 months. 13,318 micro and small enterprises benefited from the scheme. Non-performing loans amounted to 9.4% of the total. In 2006 alone, the four largest banks in Brazil loaned some R$ 75 billion to SMEs, with an average default rate of 5%. This report will focus on private sector credit in the SME market due to data constraints, as well as the due to the marked difference in the scale of funding.

In Brazil, the country with the highest tax burden (approximately 40% of GDP), efforts to reduce taxes on financial intermediation have been thus far relatively limited, perhaps due to worries over ongoing fiscal consolidation efforts, which will remain worrisome so long as Brazil endures high real interest rates. Nevertheless, in recent years, Mercosur countries have made small but important steps in improving their competitiveness. In July 2007, for example, Uruguay eliminated its counterproductive minimum capital requirement, making it easier to start a business; it abolished the COFIS (a 3% sales tax) and reduced the value-added tax from 23% to 22%; and it implemented electronic data interchange, reducing the time to process exports by five days and imports by a day.

[2] The difference between the weighted average lending and deposit rates.

It is in this context of uncertainty, within global financial markets, that this report provides an overview of the credit channels open to Mercosur's SMEs. This report is divided into the following sections:

I. SMEs: background and regional context
II. Bank credit: regional and individual context;
  a. Brazil
  b. Argentina
  c. Paraguay
  d. Uruguay
III. SMEs and credit;
IV. SME directed credit in Brazil
V. Economic Impact of Financial Services Liberalisation;
VI. Impacts on core social indicators;
VII. Environmental Impact of Financial Services Liberalisation;
VIII. Impacts on process indicators;
IX. Policy considerations;
X. Conclusions.
P.S. Promoting SME development and opportunities

Any report on the provision of credit must make allowances for incomplete and/or highly aggregated data. Not only do many banks aggregate their loans data, making it difficult to ascertain who is getting what, but guarantees (including informal letters of credit) – which are a form of credit – do not show up at all. Consequently, this report has gone beyond formal statistics and has relied largely on the information and experience provided by bankers and fund managers operating in the region.

I. SMEs: background and regional context

After decades of a 'big is beautiful' mindset, focusing on large enterprise and investments, Latin American policymakers recently recognized that SMEs were the true job creators, as well as providing important links in technology supply chains. Among Mercosur economies, only Argentina experienced a drop in the number of SMEs between 1998 and 2002 (since recovered), while these types of businesses flourished everywhere else in the region (Lukács, 2005). In Brazil, the SME sector expanded twice as fast as the economy as a whole.

A study of 1200 Latin American SMEs commissioned by Visa International in March 2007 confirmed that there is a sizeable gap between SMEs' financing needs and the volume of funds available to them. Moreover, a poor grasp of the financial aspects of business contributed to further difficulties faced by SMEs. Some highlights of the Visa International study: 1) Most Latin American entrepreneurs opt to run firms as sole proprietorships. Brazil is the great exception, since 82% of all firms in Brazil are incorporated. 2) Most business owners mix personal and business financial affairs. Half of all firms used owners' personal resources (e.g., land, dwellings) for normal business operations, but three quarters insisted on keeping personal and business spending separate (which means that 25% conflate the two). 3) Access to credit is critical for SMEs. Only 23% of Brazilian SMEs believe that they have easy access to credit; SMEs in other Mercosur countries are likely to feel even more aggrieved. 4) Suppliers offer easy credit terms to some 80% of SMEs and 70% offer

discounts for timely payments. 5) Most SMEs use inefficient payment channels (cheque or cash) and only 3% use credit or debit cards.

Although 9 in 10 firms indicated a desire to grow (as opposed to consolidate), they met with a number of different hurdles, given their varying levels of financial sophistication and understanding. For example, there was a degree of confusion regarding what credit was available to them. The study further revealed an inadequate grasp of financial instruments, cash flow management, supplier credit arrangements, and automated payment systems. Clearly, then, part of the problem regarding access to finance rests with the low level of business sophistication and know-how on the part of SME managers themselves. A better understanding of the financial side of business would allow entrepreneurs more time to dedicate themselves to their core activities.

All the same, it is worth bearing in mind that access to credit is only one of the many challenges facing the region's SMEs. Other challenges include keeping input costs down, keeping up with technological advances, attracting and retaining qualified employees, differentiating their products in a competitive marketplace, implementing an efficient and agile management structure, and competing with the informal market.

SMEs also need a conducive business environment and business-friendly regulations, adequate basic infrastructure services, access to short and long-term funding at competitive rates, access to private equity and venture capital resources and expertise, and knowledge about market opportunities. To a large degree, they are disadvantaged due to a shortage of information when compared to larger firms. Furthermore, they often suffer – initially, at least –from limited entrepreneurial skills and deficiencies in accounting/finance, production management, marketing and planning.

Governments can have a positive role in alleviating the difficulties SMEs face. Ideally, governments should be able to provide SMEs with a business environment conducive to private sector activities. Governments should also correct potential market failures and ensure a level-playing field allowing SMEs to compete with larger firms on a competitive basis. Mercosur governments, through the region's development banks should also provide finance, market expertise and access to appropriate training in finance. But this must also be tempered with caution, as international experience suggests that governments are not necessarily the best vehicles for coordinating such efforts (Lukács, 2005). Market uptake of government initiatives can also be reluctant or slow. For example, governments' public-private partnerships (PPP) wishes for SME development have not met with much success to date.

On the positive side, business globalization increasingly has drawn SMEs, including Latin American ones, into global value chains. Mercosur entrepreneurs have recognized the opportunities on offer and view gaining access to global markets as a strategic necessity, rather than minor secondary consideration as in the past. They understand that access to global markets offers SMEs a variety of potential opportunities, such as new niche markets; scale and technological advantages; access to better technology; risk diffusion; lower, shared costs, including R&D costs; and, greater access to finance. Needless to say, access to global markets is often a strategic necessity in the case of SMEs with large intellectual property investments.

II. Bank credit: background and regional context

Banks and traditional banking operations largely dominate finance in Latin America, but bank assets as a percentage of Gross Domestic Product (GDP) are not significant when compared to the rest of the world. What is more, bank credit allocated to the private sector accounts for a modest fraction of their resources and is frequently characterised by high interest rates and relatively short repayment periods. Given Latin American banks' important role in capital mobilization and allocation, and in financing investment and consumption projects, the availability of domestic credit (low volume, high cost) can only be hindering Latin America's economic development and growth (Saichin, 2008).

Thus, there are certain macroeconomic and institutional weaknesses that continue to constrain bank credit in Latin America, especially to private enterprises. First, modest levels of domestic savings and heavy public borrowing inevitably 'crowd out' the available credit to the private sector. Second, banks must contend with heightened credit risks arising from both a volatile economic environment and often slack institutional regard for creditors' rights.

However, the financial liberalization, privatization and structural reforms that led to rapid foreign capital inflows in the early 1990s were accompanied by rapid growth in domestic credit. This was not a linear process, as repeated banking and international crises brought about sharp spikes in credit expansion and contraction. In many cases, crises were followed by restructuring programmes and regulatory reforms, often at the behest of multilateral organizations, which more often than not resulted in a more robust banking sector in the early years of the 21st Century.

Following the various financial crises of the 1990s, Latin American countries restructured their banking systems. The monetary authorities often paid a high price for this restructuring: the IMF has estimated the fiscal cost at 9% of GDP for Brazil (after the 1995 crisis), 18% for Venezuela (1995), 12% for Paraguay (1995), 20% for Mexico (1995), 20% for Ecuador (following the 1998 crisis), and 20% for Uruguay (since 2002). Banks were closed, merged and/or recapitalized, liquidated or privatized, as the case might be; central banks and supervisory authorities were granted greater autonomy and a broader remit, giving them better tools to respond to illiquidity or insolvency problems; stricter standards were imposed, regarding capitalization requirements, the management of credit risks, improved transparency and greater scrutiny of both on-shore and off-shore activities.

In many countries, the restructuring of the banking market led to a boom in foreign participation (mostly European). Between 1995 and 2004, foreign banks' participation in Brazil increased from 10% of bank assets to 20%. In Mexico, it rocketed from 7% to 85%. In Argentina, foreign holdings of bank assets rose from 19% in 1995 to 58% in 2002, fell back to 23% in 2004 following the 2001-2002 crisis, and slowly regained ground until the global credit crunch hit.

Reforms have produced effective results, as regards strengthening banking systems, in several countries. In Brazil, for example, a comprehensive restructuring programme resulted in 52 banks being liquidated, reorganised or placed under temporary administration between July 1994 and December 2000. Most state banks were privatized and the regulatory framework substantially tightened.

In Uruguay, over the same period, insolvent banks were liquidated, access to IMF credit lines restored and a liquidity crisis overcome. Furthermore, a state bank restructuring programme was established, even if sluggishly implemented.

In Argentina, the influence and market share of foreign banks grew dramatically after the 1995 Tequila crisis, spurred on by the currency board regime. By mid-1997, only one of the 10 largest private banks was still in Argentine hands. Similarly, the number of public banks fell from 33 in 1994 to 12 in 2007, while cooperative banks almost completely disappeared. Subsequent to the collapse of the currency board regime in 2001 and amid the ensuing crisis, the Argentine government reacted by reducing the central bank's autonomy and by increasing the cost of the crisis for banks (primarily due to its *pesification* of loan obligations). Public banks, despite being the least solvent, received direct support, and the opportunity to genuinely reform and restructure the banking sector was missed. Foreign banks, meanwhile, were no longer perceived to be safe havens, and their market share, which had exceeded 50 per cent in 2000, halved by 2007. With the 2008 global credit crunch in full swing, Argentina’s uncertain economic and regulatory environment discouraged any expansion of its credit market. Needless to say, regulatory reforms, loan portfolio write-downs and a normalization and consolidation of public finances (to reduce sovereign risk perceptions) are necessary before a sustained recovery in bank intermediation can be contemplated.

Meanwhile, Paraguay undertook a somewhat premature and indiscriminate financial reform after 1989 that led to incautious bank lending, which resulted in over half of them being closed following the 1995 Tequila crisis. This upheaval was partly a consequence of poor banking management and, in particular, lack of specialists in credit risk management (little diversification, too much risk), incomplete information systems, unreliable financial statements, and a large and unaccountable informal economy (Fuertes & Espinola, 2006, p. 11).

Generally, whereas the various crises initially interrupted the expansion in bank credit in the region, the restructurings of the second half of the 1990s succeeded in strengthening the banking systems in the Mercosur countries, resulting in better supervised and regulated banks, which are more capitalized, less vulnerable to external shocks and therefore more able to provide credit to the private sector.

II.a. The Brazilian Financial Sector

Background

The Brazilian financial sector is the largest and most sophisticated among Mercosur countries. This is partly due to the demands place upon it during the high inflation years (1980-1994), when good financial management was critical to survival. Despite current moderate inflation rates, bank-lending spreads remain extremely high due to a combination of rapacious taxes, uneven judicial enforcement of contracts, high mandatory reserve requirements and a larger than necessary branch network. Furthermore, the lure of high yielding risk free returns from holding government securities blunts banks’ appetites for making loans.

It is undeniable that Brazilian banks made the transition from protected market in a high inflation environment to competitive market in a low inflation one remarkably well. Brazilian banks weathered the competition offered by international banks without much difficulty, and the bigger banks actually increased their market share and overall profitability. Initially, the rapid fall in inflation led to the disappearance of so-called ‘float income’, which in turn led to liquidity problems among some banks. A series of failures, mergers and acquisitions took place in the late 1990s, and the surviving banks enjoyed record profitability.

The financial sector today is fairly concentrated, with the 10 largest institutions accounting for over 65% of financial sector assets. Acquisitions have contributed to this trend as banks seek economies of scales, including through partnerships with retail chains. Lending by the large banking institutions is focused on the largest companies, leaving small and medium-sized companies underserved (U.S. Department of State, 2007).

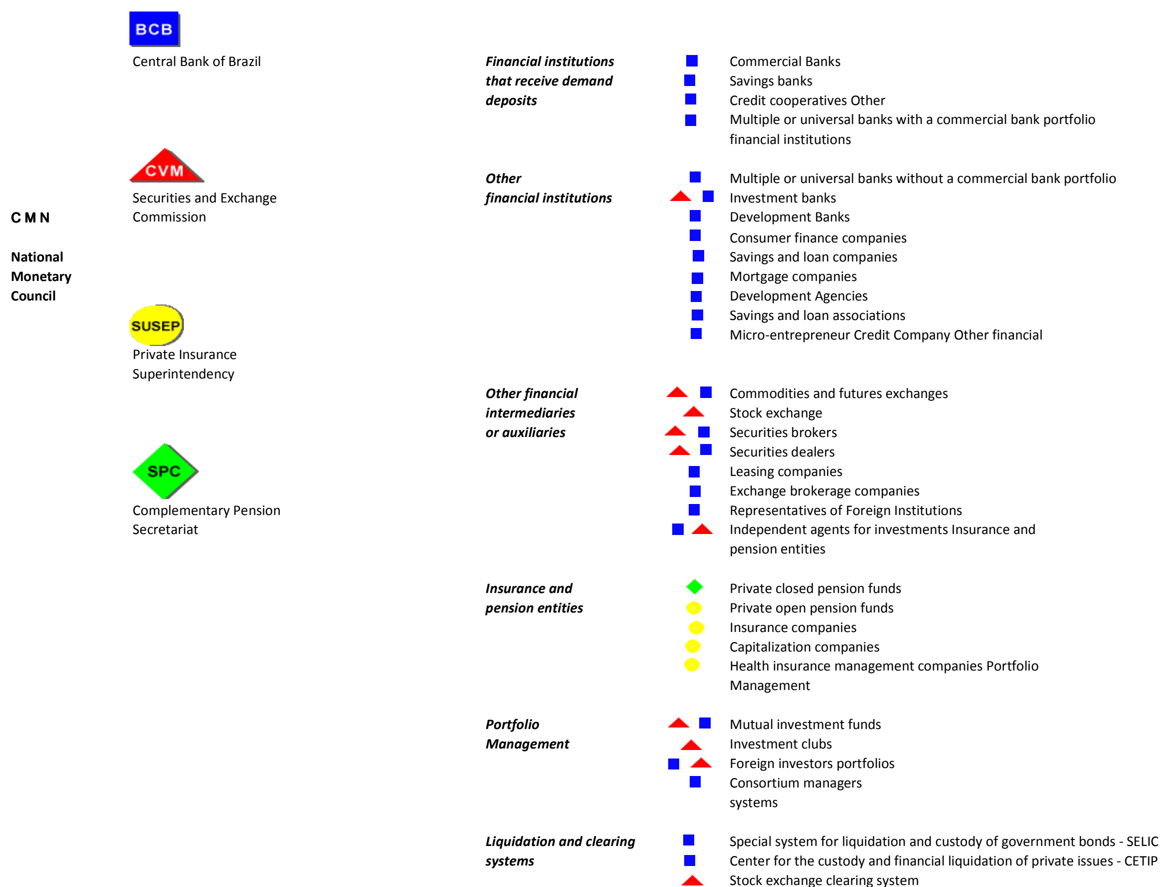
Most government-owned banks, in particular those that were owned by state governments, were privatized. These largely insolvent institutions were taken over by the federal government and subsequently liquidated or privatized. Three federally owned banks (Banco do Brasil, Caixa Econômica Federal and BNDES) still play a prominent role in the financial system. These federal banks, while in better shape than their state-level counterparts in 1994, were also undercapitalized and burdened with many non-performing loans, many politically-motivated. These banks were eventually recapitalized and historically high bank profits since 2002 helped improve their balance sheets. In an effort to prevent future problems on the part of these federal banks, the government now requires that (loss-making) social lending programs run by government-owned banks be supported with explicit government guarantees.

Amidst the various bank failures and consolidations that characterized the immediate post-liberalization period, the Central Bank strengthened bank auditing procedures, implemented more stringent internal control requirements and tightened capital adequacy rules. These measures were applied to both private and publicly owned banks.

The tables below demonstrate the reporting scheme governing the Brazilian financial system and an quantitative overview of the banking system.

The Financial System – Supervisory Responsibility

Regulation and Supervision Entities in the Brazilian Financial System



Top 50 Banks by Total Assets Less Brokerage (June 2008)

In thousands of US$

Ranked	Bank	TD	TC	Obs.	Total Assets	Net Equity	Net Profit/Loss	Total Deposits	Number of Employees	Number of Branches	Ratios: Basle Capital Ratio	Ratios: Fixed Assets to Equity
1	BB	C	1	1	253.450.840	16.565.734	2.507.429	122.793.496	104.545	4.117	13,08%	16,14%
2	ITAU	C	3		213.326.448	20.276.673	2.593.486	54.668.407	66.077	2.639	17,07%	25,92%
3	BRADESCO	C	3		218.826.692	21.230.637	2.585.283	77.715.377	76.339	3.205	14,35%	47,26%
4	CEF	I	1		166.086.372	7.839.791	1.597.471	92.979.879	104.179	2.06	22,36%	13,89%
5	ABN AMRO	C	4		103.154.300	8.188.755	567.156	44.188.360	33.949	1.148	13,62%	11,35%
6	UNIBANCO	C	5		106.610.051	8.055.698	936.639	33.165.008	26.492	947	13,71%	40,63%
7	SANTANDER	C	4		79.960.033	6.667.314	498.384	29.830.491	21.136	1.09	13,57%	15,90%
8	HSBC	C	4		61.240.914	3.714.743	483.272	33.652.741	27.338	925	13,11%	27,60%
9	VOTORANTIM	C	3		46.253.876	3.979.284	377.975	13.168.591	1.026	14	14,12%	1,01%
10	SAFRA	C	3		38.755.272	2.518.951	279.669	5.954.433	5.444	124	11,88%	14,96%
11	NOSSA CAIXA	I	2		33.928.545	2.008.977	330.265	20.729.071	15.583	560	13,81%	13,01%
12	CITIBANK	C	4		24.758.621	2.596.086	757.894	4.555.758	6.184	127	13,17%	17,20%
13	BNP PARIBAS	C	4		15.617.361	726.045	25.026	2.138.682	361	4	15,40%	3,04%
14	BANRISUL	C	2		14.681.195	1.826.127	193.64	8.272.753	11.238	423	22,24%	8,11%
15	CREDIT SUISSE	C	4		11.620.904	1.605.764	367.891	2.594.662	75	2	21,76%	28,29%
16	UBS PACTUAL	C	4		12.953.513	2.762.276	356.734	1.551.230	880	6	30,73%	5,65%
17	BNB	I	1		9.456.388	1.084.115	128.834	2.119.068	11.362	182	15,08%	10,95%
18	ALFA	C	3		8.884.531	939.354	63.403	2.213.187	1.29	9	15,74%	8,81%
19	BBM	C	3		8.471.295	548.048	44.627	2.274.376	590	6	16,59%	14,76%
20	DEUTSCHE	C	4		7.657.947	418.771	22.875	1.277.563	195	2	16,09%	12,06%
21	BIC	C	3		7.388.009	1.083.823	125.62	3.673.369	890	33	14,93%	2,37%
22	JP MORGAN CHASE	C	4		7.889.257	927.806	-14.621	244.809	398	5	22,06%	4,00%
23	FIBRA	C	3		10.168.265	353.288	37.718	1.713.789	437	10	11,48%	21,16%
24	BMG	C	3		4.830.940	1.274.022	94.937	1.328.080	815	13	16,89%	4,28%
25	SS	C	3		4.337.509	900.516	100.553	1.687.154	74	1	22,22%	8,01%
26	BANESTES	C	2		6.045.536	381.776	50.415	2.819.789	3.663	126	18,32%	19,38%
27	BASA	I	1		4.258.171	1.131.546	23.714	1.131.324	4.22	105	27,88%	13,40%
28	DAYCOVAL	I	3		4.920.367	1.003.456	83.324	1.856.906	759	23	25,56%	3,65%
29	MERCANTIL DO BRASIL	C	3		4.786.977	351.491	20.692	2.302.366	3.573	163	11,57%	28,57%
30	ABC-BRASIL	C	4		3.963.750	710.967	51.124	1.635.624	449	4	19,18%	0,88%
31	BESC	C	1		3.942.043	273.692	18.158	2.515.501	4.897	252	29,89%	8,13%
32	SOFISA	C	3		3.803.328	535.401	35.041	2.104.334	338	14	17,57%	47,20%
33	RABOBANK	I	4		3.919.712	280.28	12.378	307.401	308	13	14,86%	2,23%
34	PINE	C	3		3.712.778	523.66	49.92	1.473.681	400	15	16,52%	1,84%
35	IBIBANK	I	4		3.442.786	490.284	18.934	1.414.317	869	1	13,87%	38,12%
36	BANCOOB	I	3		3.510.525	91.332	6.939	1.503.999	735	8	11,86%	40,15%
37	SOCIETE GENERALE	C	4		3.286.793	897.937	17.547	1.051.423	497	3	34,73%	49,12%
38	BANSICREDI	I	3		5.257.154	98.73	8.833	2.216.050	233	5	14,29%	28,80%
39	BRB	C	2		3.076.300	246.63	44.012	2.447.249	3.33	59	11,93%	19,94%
40	CRUZEIRO DO SUL	C	3		3.075.780	717.423	94.495	1.211.445	708	6	22,54%	6,19%
41	CLASSICO	I	3		2.999.491	2.899.997	36.683	347	6	2	108,74%	0,00%
42	BARCLAYS	I	4		2.714.082	252.341	16.749	144.956	88	1	39,83%	3,08%
43	ING	C	4		2.293.721	466.675	62.755	124.26	138	1	51,39%	0,61%
44	BANIF	C	4		1.838.069	159.472	43.715	529.666	0	0	15,61%	22,85%
45	MORGAN STANLEY	C	4		1.812.681	530.897	48.732	0	79	2	38,86%	2,25%
46	WESTLB	C	4		1.753.563	285.24	14.925	200.759	153	1	33,79%	0,34%
47	SCHAHIN	C	3		1.573.787	236.241	15.485	973.412	232	2	19,72%	5,53%
48	INDUSVAL	C	3		1.863.391	271.981	24.464	674.519	385	11	26,07%	3,32%
49	DBB BM	I	4		1.360.236	195.051	-10.225	879.462	86	1	24,61%	2,26%
50	RURAL	C	3		1.312.937	234.183	25.115	804.6	599	28	14,18%	39,18%
Total Top 50 Banks (Banking - Consolidated I)					1.550.833.036	131.359.281	15.876.084	594.813.724				
% Participation Top 50 Banks (Banking Consolidated I)					86,3%	77,0%	79,6%	92,0%				
Total other banking institutions (Banking - Consolidated I)					25.210.079	4.349.899	190.131	9.954.935				
Total Banking - Consolidated I (101 Institutions)					1.576.043.115	135.709.180	16.066.215	604.768.659				
% Participation Banking Consolidated I					87,7%	79,5%	80,6%	93,5%				
1	BNDES	I	1	1	137.319.100	18.074.856	2.594.719	16.181.777	2.133	1	29,93%	37,96%
2	VOLKSWAGEN	I	4	2	6.147.419	717.841	139.829	3.225.024	523	1	11,02%	10,02%
3	BANCO GMAC	I	4		4.787.527	595.333	60.375	2.203.006	374	1	14,22%	17,03%
4	BRDE	I	2		3.436.196	613.254	31.355	0	556	3	20,67%	2,03%
5	DAIMLERCHRYSLER	C	4		3.236.037	317.116	20.33	468.79	214	1	11,89%	0,00%
Total Top 5 Banks (Banking - Consolidated II)					154.926.279	20.318.400	2.846.608	22.078.597				
% Participation Top 5 Banks (Banking Consolidated II)					8,6%	11,9%	14,3%	3,4%				
Total other banking institutions (Banking - Consolidated II)					24.470.272	3.998.559	293.441	6.622.083				
Total Banking - Consolidated II (33 Institutions)					179.396.551	24.316.959	3.140.049	28.700.680				
% Participation Banking Consolidated II					10,0%	14,3%	15,7%	4,4%				
Total Banking - Consolidated III (1441 Institutions)					28.281.038	5.301.317	306.735	12.451.240				
% Participation Banking Consolidated III					1,6%	3,1%	1,5%	1,9%				
Total Non-banking - Consolidated (296 Institutions)					14.409.540	5.371.718	431.7	761.681				
% Participation Non-banking Consolidated					0,8%	3,2%	2,2%	0,1%				
TOTAL					1.798.130.244	170.699.174	19.944.699	646.682.260				

Source:Sisbacen

TD (Type of Document): C - Conglomerate , I - Independent Institution

TC (Control Type): 1 - Federal Government Owned , 2 - State Government Owned , 3 - Domestic Private , 4 - Foreign Controlled Private , 5 - Foreign Participation Private

Obs.: 1 - Exception - See Report

2 - Leading institutions of banking conglomerates which do not opt for the monthly consolidation of balance sheets.

Capital markets

The Brazilian stock exchanges serve to raise financing primarily for domestic companies, although the Sao Paulo Stock Exchange (BOVESPA) has more global aspirations. The Brazilian subsidiaries of some European and U.S. companies have issued shares on the BOVESPA. There were 9 Initial Public Offerings (IPOs) on the Sao Paulo Stock Exchange (BOVESPA) in 2005; 26 IPOs in 2006, where the total volume of money accounted was R$ 15.2 billion; and 64 IPOs in 2007, worth R$ 55 billion (US$ 42.8 billion). In late 2007, the Bovespa stock exchange itself raised R$ 6.6 billion (US$3.7 billion, €2.6 billion) in its initial public offering, setting an individual Brazilian IPO record.

The total number of companies listed on the BOVESPA increased from 361 in 2004 to 382 in 2005, 394 in 2006, and 433 in 2007. Trading is highly concentrated, with the top 10 stocks accounting for some 40 percent of turnover. As of 2006, some 34 Brazilian firms, including Petrobras, Embraer, Banco Itau, CVRD, and Brasil Telecom were also listed on the NYSE via American Depository Receipts (ADRs).

In 2000, with the intent of promoting the stock market and improving liquidity, the numerous regional stock markets agreed to consolidate. All stock trading is now done on the São Paulo stock market, while trading of public securities is conducted on the Rio de Janeiro market. The São Paulo stock market also launched the Novo Mercado (‘New Market’), in which the listed companies would comply with strict corporate governance requirements. The Novo Mercado celebrated its 100th listing in July 2008.

In 2008, the Brazilian Mercantile & Futures Exchange (BM&F) and the São Paulo Stock Exchange (Bovespa) merged, creating BM&FBOVESPA S.A., a highly sophisticated securities, commodities and futures exchange. The merger made BM&FBOVESPA S.A. the third largest exchange in the world, in terms of market value, the second largest in the Americas, and the leading exchange in Latin America.

Until 2001, up to two-thirds of a Brazilian corporation's capital could be preferred (non-voting) shares, so that it was possible to achieve majority control of voting shares, in some cases, by holding only 17 percent of total capital; now preferred shares for new issuances is limited to 50 percent. The rights of minority shareholders were also strengthened at the same time.

Export credit

BNDES, the government national development bank, is the primary Brazilian source of longer-term credit, and also provides export credits. FINAME (Special Agency for Industrial Financing) provides foreign and domestic companies operating in Brazil financing for the manufacturing and marketing of capital goods. FINAMEX (Export Financing) is a part of FINAME, which finances capital good exports for both foreign and domestic companies. An export credit program for capital and some consumer durable goods, known as PROEX, was established in 1991. PROEX receives funds from the National Treasury to offer assistance in the areas of interest rate equalization, capital and other goods exports, and service exports.

II.b. The Argentine Financial Sector

Before 2008, Argentina had five consecutive years of real GDP growth over 8 percent and attracted considerable foreign investment. The Argentine government continues to encourage foreign direct investment (FDI), aware that the nation’s productive capacity lags many of its

neighbours and hoping to sustain GDP growth. However, the country's attractiveness (at least in some sectors) to foreign investors is clouded by uncertainties concerning creditor and contract rights, as well as a perception of unpredictable regulatory changes, which has heightened since the global financial crisis (U.S. Department of State, 2008).

Background

In 1991, Argentina put a currency board (with absolute, unlimited convertibility) into place and pegged its peso to the U.S. dollar at a 1:1 exchange rate, with the aim of breaking the curse of hyperinflation. The country adopted far-reaching market-based policies, including the dismantling of a web of protectionist trade and business regulations and the implementation of an ambitious privatization program. Argentina subsequently received among the highest FDI flows in Latin America through most of the 1990s. While convertibility defeated inflation, the rigidity that a currency board imposed on exchange rate policy, combined with lack of fiscal discipline and short-sighted governance, undermined Argentina's export competitiveness and led to persistent deficits in the current account of the balance of payments, which were financed by massive borrowing. The Asian financial crisis of 1998 also contaminated Argentina and precipitated capital outflows and a four-year long recession that culminated in a financial panic in November 2001.

In January 2002, the government ended convertibility and defaulted on roughly US$82 billion in privately held debt and over US$6 billion in obligations to official creditors. In February 2005, private investors holding 76 percent of Argentina's defaulted debt accepted an Argentine offer of approximately 30 cents on the dollar of old debt; some remaining private bondholders are still actively seeking redress but the Argentina government has to date declined to engage with private bondholders who chose not to participate in the 2005 restructuring. Of the over $6 billion owed to official government creditors,. In September 2008, Argentina paid off its defaulted debt with the Paris Club, some US$6.706 billion (of which over $4 billion consists of arrears and past-due interest), using the reserves held by its Central Bank.

Argentina posted real GDP growth of 8.8 percent in 2003, 9.0 percent in 2004, 9.2 percent in 2005, 8.4 percent in 2006 and 8.7 percent in 2007. This strong economic recovery can be attributed to a number of factors: a flexible exchange rate regime, sustained global and regional growth, a boost in domestic aggregate demand via monetary, fiscal incentive and income distribution policies, and favourable international commodity prices. Not all these factors currently apply and there are challenges to sustaining high levels of growth in the future, including: capacity constraints, lack of investment in infrastructure, potential energy shortages, an increasingly tight labour market, and a resurgence of significant inflation.

Private sector bank balance sheets, which deteriorated significantly during Argentina financial crisis have recovered. Liquidity improved and net exposure to the public sector significantly reduced; credit – primarily to the private sector – increased at a faster pace than nominal GDP growth, prior to 1H08. As per the rating agencies, most private banks (which hold approximately 55 percent of total financial system deposits and 67 percent of loans) are solvent. In 2007, the ratio of private bank non-performing loans fell to a historic low of some 2.5 percent, and profits for the overall banking system reached their highest levels in over a decade. The central bank claims that, public banks, which hold the remaining assets, are also solvent and liquid. However, lending is mostly short-term, as access to long-term financing is limited and borrowers are naturally reluctant to borrow long-term at variable rates. Furthermore, the uncertainty surrounding official inflation figures and the global financial crisis will continue to complicate government and private sector efforts to develop a long-

term fixed interest rate market, without which it will be difficult to deepen Argentina's financial markets or support large-scale project finance.

ARGENTINE FINANCIAL INSTITUTIONS - 2008 Ranking (millions of Argentine Pesos)

	ASSETS		LOANS		DEPOSITS		NET EQUITY	
1	NACION ARGENTIN	82.412,3	NACION ARGENTIN	21.950,2	NACION ARGENTIN	61.625,0	NACION ARGENTIN	7.151,1
2	PR BUENOS AIRES	30.325,6	SANTANDER RIO	13.442,7	PR BUENOS AIRES	22.136,4	MACRO SA	2.745,5
3	SANTANDER RIO	20.776,1	FRANCES SA	10.637,0	FRANCES SA	15.095,8	HIPOTECARIO	2.647,9
4	GALICIA Y BS AS	20.676,2	GALICIA Y BS AS	9.347,5	SANTANDER RIO	15.078,5	FRANCES SA	2.133,1
5	FRANCES SA	19.998,5	MACRO SA	8.889,5	GALICIA Y BS AS	13.138,1	SANTANDER RIO	1.922,4
6	MACRO SA	19.043,5	PR BUENOS AIRES	8.756,5	MACRO SA	12.385,4	GALICIA Y BS AS	1.848,9
7	HSBC BANK	14.823,9	CIUDAD DE BS AS	6.513,1	HSBC BANK	10.162,0	PR BUENOS AIRES	1.794,8
8	CITIBANK N.A.	11.392,3	HSBC BANK	6.374,9	CIUDAD DE BS AS	9.038,0	HSBC BANK	1.484,4
9	CIUDAD DE BS AS	11.183,7	CITIBANK N.A.	5.770,7	CREDICOOP COOP	8.471,2	PATAGONIA SA	1.421,1
10	HIPOTECARIO	10.638,4	CREDICOOP COOP	5.056,4	CITIBANK N.A.	8.219,3	CIUDAD DE BS AS	1.304,3
11	CREDICOOP COOP	10.025,6	STANDARD BANK	4.543,4	STANDARD BANK	6.447,1	NVO BISEL SA	1.264,8
12	STANDARD BANK	8.706,4	HIPOTECARIO	4.413,5	PATAGONIA SA	5.131,8	CITIBANK N.A.	1.169,3
13	PATAGONIA SA	8.428,8	PATAGONIA SA	3.669,3	NVO SANTA FE SA	4.875,8	BICE SA	1.127,9
14	NVO SANTA FE SA	6.175,0	NVO SANTA FE SA	3.452,9	PROV DE CORDOBA	3.733,6	CREDICOOP COOP	856,2
15	PROV DE CORDOBA	4.602,4	ITAU BUEN AYRE	2.711,0	ITAU BUEN AYRE	3.020,6	AMERICA NAT ASS	810,7
16	ITAU BUEN AYRE	4.407,5	PROV DE CORDOBA	2.122,3	SUPERVIELLE SA	2.906,6	STANDARD BANK	755,0
17	NVO BISEL SA	3.996,3	NVO BISEL SA	1.995,6	COMAFI SA	2.099,8	NVO SANTA FE SA	734,0
18	SUPERVIELLE SA	3.847,0	SUPERVIELLE SA	1.764,8	HIPOTECARIO	2.095,4	SAN JUAN SA	714,7
19	COMAFI SA	3.086,8	COMAFI SA	1.424,9	NVO BISEL SA	1.976,1	ITAU BUEN AYRE	396,2
20	DEUTSCHE S.A.	2.541,2	NVO ENTRE RIOS	1.199,9	LA PAMPA S.E.M.	1.782,2	SUPERVIELLE SA	330,5
21	LA PAMPA S.E.M.	2.269,6	LA PAMPA S.E.M.	999,8	NVO ENTRE RIOS	1.661,2	NVO ENTRE RIOS	320,6
22	NVO ENTRE RIOS	2.162,6	ARGENTINA CFSA	963,6	PROV DEL CHUBUT	1.294,9	DEUTSCHE S.A.	310,7
23	SAN JUAN SA	1.977,4	NVO.B.INDU.AZUL	944,2	PR DEL NEUQUEN	1.260,9	PROV DE CORDOBA	306,6
24	NVO.B.INDU.AZUL	1.880,0	BICE SA	879,3	NVO BCO CHACO	1.218,3	LA PAMPA S.E.M.	259,4
25	PROV DEL CHUBUT	1.729,1	DEL TUCUMAN S.A	860,0	SAN JUAN SA	1.171,7	ARGENTINA CFSA	241,9
26	PR DEL NEUQUEN	1.692,4	GMAC CFSA	815,6	NVO.B.INDU.AZUL	1.170,9	COMAFI SA	225,7
27	BNP PARIBAS	1.659,0	ABN AMRO	748,0	SGO.ESTERO SA	1.164,6	JP MORGAN CHASE	219,9
28	BICE SA	1.588,1	PR DEL NEUQUEN	646,9	DEL TUCUMAN S.A	1.065,5	FIAT CRED CFSA	216,3
29	SGO.ESTERO SA	1.512,3	BNP PARIBAS	642,0	BNP PARIBAS	887,3	PROV DEL CHUBUT	204,1
30	NVO BCO CHACO	1.493,6	GE CFSA	549,7	DEUTSCHE S.A.	830,8	BANCO CMF	199,9
31	ARGENTINA CFSA	1.316,0	ROMBO CFSA	531,3	CORRIENTES S.A.	825,7	SGO.ESTERO SA	196,9
32	VALORES	1.300,5	DAIMLERCHRYSLER	527,2	SANTA CRUZ S.A.	693,3	DAIMLERCHRYSLER	184,2
33	DEL TUCUMAN S.A	1.274,3	PROV DEL CHUBUT	513,6	VALORES	670,7	NVO.B.INDU.AZUL	179,8
34	AMERICA NAT ASS	1.190,6	SGO.ESTERO SA	496,8	ABN AMRO	618,5	FORD CRED CF	165,5
35	ABN AMRO	1.108,3	BANCO CMF	490,7	COLUMBIA SA	575,5	PR DEL NEUQUEN	165,3

Source: Central Bank of Argentina

Conversion and Transfer Policies

Argentina imposed limited capital controls in July 2003 through Decree 285/2003, which established a regime for capital inflows and outflows, and obligated investors to keep foreign currency inflows in the country for a period of at least 180 days. In June 2005, the government further tightened capital controls through Decree 616/2005, which increased the minimum holding period for capital inflows from 180 to 365 days and established that some capital inflows are subject to a 30 percent unremunerated reserve requirement to be deposited in a local bank for 365 days. The remaining 70 percent is free to be invested (or used as collateral), but is subject to the 365-day minimum holding period. Capital inflows arising from trade transactions, foreign direct investment, primary public offerings of stock or bonds (from both the private and public sector), as well as inflows from International Financial Institutions are exempt from controls.

Resident individuals or companies are allowed to purchase up to USD 2 million per month of foreign currency without Central Bank authorization; any excess is subject to a 30 percent reserve requirement and 365-day minimum investment period. In December 2006, the Central Bank established that capital inflows and outflows must be registered under a person's or business's name instead of the name of the local brokerage/exchange house. There are special rules regulating the purchase of foreign currency to settle financial debt, and for the private issuance of bonds denominated in foreign currency.

Efficient Capital Markets and Portfolio Investment

European banks, securities firms and investment funds are well represented in Argentina and are dynamic players in the local capital markets. In July 2003, the government began

requiring foreign banks to disclose to the public the nature and extent to which their foreign parent banks guarantee their branches or subsidiaries in Argentina. The private pension fund system – updated and consolidated in 1995 – provided a growing base for capital markets until the 2001-2002 economic and financial crises. Following the government's 2005 debt restructuring, private pension funds again became significant players in the domestic capital market.

In October 2007, the government introduced new regulations requiring the private pension funds (the so-called AFJPs) to gradually repatriate their investments in Mercosur countries (the majority of which are in Brazilian financial assets) in a move apparently designed to increase the liquidity and depth of domestic capital markets. According to previous rules governing investments, AFJPs could invest ten percent of their portfolios in foreign assets. However, investments in Mercosur countries were excluded from this ten percent limit, meaning that AFJPs could account for them as domestic assets. To preclude sudden large foreign exchange inflows, the government resolution calls for the gradual reduction of Mercosur investments, beginning with a cap of eight percent of total assets in December 2007, falling to six percent in April 2008, four percent in August 2008, and ending at two percent in December 2008. By December 2008, returned funds are expected to total some 8 billion pesos (approximately $2.5 billion).

II.c. The Paraguayan Financial Sector

Paraguay’s financial system comprises 13 banks: one state owned bank and 12 private ones; 5 of which are foreign institutions, 4 are majority foreign owned and 3 are majority locally owned. Also, there are 14 financial credit agencies, 2 savings and loan institutions that offer credit for housing and 35 insurance companies (The Paraguayan American Chamber of Commerce, 2008).

The financial and insurance system suffered great volatility and erratic growth between 1997 and 2006, reflecting the different financial crises that took place in 1995, 1998 and in 2002. A clear effect of these crises was the ‘flight to quality’ migration of deposits from local banks to foreign resident banks; this has since been reversed.

PARAGUAYAN BANKING SECTOR
31/07/2008

(In millions of guaranies)

BANKS	ASSETS Total		ASSETS % of Total	DEPOSITS Total		DEPOSITS % of Total	NET LOANS Total		NET LOANS % of Total	NET EQUITY Total		NET EQUITY % of Total
FOREIGN												
1 Citibank N.A.	1,272,819	9	4.77%	922,265	10	4.38%	438,592	10	3.33%	147,200	8	5.20%
2 ABN Amro Bank N.V.	3,026,857	4	11.34%	2,290,664	4	10.87%	1,607,879	4	12.22%	361,788	2	12.77%
3 Banco Do Brasil S.A.	777,599	12	2.91%	690,175	11	3.28%	430,143	11	3.27%	71,350	13	2.52%
4 Banco de la Nación Argentina	392,017	14	1.47%	336,330	14	1.60%	158,820	14	1.21%	50,330	14	1.78%
SUB-TOTAL	**5,469,292**		**20.49%**	**4,239,434**		**20.12%**	**2,635,434**		**20.03%**	**630,668**		**22.27%**
MAJORITY FOREIGN-OWNED												
1 Interbanco S.A.	3,965,145	1	14.85%	3,009,744	1	14.29%	2,005,564	2	15.25%	478,206	1	16.88%
2 Sudameris Bank S.A.E.C.A.	1,609,567	7	6.03%	1,109,739	8	5.27%	560,015	7	4.26%	227,002	6	8.01%
3 Banco Bilbao Viscaya Argentaria Paraguay S.A.	3,870,325	2	14.50%	2,930,593	2	13.91%	2,216,946	1	16.85%	309,287	4	10.92%
4 Banco Integración S.A.	1,046,416	10	3.92%	925,815	9	4.39%	471,618	9	3.58%	88,677	11	3.13%
5 HSBC Bank Paraguay S.A.	1,301,698	8	4.88%	1,148,883	7	5.45%	600,735	6	4.57%	109,217	9	3.86%
SUB-TOTAL	**11,793,152**		**44.17%**	**9,124,773**		**43.31%**	**5,854,877**		**44.51%**	**1,212,389**		**42.80%**
DOMESTIC												
1 Banco Regional S.A.	2,484,639	5	9.31%	1,971,893	5	9.36%	1,578,825	5	12.00%	258,040	5	9.11%
2 Banco Amambay S.A.	712,756	13	2.67%	589,945	13	2.80%	259,568	13	1.97%	103,474	10	3.65%
3 Banco Continental S.A.E.C.A.	3,262,118	3	12.22%	2,713,741	3	12.88%	1,872,085	3	14.23%	338,715	3	11.96%
4 Visión Banco S.A.E.C.A.	816,568	11	3.06%	600,675	12	2.85%	544,876	8	4.14%	80,381	12	2.84%
SUB-TOTAL	**7,276,081**		**27.25%**	**5,876,255**		**27.89%**	**4,255,354**		**32.35%**	**780,610**		**27.56%**
TOTAL - PRIVATE SECTOR BANKS	**24,538,525**		**91.91%**	**19,240,461**		**91.32%**	**12,745,664**		**96.89%**	**2,623,668**		**92.63%**
STATE												
1 Banco Nacional de Fomento	2,160,087	6	8.09%	1,828,784	6	8.68%	409,749	12	3.11%	208,833	7	7.37%
SUB-TOTAL	**2,160,087**		**8.09%**	**1,828,784**		**8.68%**	**409,749**		**3.11%**	**208,833**		**7.37%**
BANKING SYSTEM	**26,698,612**		**100.00%**	**21,069,245**		**100.00%**	**13,155,414**		**100.00%**	**2,832,501**		**100.00%**

Source: Central Bank of Paraguay

Openness to Foreign Investment

There are no formal restrictions on foreign investment in Paraguay. Equal treatment of foreign investors is guaranteed by Law 117/91, as is the full repatriation of capital and profits by Law 60/90. Historically, Paraguay's tax burden has been the lowest in Mercosur. The corporate income tax rate is currently ten (10) percent, a personal income tax of ten (10) percent will take effect in 2009, and Paraguay has a ten (10) percent value added tax on most goods and services (U.S. Department of State, 2008).

The total stock of foreign direct investment in Paraguay stood at approximately US$ 1,600 million in 2007, according to the Central Bank. The United States was the largest foreign investor in Paraguay, with US$ 617 million, followed by Brazil with US$ 231 million, and the Netherlands with US$ 130 million.

Government efforts to attract foreign investment through privatization have progressed slowly because of political opposition. Political realities and the current global financial environment render further outright privatizations unlikely in the medium-term. The large state-run companies most attractive to foreign buyers (such as the telecom and electricity distribution companies) employ thousands of potential voters and are outlets for political patronage. The telephone and electricity companies were in the process of being privatized when the government suspended their privatization in June 2002, bowing to political pressure. The current government has said that it is against privatization. The following are presently

state-owned monopolies: rail, oil & gas, cement, electricity, water, and basic and long distance land-line telephone services.

The judicial sector has long been a weak point for investors. Many investors find the enforcement of contracts uncertain, due to judicial inefficiency and corruption.

Capital Markets

Paraguay's small capital market began operations in 1993. In 2004 the market handled US$ 16 million in transactions. In local currency terms, the volume increased 57 percent in 2005, and 91 percent in 2006. In 2007, the amount handled increased to almost Gs.211 billion, or USD 42 million. There are currently 70 companies traded on the exchange, but although the high cost of capital makes the market an attractive alternative, many family-owned enterprises fear a loss of control and do not pursue a listing . Most of the exchange's volume occurs in fixed income securities.

Credit is available through various sources, but high collateral requirements are generally imposed. The banking system is generally sound, but remains overly liquid. As of July 2007, the top eight private banks had 86.8 percent of the US$ 3,541.6 million total assets of the local private banking system.

The system-wide level of non-performing loans in 2007 was 1.7 percent of total loans, down significantly from 3.28 percent in 2006, and 6.45 percent in 2005. This compares favourably with the regional average of some 2.5%.

Bilateral Investment Agreements

Paraguay has bilateral investment agreements or treaties with the following countries: Argentina, Brazil, Chile, France, South Africa, Taiwan, United Kingdom, and Uruguay. Paraguay has signed other investment agreements with Austria, Benelux, Costa Rica, Ecuador, El Salvador, Germany, Hungary, Korea, Netherlands, Peru, Romania, Spain, Switzerland, and Venezuela.

II.d. The Uruguayan Financial Sector (U.S. Department of State, 2008)

Background

Since the restructuring of Uruguay's banking sector in 2002, there has been significant bank consolidation. The banking sector currently encompasses two state-owned banks, Banco de la Republica Oriental del Uruguay (BROU) and Banco Hipotecario Uruguay (BHU), 13 private banks, including Nuevo Banco Comercial (NBC), and a number of credit cooperatives. NBC has the most extensive branch network among private banks and is the only one with a truly national reach.

BROU is Uruguay's largest bank (with some 40% of all private deposits) and generally offers the lowest rates and best terms on loans. The mortgage bank, BHU, is the leading supplier of housing loans. During the banking crisis, the government transferred BHU's dollar-denominated time deposits to BROU. The Uruguayan Government agreed with the IMF to restructure and strengthen BHU as a result of BHU's severe financial difficulties.

Insurance provision was a government monopoly until the mid-1990s. In 1996, a law was passed to liberalise the insurance sector, except for workers´ compensation. Private firms may now compete with the government-owned provider, Banco de Seguros del Estado (BSE).

Private banks supply Uruguay's private sector with short-term, dollar-denominated credit and receive mostly dollar-denominated deposits (almost 95% of the private sector's deposits in the private commercial banking system are dollar-denominated.)

For many years, Uruguay was regarded as a safe-haven for Argentine depositors. Before the 2002 banking crisis they held about 40% of total deposits. However, following the critical events in their own country many Argentine depositors withdrew their deposits in 2002 and their share in Uruguayan banks dropped to about 30% by the end of that year, resulting in the sector's severe contraction .

Financial Institutions Operating in Uruguay

Banco de la Republica Oriental del Uruguay (BROU)	Citibank N.A.
Banco Hipotecario del Uruguay (BHU)	Bank Boston
Nuevo Banco Commercial	Lloyds TSB Bank Plc
Banco ACAC	ABN-AMRO
Banco Santander Uruguay	Banco Bilbao Vizcaya Argentaria
HSBC Bank (Uruguay) S.A.	Banca Nazionale del Lavoro
Banco Sudameris	American Express Bank
HSBC Bank	Banco Europeo para America Latina
	Banco Galicia

Offshore financial institutions operate with limited functions - e.g. they may neither accept resident deposits nor offer checking account services.

The Investment Climate

The Uruguayan government takes the country's (now somewhat dented) reputation as the 'Switzerland of the South' seriously, and actively seeks to maintain a favourable investment climate. This was last formalized in 1998, with the passing of Law No. 16906. The law states

that (1) foreign and national investments are equal before the law, (2) investments are permitted without prior authorization or registration ,(3) the government will not bar investments, and (4) investors may freely transfer their capital and profits abroad.

In November 2007, the government altered some aspects of the 1998 investment law with Decree 414/07, which provided new incentives to a broader base of firms and listed the government´s criteria for granting incentives. More negatively, a law was passed in January 2007 (Law No. 18,092) requiring that land purchases by corporations be paid with registered shares (instead of bearer shares) caused some foreign investors to put planned investments on hold; later in the year the government exempted some large foreign firms from this requirement.

Uruguay has a history of maintaining state monopolies in a number of areas in which direct foreign equity participation is prohibited by law. While privatization is widely opposed by the population (and the turbulence of global financial crisis of 2008 will likely reinforce that opposition), some progress was achieved since the early 1990s in dismantling government-run monopolies and increasing private sector participation in the economy. Several state-owned entities have contracted with foreign-owned companies to provide specific services for a given period of time under Build-Operate-Transfer (BOT) regimes. While fixed line telephony remain a monopoly, government-owned ANCEL, SPAIN's Telefonica, and Mexico's America Movil provide cellular services. International long distance, the installation and maintenance of public telephones, data transmission, and some value-added services are also open to the private sector. Although the Telecommunication and Postal Services regulatory agency, URSEC, aims to preserve a level playing field for private and public firms, it sometimes lacks the strength to enforce regulations on government-owned ANTEL.

Other sectors demonstrate varying levels of state domination. For instance, the state-owned oil company, ANCAP, remains the only importer and refiner of petroleum products, but the government has discussed the possibility of a joint venture between ANCAP and Brazil's Petrobras and Venezuela's PDVSA. Ports are widely privatized, with private companies providing most services since 1992. In 2007, the government sold 75% of airline PLUNA, its national carrier, to a consortium of US investors. However, an October 2004 constitutional amendment, approved by 64% of voters, declared water a national resource to be controlled exclusively by the State. Furthermore, in keeping with a practice common in many developed economies, government tenders will favour local producers or service providers, provided the products/services provided are of equal quality and not more than 10% more expensive than foreign goods or services.

Foreign Direct Investment

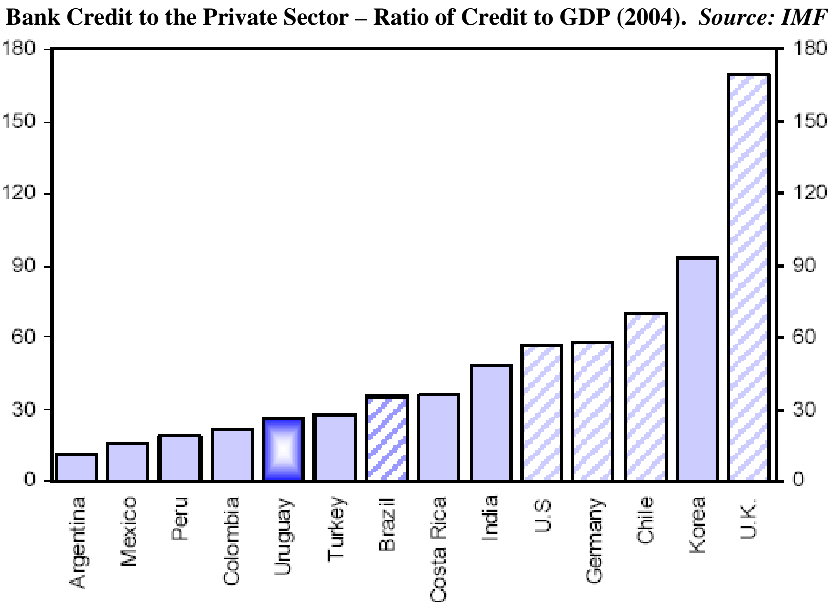
Foreign Direct Investment (FDI) in Uruguay has been traditionally low, even by Latin American and regional standards, because of the country's small market, the lack of major privatizations, and the small number of firms that base their Mercosur-wide operations locally. However, FDI rose significantly to US$4.2 billion in 2006 (4.3% of GDP), above its pre-crisis levels. According to the Central Bank, Spain and Argentina were the country's major investors in 2005, with 24% and 13% of FDI respectively. Most foreign investment in recent years has gone into agriculture-related activities, construction (residential and commercial) and services. Botnia's construction of a US$ 1.2 billion pulp mill in 2005-2007 was Uruguay's largest-ever foreign investment. Another cellulose producer, Spanish firm Ence, has plans to build a pulp mill worth US$ 1.0 billion over the next 2-3 years, but these plans have led to disputes with Argentina (ostensibly on environmental grounds).

Financial Services

Foreign investors can access credit on the same market terms as nationals, however long-term banking credit has traditionally been difficult to obtain. Uruguay's capital market is underdeveloped and concentrated in public paper, consequently while Uruguay is receiving investments oriented to establishing new firms or gaining control over existent ones (FDI), it is hampering its own competitiveness by not fomenting deeper capital markets, which are an essential source of start-up capital and of liquidity for new ventures and growing companies.

Prior to the banking crisis of 2002, credit levels relative to GDP in Uruguay were broadly in line with Latin American averages, although low by international standards. In the early 1990s, bank credit to the private sector fluctuated around 30 percent, comparable to the levels at that time in Argentina, Brazil and Colombia—but below OECD levels of around 70 percent. In 2004, the ratio of credit to GDP in Uruguay stood at 25 percent; the global financial crisis of 2008 is likely to push back this ratio. Similar to other emerging economies in the region, Uruguay’s growth prospects would be enhanced through deeper financial intermediation.

Banks have traditionally been an important source of finance for Uruguayan companies; recourse to the capital markets is minimal. In 2007, 10 companies were listed on the domestic stock market, of which two were not traded; 23 companies were listed on the corporate bond market. In 2005, only 4 companies issued bonds. In common with other ‘underbanked’ countries, retained earnings remains the most important source of financing for Uruguayan firms. External financing is divided up in broadly similar shares among bank loans and suppliers’ credit.



Bank Credit to the Private Sector – Ratio of Credit to GDP (2004). ***Source: IMF***

III. SMEs and credit

It is generally understood that the development of credit markets boosts domestic economic growth. Credit markets improve the selection and monitoring of productive enterprises and undertakings, help contain financial and liquidity risks, and reduce the costs of mobilizing funds. However, the functioning of credit markets in this regard is rarely perfect, as transaction costs and asymmetric information often present serious obstacles to the intermediation process.

Borrowers have better information regarding their projects than is available to banks. Furthermore, borrowers have a downside limit on their liability equal to the outstanding portion of the loan, which may lead them to minimize the actual risk of their projects (adverse selection), to steer the funds to other – riskier – projects than the ones agreed upon with the creditor (moral hazard) and to falsely claim insolvency. These potential conflicts of interest when allied to unreliable, slow and expensive legal recourse (as prevails throughout Mercosur) leads creditors to raise the cost of capital or even to ration its supply, especially to SMEs.

An excellent illustration of this is the case of Argentine SMEs, which invariably find it difficult to gain access to credit. Of the four Mercosul countries, Argentina has had the most uneven banking sector liberalization stance, with the monetary authorities backtracking in a number of areas and sowing confusion, directly impacting SME financing. A 2006 survey of Argentine SMEs showed that only 8% of their investment expenditures were financed with bank credit (Bebczuk, 2007), while financing from retained earnings accounted for 83%. An earlier survey of balance sheet data found an average loans-to-assets ratio of just 13.3%, with most of the (short term) credit coming from overdraft lines at high interest rates. Thus, the domestic commercial loan market was unable to fully meet the financing needs of Argentine SMEs, whose growth prospects suffered accordingly. Moreover, other Mercosur economies do not yet have surplus cash to adequately fund cross-border activities.

Interestingly, in recent years when it came to investing their financial resources, as opposed to raising them, SMEs demonstrate a greater preoccupation with developing their products as opposed to selling more of the same (Deloitte, 2007). Concerns with product differentiation and product development trumped concerns over expanding markets, suggesting that SMEs were now taking a longer and more strategic approach to business development, as opposed to the survivalist mindset that prevailed prior to liberalization.

IV. SME directed credit in Brazil

In Brazil, SMEs accounted for half of non-state banks' commercial credit operations in 2006 and 2007 and close to 60% during the first half of 2008. Bradesco, Itaú, ABN Amro and Unibanco loaned some R$ 100 billion to Brazilian SMEs in 2007, or 25% more than 2006. Growth at HSBC and Santander banks is believed to have been similar. Banco Itaú puts growth in commercial credit for micro, small and medium enterprises at 18.5% in 2007 (Bahé, 2007).

Although growth in credit – both commercial and retail – rose in Brazil for several years, it grew more rapidly for the SME sector from 2005. By early 2008, banks' commercial loan portfolios were probably evenly split between SMEs and large firms (higher in the case of ABN Amro, lower in the case of Unibanco, reflecting the latter's long standing relations with large, traditional firms). And this interest in promoting SME activity is expected to continue, in spite of the global credit crunch and a feared economic slowdown, for a simple reason: loan charges are higher for SMEs than for large firms.

Larger firms in Brazil have the option of obtaining funds through the capital markets, an option generally not available to SMEs. So although it appears at first glance that large firms are losing their access to funds, this is true only as regards traditional loans; banks continue to work with large firms in structuring and coordinating other types of financing.

Real interest rates in Brazil were slashed by half between 2005 and 2008, and this has provided banks with the impetus to broaden their commercial loan portfolios. As returns on government bonds fell, banks were compelled to extend more credit to SMEs, a state of affairs which proved to be mutually beneficial.

In 2007, the volume of credit operations reached 35% of GDP. This is high by Brazilian and Mercosur standards, but low when compared to Chile (60%) and very low when compared to the G7 (120%). Unsurprisingly, then, (lack of) access to credit is consistently rated by firms as the greatest barrier to operation and growth in Brazil, and small firms are constrained the most.

From the banks' perspective, the recent credit expansion has a very real downside: an increase in non-performing loans, which rose in 2006 (5%) and 2007 (7%). Non-performing loans were up 4.7% in 1Q08 year on year, significantly less than the expansion of credit in the same period. Banks are beefing up their credit departments and improving their data collection to aid credit analysts. Despite almost fifteen years of liberalization and a non-inflationary environment, Brazilian banks have dedicated very little attention to credit analysis (except for the largest firms), and still largely rely on external analysts' reports.

V. Economic Impact of Financial Services Liberalisation

Mercosur Firms

The further exposure of Mercosur's financial services industries to foreign entry and competition might result in a short term decline in domestic investment in the sector, but would be mitigated by an expanding commercial presence on the part of EU companies. After any initial decline, domestic investment in financial services provision can be expected to increase, as local firms adapt themselves to the more competitive environment.

Employment

In Mercosur countries there will be small negative adjustment effects on employment in the short-run, partly through a transfer of activity to EU suppliers employing fewer local employees, and partly through competitive pressures for greater efficiency and productivity. However, job losses in the financial sector should be compensated for increased employment in the non-financial sector, as a result of lower costs to users and greater credit availability to businesses.

As the Paraguayan economy is the least competitive, these adjustments would potentially impact it the hardest. The country's financial services sector, although significantly liberalised since 1998, remains small and relatively unsophisticated.

The long term effects on employment in Mercosur are expected to be positive, both within the financial services sector itself, and in other sectors of the economy whose growth is expected to benefit from improved financial services. However, the experience with liberalisation to date suggests that further liberalisation without corresponding strengthening of domestic and international regulatory regimes would increase the risk of financial instability, adversely affecting the region.

VI. Impacts on core social indicators

Poverty

Employment in the financial services sector is primarily of professionals and high skilled workers, with little direct influence on poverty. Nevertheless, staffing levels in domestic banks tends to be higher than those found in more competitive markets, and support staff numbers are larger too. For example, whereas banks in a competitive market would outsource courier services, in Mercosur countries couriers are often employed by the banks themselves. The short term impact on wage rates in the sector is expected to be fairly neutral, associated with a small decline in employment in local firms and increased demand in international firms, and overall numbers of employees in financial and ancillary services is likely to rise over the medium term.

The main impacts in Mercosur of (further) liberalisation may be expected to occur through indirect effects on other economic sectors. Provided that liberalisation achieves the desired effect of stronger economic growth (initially, through lower costs and related productivity gains), it can be expected to have a longer term impact on poverty alleviation. This, however, must occur in the context of an enhanced regulatory environment – with effective oversights and timely intervention – and policies that do not unduly favour larger institutions or encourage economic concentration. Further liberalization without consideration to these provisos would elevate the risk of financial instability and adversely impact poverty-reduction in both the short and long term.

Health and Education

Impacts on health and education will be similar to those on poverty, occurring indirectly rather than directly. Faster growing economies with a strong financial sector both require and foster higher personal incomes, both of which are correlated with improved health and education. Thus, if stronger economic growth is achieved, this can be expected to deliver long term benefits in the provision of health and education services. Conversely, any increase in the risk of financial instability could result in severe adverse impacts on expenditure and hence on the provision of these services.

VII. Environmental Impact of Financial Services Liberalisation

No significant environmental impacts have been identified for financial services liberalisation for most of Mercosur. In the case of Brazil, lower financial costs and improved access to credit will almost certainly result in a greater number of questionable projects getting underway in the Amazon and other protected regions. This is not, it must be said, due to official corruption or negligence, but a result of often doubtful land rights, insufficient oversight in a region larger than Western Europe, the existence of a large free trade zone in the heart of the Amazon, and a lethargic judiciary. As most of the illegal output of operations in the Amazon region ends up in Europe, there is scope for increased cooperation and coordination of efforts to combat fraud and contraband. Most large financial services organisations in the EU have adopted sustainable development principles in their operations, and the anticipated increase in their activities in Mercosur can be expected to follow these principles.

Impacts (beneficial or adverse) on long term economic growth may contribute significantly to environmental impacts in either direction, but the direct impact of the sector itself are relatively neutral for all three core indicators (biodiversity, environmental quality and natural resource stocks).

VIII. Impacts on process indicators

The effects of financial services liberalisation are assessed as being neutral, except in so far as they influence long term economic growth. Growth is in principle highly consistent with goals of socio-economic transformation and poverty reduction, while at the same time intensifying the need for change in unsustainable patterns of consumption and production.

The effects of financial services liberalisation on sustainable development strategies are assessed as being relatively neutral, in that they neither add to nor detract from Mercosur countries' capacity to implement effective strategies. The impact in the EU is also assessed as neutral.

Sustainable development impacts of financial services liberalisation in Mercosur

Impact	Countries / sectors affected	Causal factors	Factors affecting significance	Potential significance	
				short term	long term
Economic					
Real income	All	Economic growth Risks of greater instability	Coordinated regulatory reforms	-	⇧
Fixed capital formation	All (mostly Brazil and Argentina)	Exposure to competition, increased competitiveness		⇧	⇧
Employment	Brazil, Argentina	Economic growth	Coordinated regulatory reforms	⇧	⇧
Social					
Poverty	Mercosur	Economic growth. Risk of instability	Coordinated regulatory reforms	-	⇧
Health and education	Mercosur	Economic growth	Parallel policy measures	-	⇧
Equity	Small impacts, non-significant			-	-
Environmental					
Biodiversity	Brazil			-	⇧
Environmental quality	Brazil			-	⇧
Natural resources	Brazil			-	⇧
Process					
SD principles	Positive for socio-economic change and poverty reduction, adverse for consumption and production, otherwise neutral.	Economic growth	Parallel policy measures, environmental regulation.	-	⇩
SD strategies	Neutral impact			-	-

Legend: 🡅 positive greater significant impact, 🡇 negative greater significant impact, ⇧ positive lesser significant impact, ⇩ negative lesser significant impact, ⇧⇩ positive and negative impacts likely to be experienced according to context (may be lesser or greater as above), **?** or ? uncertain positive or negative impacts of greater or lesser significance, - non-significant impact compared with the base situation.

IX. Policy considerations

The global credit crunch did not hit Mercosur head-on but its effects were felt just the same. The affordability and quantity of capital available to the region's firms fell quickly and many investment plans were put on hold. Even firms on the cutting edge of technology met with unexpected difficulties: Brazilian firms that won contracts for building ships and drilling

platforms for Petrobras found that domestic banks would not be able to meet their needs and were forced to go abroad. This will impact regional growth going forward.

According to a 18 September 2008 report in *Valor Econômico*, foreign banks suspended financing of some R$ 12 billion for projects already approved. And this situation repeats itself throughout Latin America (Hollingworth, 2008). Foreign banks, facing higher borrowing costs themselves, are worried about liquidity and how this impacts borrowers, regardless of worthiness, directly and immediately. Sovereign credit spreads widened with the deepening financial crisis (Brazil's went from 190 basis points to 350 bps in September 2008), reflecting rising risks and falling liquidity. During a two-week period in September 2008, more than US$ 2.68 billion left the country. Even if investors were not worried about Brazil's prospects and just needed the money to cover losses elsewhere, the ultimate effect is similar.

Due to the smaller scale of their operations, the costs of participation and capacity-building are relatively greater for SMEs than for large firms. Furthermore, policy, regulatory and institutional frameworks have not always favoured SMEs. This segment is often constrained by opaque regulations, shifting priorities and politically motivated initiatives and incentives. Why this is so remains a mystery. Doubtless, large gaps remain in policymakers' and analysts' knowledge about small and medium size enterprises. The evidence is mixed about how efficient SMEs are relative to larger firms, so it is difficult to assess in what kind of environment SMEs are likely to compete and survive, grow and generate employment (Batra & Tan, 2003, p. 3). Several factors are thought to constrain SME growth, but there is little empirical evidence on which market or policy failures are most important. The shortage of working capital among SMEs is often cited as the principal constraint. Other candidates include poor access to information, low skill levels, weak management and limited technological capabilities. As a result, policymakers have often been forced to devise policies with little or incomplete information about SMEs.

It is obvious that a conservative lending environment will not favour SMEs. Stringent demands for collateral and high penalties for non or partial performance puts smaller firms at a competitive disadvantage. Perhaps in recognition of these failures in recent years, Mercosur countries begun to redouble their efforts to assist and promote SMEs. In June 2008 the finance ministers of the Mercosur economies met to approve funding for SME exporters, as well as 'productive integration' program to "promote economic convergence and reduce competitive inequalities" (ANSA, 2008).

In Latin America, SMEs generally do not find meet with a supportive state apparatus or ample public funds, despite their being major employers and economic drivers, but in Mercosur, at least, this is slowly changing. Here the EU experience could be instructive – after all, SMEs are the backbone of many EU economies, and not just the German or Italian ones, and they are duly supported and encouraged.

A dedicated department or organ to promote SME development would be beneficial to both EU and Mercosur agencies. EU expertise in this area could be tapped and linkages forged between bi-regional firms. Since SMEs have fewer resources than larger firms to achieve their international marketing potential, such linkages could foster bi-regional trade and cooperation.

X. Conclusions

Access to credit is generally considered by Mercosur's smaller SMEs as the greatest barrier to their development and growth. As they are the regional economy's main employers, this is cause for worry. As they are also the most likely partners of EU firms wishing to tap one of the world's fastest growing regions, this is cause for even greater worry.

As regards the availability of credit to the region's SMEs, there are two aspects must be kept in mind. The first regards indicators of quality, coverage and accessibility of credit information; that is to say, the information that lenders use to assess credit risk. Credit rating/scoring has not been a prominent feature of Mercosur's banking practice, historically. The situation improved – out of necessity – after liberalization in the region (excepting Uruguay), but is still in its infancy. The situation in Brazil was typical – its much vaunted credit information system worked adequately when applied to the largest firms and borrowers, but was of no use to smaller borrowers. Bank analysts could give detailed information of their largest customers, but had neither the time and resources nor the incentive to apply the same methods to assessing potential SMEs.

There is substantial scope for improving credit information. The major challenge is to make information on potential borrowers more readily available to lenders, thus facilitating credit creation. Furthermore, this credit information should be made public, strengthening credit information registries and facilitating the portability of credit information across lenders, thereby increasing competition and reducing intermediation costs.

The second indicator depicts how well laws pertaining to collateral requirements and bankruptcy procedures facilitate lending. Banks have traditionally maintained a very narrow of interpretation as to what constitutes 'appropriate' collateral (usually land, buildings and deposits), and even then they were very concerned about the legality of the collateral. Land registries are still often fraught with errors, especially in rural areas, and the provenance of the cash to be used as collateral must often be established (a delicate point given the large informal economies in the region). And as for bankruptcy proceedings, they are still lengthy and costly, even if much improved since liberalization.

Non-banking factors are also important. There are significant structural impediments to SME growth and development. High taxes (and a high number of taxes), inflexible labour laws, excessive bureaucracy and unfair competition all concern the region's SMEs. These concerns would probably be echoed the world over, but Latin American countries were the first and most enthusiastic adherents of import-substitution policies, self-sufficiency strategies and state-directed monopolies in core sectors. This naturally led to a vast bureaucracy and a bureaucratic mindset that affects even small businessmen, not least because the state if often their biggest customer.

Prior to 3Q2008, the path that economic and financial sector liberalization had set was steady and clear. Banks were becoming more efficient, and their loans books were expanding – not just to major firms and the retail sector, but to SMEs as well. Argentine banks were better capitalized and had fewer non-performing loans. Paraguay's banks had grown and matured and were offering more sophisticated products to a wider customer base. And Uruguay's had successfully 'decoupled' from the volatility arising in its neighbours. So with two investment grade economies (plus a former investment grade one) to its name and an expanding global economy as its playground Mercosur's future looked excellent.

But the global credit crunch eventually reached the region. It avoided the worst impacts felt at ground zero (a collapse of its secondary mortgage market and its main investment houses), but felt the financial and economic aftershocks quite cleanly. Sovereign spreads on Brazilian

and Argentine bonds widened (mostly due to a rush to liquidity), investment projects (even those already approved) were put on hold, foreign firms accelerated profit remittances to their headquarters (putting pressure on Mercosur's currencies and on interest rates), and stock market volatility picked up.

Financial sector liberalization had been touted as a way for Latin America to avoid being buffeted by international events not of their making. It would recompense virtue and permit the region's lenders and borrowers to plan for the long term, thus employing scarce capital more effectively and efficiently. But the global credit crisis of 2008 demonstrated that the region is not immune from events to which it did contribute. As a result, there is a growing call for mechanisms to regulate short term capital flows (Gandra, 2008) despite the backtracking that it would involve (Sevares, 2008)**.** Chile's 'encaje' was often mooted as a flexible and effective deterrent to speculative flows and calls for a similar mechanism across all Mercosur countries is likely to grow in direct proportion to the severity of the crisis. The capital control measures contemplated may be seen as temporary insofar as they may be introduced or removed as the situation requires.

For the EU, an increase in Mercosur's capital controls is clearly not a good thing. If the controls are too harsh then flows would dry up and both regions would be penalized; if the holding periods are too long then investment flows will dry up as quickly as portfolio flows. Less likely, but equally worrying, it that by setting up 'mild' capital controls with modest holding periods, portfolio flows may not change much at all, in which case the monetary authorities will deem it an effective tax on financial transactions, raising costs to EU investors with no corresponding benefit to Mercosur's business sector. The temptation to revert to some form of capital control should be resisted.

Post Script. Promoting SME development and opportunities

Latin American SMEs (indeed, all business firms) have been managing growth and change in an environment where the rate, methods and organization of production have changed dramatically since the late 1980s. The debt crisis of 1982 led to almost a decade of economic stagnation and widening inequality in the region; later, trade liberalization, privatization and democratization, as well as the acceleration of the information age helped create the conditions for the region's renewal and promising renaissance. Part of this renewal was shifting policy emphasis to SMEs. Moreover, the SME sector will remain an important component of practically every economy in the region for some time to come. Mercosur's SME sector is estimated to account for upwards of 90% of non-agricultural firms in the region. The region's SMEs also account for between 44% and 65% of formal jobs (SEBRAE). The relative share of SMEs in total output and exports is generally much smaller, i.e., one third or less, but this percentage is slated to grow, especially now that Brazil-Argentina bilateral trade can be done in local currency (Marin, 2008).

It will come as no surprise, then, that efforts to promote SME growth and competitiveness are increasingly mooted. The various financial and economic crisis faced by the region since 1995, but especially the Asian (1997) and Russian (1999) crises, which were far removed from the region both geographically and in terms of economic linkages, served to demonstrate to policymakers that the strengthening and modernization of the domestic economy must precede efforts to fully integrate into the global economy. Weak domestic economies serve neither the interests of importers nor exporters, creditors nor debtors, consumers nor producers.

This renewed focus on SMEs has been gaining steam for almost a decade now. Most recently, during the 35th Common Market Council meeting in Argentina, in June 2008, delegates agreed the creation of a fund to assist exporting SMEs and approved development financing for five infrastructure projects in Paraguay. In addition, the Council signed an accord with the Southern Africa Customs Union (SACU) regarding preferential customs duties, and outlined similar plans with regard to Jordan and Turkey (ANSA, 2008). The Council noted the importance of promoting SME entrepreneurship and employment opportunities.

Thus in the context of current EU-Mercosur negotiations, Mercosur's SMEs present opportunities and challenges to the EU. Moreover, SME development and access to credit is a two-way street, and the dynamics pertaining to policy issues and SME growth and competitiveness apply equally to Mercosur and EU firms. Putting SMEs centre-stage in EU-Mercosur business, trade and development agendas should yield promising results over the coming years.

Equal opportunity for export growth

Measured by actual trade flows, the post-WTO trading system has been a success. Global trade grew, on average, almost twice as quickly as GDP between 1990 and 2005 (World Bank, World Development Indicators), reaching some $16 trillion in 2007, or 31% of world GDP. During the same period, stocks of foreign direct investment expanded almost five times as quickly as world GDP. Even when the fast-growing economies of Asia are taken out of these statistics, the picture looks hardly less impressive.

On a sub-regional level, Mercosur exhibited the most impressive growth in total exports, growing 17% to an estimated $221 billion in 2007. Paraguay led the regional grouping with 63.2% growth in total exports, while export growth in Argentina, Brazil, and Uruguay was 17.6%, 16.5% and 11.5%, respectively over the same period. Effective regional integration in Mercosur continued, with intra-bloc trade rising 27% year-on-year; taken as a whole, members increased their intra-regional exports by more than 20%, led by Paraguay's particularly strong growth (Cornejo, Moreira, & Shearer, 2007).

Latin America has experienced strong growth in its exports for almost a decade, but some clouds are gathering on the horizon. Clearly, the major challenge facing the region is the slowdown (or more likely, the recession) facing the United States – and to a lesser extent, Europe – as a result of the 2008 credit crisis. Similarly, the appreciation of some of the region's currencies, such as the Brazilian real, vis-à-vis the U.S. dollar has not helped those countries' exports to the U.S. Continued appreciation of the region's non-dollarized currencies is likely to adversely impact the region's manufacturing sector in due course. Also, while the recent multi-year increases in commodities prices have proven surprisingly sustainable in a rapidly expanding global economy, this dynamic is likely to change considerably over the medium term, especially if demand from China slows considerably.

In theory, if not always in practice, wealth-generating assets such as finance and technology can be produced, sourced and shifted with relative ease within and across the bloc's economies. There is now greater scope for inter-firm linkages to enhance overall efficiency and competitiveness, but this has not yet led to a proliferation of complex networks, international production schemes and cross-border supply chains (although there have been linkages in the agricultural sector).
The emerging economies of Mercosur share at least one characteristic with those of the advanced EU economies: an increasing reliance on technology as a factor for change. A

country's (potential) competitiveness is increasingly a function of its technological resources, and less of its natural resources. Japan and other relatively commodity-poor Asian economies consistently progressed since the 1950s, first through Import-Substitution (IS) and later through export driven schemes. In Latin America, by contrast, a mercantilist, zero-sum, mindset prevailed until very recently, and the region's vast natural resources were guarded jealously to 'preserve autonomy' even as its human capital remained undeveloped as a result of inefficient and insufficient investments in education and training.

It is widely accepted now that competitiveness is a function of human resources and its application, and that it can be developed by factors other than propitious geographical location and natural resource endowments. The quest for productivity gains, then, has become more frantic. Since the early-1990s and Mercosur's liberalization and privatization initiatives, more thought and effort has gone into acquiring and applying information technology and advanced innovation and management skills. Even so, research and development (R&D) expenditures in the region amount to just 0.6% of GDP (two thirds of which by the state sector) – compared to an average of 3% in the G7 – and the pace of expenditures on information technology is outstripping the world average (currently 2% of GDP in Brazil – the highest among the BRICs and comparable to France and Japan) (Agência Estado, 2008). The figures for expenditures on computers and computer technology, however, are likely to be understated, as all Mercosul economies have a sizeable and sophisticated 'informal' or 'black' component exceeding 40% of GDP, according to the World Bank and others.

Even medium-sized firms still employ 'informal' market operations to save costs and reduce their tax bill, but this is becoming less prevalent as SMEs develop more integrated operational networks that by definition require transparency of operations and accounts.

Assessing competitiveness

SMEs generally require assistance – financial and operational – to grow and compete. Of course, it is expected and assumed that this will likewise raise the level of competitiveness and dynamism of other local enterprises and, consequently, the greater economy. Needless to say, however, that some SMEs receive more support and services than others. Mercosur members' priorities have become more focused, following their liberalization, privatization and administrative deregulation or de-bureaucratization efforts. Some industries were specially favoured; for example, companies competing in the energy markets – alternative or traditional – have received the bulk of the attention. But firms in traditional, consumer-oriented manufacturing (e.g., toys, shoes) have largely been left to fend for themselves.

For businesses not operating in a rapidly growing environment, competitiveness is processed and assessed at the micro-level[3], regardless of whether it is measured and benchmarked at the industry, sectoral or national level. Largely for this reason, the quantity and quality of data and information available in the region regarding SME activity is insufficient to effectively monitor and contrast the evolving capabilities and potential of a broad spectrum of firms. Unfortunately, this information is necessary in order to gain an accurate picture of the capabilities (and weaknesses) of regional SMEs.

[3] That is, at the department, project or individual level.

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ANNEX 2. CASE STUDY OF THE BRAZILIAN REINSURANCE SECTOR

Pedro Regina

Executive Summary

This report provides an overview of the liberalizing Brazilian reinsurance sector, the largest in Latin America, and examines recent developments and prospects in the regional context.

The report discusses the policy context for the insurance sector in Latin America since 1990. After a brief history of the evolution of the insurance sector in Brazil, if focuses on the liberalization of the reinsurance sector, including the end of the state-owned monopoly IRB-Brasil Resseguros S.A.

The report discusses opportunities and prospects for reinsurance in Brazil and notes that reinsurance premiums in Brazil could double in less than 5 years, implying yearly growth of some 15% p.a. Furthermore, the consolidation of the primary insurance sector could spark a boom in M&A activity over the medium term, both for foreign insurers looking to gain a foothold in the Brazilian market, and for large local insurers looking to expand. European insurance companies, many of which have already undergone competitive consolidation in their own home markets, will have the experience and resources necessary to compete in the liberalized Brazilian market.

The main conclusions of the report suggest that:

- Liberalization and increased competition should fuel the rapid development and sophistication of Brazil's reinsurance market.
- New entrants to the Brazilian reinsurance market will quickly fill niches, offering new products. Established global companies, but new to Brazil, will increase competition and help develop the country's insurance industry, including reisurance. Driven by falling reinsurance costs, the country's insurance sector will grow, further fuelling growth in the reinsurance sector, in a virtuous cycle.
- Because of this and the country's increasing integration with the global economy, reinsurance in Brazil is poised to become more dynamic, permitting it to adapt more quickly to evolving market conditions. Brazil's general economic growth and relative underinvestment in transport and energy infrastructure practically ensure that it will continue to attract large corporations and large-scale investments. These in turn will further drive the country's already impressive agricultural sector, and also fuel the rapid development and sophistication of its reinsurance market.
- A mass reinsurance market, however, is still in the distant future, and the consensus is that in these early days after liberalization, the focus of the established player and the first movers will be on a relatively small number of high value clients. Over the medium to longer term, specialist or niche expertise, such as that available to European reinsurers, will offer new products and services that will transform the insurance landscape in Brazil and the region.

Introduction

Between the discovery of South America in 1500 and until the widespread European migration to that continent at the end of the 1800s, the Southern Cone's insurance industry was a limited affair. Brazil, the largest country in the region, counted only two million people at the start of the 19th Century and some 18 million at the end of it (much of the increase by way of the slave trade and large-scale immigration destined for rural labour); Argentina grew from less than 800,000 people to 4.6 million over the same period; Paraguay had barely 400,000 at the start of the 20th Century. Most insurance in this period arose from the maritime trade and was dominated by Europeans, with locals having only marginal participation.

The start of the 21st Century finds Mercosur countries in a much better position, insurance-wise, and with brighter prospects for the coming years. The low levels of insurance penetration throughout the region suggest that these markets have the potential to grow strongly. The potential for sustained growth has never been better, and recent political and economic developments in the region point to an attractive investment climate for insurers. Brazil, the country that this report focuses on, currently represents 40% of the Latin American insurance market and its market looks well placed for growth given the improving economic environment and the deregulation of reinsurance.

However, in Brazil insurance penetration is still very low, although it rose to approximately 2.7% of gross domestic product in 2007 (excluding private pensions), up from 1.6% in 2002. Chile, the leader of the largest four countries in terms of penetration, did slightly better and insurance penetration was 6% in 2007 from 4.1% in 2002. In comparison, the average per capita insurance spend in the United States is 9.2% of gross domestic product (Benfield Group Limited, 2007, p. 6).

While the insurance sector in general offers substantial long term potential to established European concerns, Brazil's reinsurance market is undoubtedly the last great frontier in Mercosur's insurance sector. This market was constrained by a government-sanctioned monopoly for the past seventy years. Now that this monopoly has ended both domestic and international insurance companies can look forward to participating actively in the sector. The question remains, however, of how quickly or thoroughly the heavy hand of the state and the dominance of the incumbent will cede space to newcomers.

This report provides an overview of the insurance industry in Mercosur, with a focus on the reinsurance sector in Brazil. In line with the Sustainability Impact Assessment (SIA) methodology, outlined in George & Kirkpatrick (2004), it gives special attention to economic, social and environmental aspects. The report is divided into four main sections, with some sub-sections:

I. Policy Context of the Insurance Sector in Latin America;
II. Brief History of the Insurance Sector in Brazil;
III. The Brazilian Reinsurance Sector: Past, Present and Future;
IV. Impact assessment: Economic, Social and Environmental.

This report does not rely much on published academic papers, nor indeed on published industry reports. Experience tells us that the former provide an excellent analysis of the past, but are of little predictive use, while the latter is not rigorous in its analysis, often putting a gloss on uncomfortable truths. The analysis and conclusions of this report, then, owes more to the author's own experience and that of the market practitioners with whom he consulted. Former Brazilian President Fernando Henrique Cardoso once opined that policy-making was

about integrating the desirable with the possible. In an ideal world, regulators would be independent, transparent and incorruptible; markets would be open, and supported by an efficient and technically proficient judiciary. Although the current situation is far from perfect, it still is substantially better than it was ten or fifteen years ago; and bi-regional negotiations could ensure further improvements in the next ten or fifteen years.

Finally, a word of caution: it is important to keep in mind the pitfalls of establishing exact comparison figures. For example, certain numbers, like the 2.7% penetration rate for Brazil are bandied about by the press and certain government offices with scant notion of how the number was derived. Not only is it unclear which insurance products are under consideration (and these *do* vary), but also which calculation of GDP is being used (the Finance Ministry changed its calculation methodology for nominal GDP in early 2007; moreover, many comparisons utilize PPP figures which create additional problems).

I. Policy Context of the Insurance Sector in Latin America

A well functioning insurance market is not only important for financial sector development but is also complementary to productive activities. Insurers enter the market with equity capital and write insurance policies, which act as a form of debt capital. The funds raised in the issuance of both types of capital are invested until required to pay out claims. In this context, an effective insurance sector is not only relevant for productive and economic activity and for facilitating risk diversification, but also plays a vital role in the investment of savings (Masci, Tejerina, & Webb, 2007, p. 4).

Far-reaching policy shifts occurred in Latin America during the 1990s, largely in response to the after affects of the debt crisis of the previous decade. Seeking to stimulate their economies and spurred on by neo-liberal fervour, the countries of the region privatized, liberalized and deregulated in order to strengthen their financial markets, including their insurance markets.

Privatization: Government participation in the economy through state-owned enterprises was scaled back considerably in the 1990s in Mercosur countries. While seeking out greater productive efficiency and fiscal rectitude, privatization also was hailed as a way to kick-start domestic capital markets by widening share ownership, expanding the supply of investment securities and lowering the cost of corporate borrowing. State-owned industrial and financial firms were sold off or opened to competition; the only major state-owned player in Mercosur insurance markets that remained was IRB-Brasil Resseguros S.A. (IRB), Brazil's reinsurance monopoly.

At the time, there was also a movement toward social security (pension) privatization, intended to deepen capital markets by generating a pool of private savings to finance private investments. Individual capitalization regimes began replacing state-run pensions in the region, following Chile's (1981) groundbreaking example. Peru moved to an individual capitalization regime in 1993, Argentina and Colombia in 1994, Uruguay in 1996, Bolivia and Mexico in 1997 (Masci, Tejerina, & Webb, 2007, p. 13). Brazil tried to move in the same direction, but met with resolute resistance from factions on the left. Modest pension reforms were approved in 2003 and 2006, and complementary pensions (including redeemable life policies) began to grow in importance as a result.

Liberalization: The liberalization of Latin American financial markets (including stock markets) intensified in the 1990s. The opening to international finance, it was assumed, would increase the inflow of foreign capital, as well as provide more rigour and efficiency to

domestic capital markets. Some (Argentina) embraced the logic wholeheartedly, some chewed around the edges (Uruguay), some never quite grasped the attraction (Paraguay), and others (Brazil) grasped defeat from the jaws of capital markets development victory. In implementing a 'temporary' tax on financial transactions[1] in 1997 to cover a budget shortfall, Brazil managed to transfer an incipient domestic capital markets boom to New York (PUC, 2003). This was possibly the worst self-inflicted capital markets disaster since President Kennedy imposed an interest equalisation tax and effectively launched the Eurobond market.

On the insurance front, liberalization was expected to entice foreign insurers into providing new capital and know-how through innovative and sophisticated insurance products and distribution channels. With reduced entry barriers, many international insurers entered the region's insurance markets. Merger and acquisition activities accelerated and competition intensified. By 2004, the market share of foreign insurers ranged between 30% and 75% in economies within the region's market.

Regulatory Reform: Across the region, alongside privatization and liberalization, advances in securities market supervision, governance and infrastructure accelerated rapidly in the 1990s. The goal was to modernize exchange platforms and systems to lower transactions costs, as well as to create regulatory bodies and legislation to protect investors and elicit more investment (Masci, Tejerina, & Webb, 2007, p. 14). However, after some initial successes, in both Brazil and Argentina, the independence of regulators has been gradually eroded since 2002.

II. Brief History of the Insurance Sector in Brazil

Insurance in Brazil began in 1808, with the establishment of the country's first insurance company, the Companhia de Seguros Boa-Fé in the state of Bahia, the epicenter of the country's maritime industry at the time. Indeed, it was only in the mid-1800s, with the enactment of the Commercial Code, that anything other than maritime insurance became widely available. With commercial legislation firmly in place, the insurance industry began to offer a variety of new products, such as fire insurance and slave indemnity (an important source of labour at the time).

In 1855, the Companhia de Seguros Tranqüilidade was established in Rio de Janeiro, offering the first life insurance policies in Brazil. A few years later, several foreign firms began establishing operations in the country. In 1935, the company that was to become Latin America's largest insurance company, Atlântica Companhia Nacional de Seguros (which evolved into today's Bradesco Seguros), was founded.

State intervention in the insurance sector became overt when, in 1939, the administration of President Getúlio Vargas established the Instituto de Resseguro do Brasil (IRB) and granted it a monopoly on reinsurance activities in the country. The intention was to concentrate reinsurance premiums in Brazil and limit capital flight through foreign insurance companies. This monopoly *legally* ended in January 2007 (although complementary legislation was not effected until early 2008). However, it still remains to be seen when IRB's long-standing monopoly *effectively* ends.

[1] Earmarking the proceeds to finance the national health system.

III. The Brazilian Reinsurance Sector: Past, Present and Future

Liberalization and attempted privatization of IRB

Instituto de Resseguro do Brasil (IRB) remained a monopoly for almost 70 years, until the government reluctantly yielded to pressure to liberalize. In 1997, IRB became a joint stock company and its name changed to IRB-Brasil Resseguros S.A. The government held a 51% stake (and 100% of the voting stock) in IRB, with the remainder held by a number of Brazilian insurers. At this point, the government of President Fernando Henrique Cardoso (1995-2002) made the first attempt to privatize IRB, as part of its economic reform agenda, but opposition politicians convinced the courts to declare the process unconstitutional. A series of legal wrangles forced the government to back down and postpone subsequent privatization attempts. The earlier opposition was only overcome once the Workers' Party (PT) itself came to power, and President Lula da Silva finally managed to push the reforms through Congress in early 2007, at the start of his second term in office.

Thus, after ten years of false dawns, in 2007 Supplementary Law 126[2] was approved and sanctioned, thus formally opening the Brazilian reinsurance market. The law required regulatory legislation to be effected but this was not immediately forthcoming. It was only in early April 2008 that the Superintendência de Seguros Privados (SUSEP), the insurance regulator, began authorizing licenses for other reinsurers to enter the market.

Thus, in 2007 IRB was one of only two remaining majority state-owned monopolistic reinsurers in Latin America (the other was in Costa Rica). For years, the government had seen no reason to privatize IRB, reasoning that it was a profitable organization that added to government coffers (Tamer, 2006). The situation is not unlike that of another former monopoly, Petrobras, which remains dominant (and more profitable than ever) in the domestic market, despite a modest reduction in its market share. The process of liberalization was overly drawn out and was marked by malleable timetables that further rendered the Brazilian reinsurance market an international anomaly.

Table 1: Steps to end IRB monopoly.

- On 17 July 2007, the CNSP approved Resolution nº 164, establishing transitional norms for the reinsurance sector pending the issuance of definitive norms;
- On 17 August 2007, SUSEP Circular nº 350 detailed some of the rules to be observed during the transition period;
- On 17 December 2007, CNSP implemented Suplementary Law nº 126/07, via Resolution nº168/07;
- On 17 April 2008, the reinsurance market was formally opened;
- On 14 October 2008 the extraordinary transition period granted to IRB will end.

IRB's monopoly is now formally broken and it is 'just' another firm in the market. However, a series of 'safeguards' in the relevant legislation gives IRB a market reserve (60% for three years, falling to 40% thereafter) in some areas, such as Life and Pensions, and in the market as a whole, partly to ensure a national champion (Júnior, 2008). To this end, IRB had begun a process of institutional modernization even before its monopoly was broken. Conscious of the need to maintain its competitive position, IRB's board had implemented a series of measures designed to enhance its competitiveness and efficiency. For example, it created an

[2] Here is a brief description of the law in Portuguese: LEI COMPLEMENTAR Nº 126, DE 15 DE JANEIRO DE 2007. Dispõe sobre a política de resseguro, retrocessão e sua intermediação, as operações de co-seguro, as contratações de seguro no exterior e as operações em moeda estrangeira do setor securitário; altera o Decreto-Lei no 73, de 21 de novembro de 1966, e a Lei no 8.031, de 12 de abril de 1990; e dá outras providências.

ombudsman's office, established productivity targets, and reinstated the practice of holding competitive examinations for new hires.

The current scenario

IRB-Brasil Re had 3.27 billion reais in reinsurance premiums and net profits of 374 million reais in 2007, and SUSEP believes reinsurance premiums will hit 5.2 billion reais in 2008, although local analysts put the figure at closer to 4.5 billion for this year, before rising to 5 billion reais in 2009, 6 billion reais in 2010 and 6.5 billion reais in 2011. Reinsurance premiums could climb as much as 200% in the first three years post-liberalization. These estimates do not seem unreasonable given the size of the Brazilian economy (2.5 trillion reais in 2007).

Not surprisingly, a number of competitors have sought to enter the reinsurance market, including those from Switzerland, Germany, the United Kingdom, the United States and Spain; French and Italian firms have also expressed an interest in the sector. In addition, local niche insurance companies, such as the budding reinsurance division of surety bond specialist J Malucelli, have made evident their interest in competing in the sector. What they all seek is a piece of Latin America's largest reinsurance pie.

The liberalization of insurance markets in emerging economies, such as those of Mercosur, is attractive for a number of reasons. None of the countries has the necessary capital to meet all domestic insurance requirements, including reinsurance needs, as evidenced from their low penetration levels. In Brazil, the liberalization of the reinsurance market will encourage competition for business and should result in the end of set rates and the beginning of differentiated pricing on a risk-adjusted basis. Also, open and competitive markets encourage an inflow of foreign-based talent and capital, which in turn strengthens the market and provides product innovation and development. The early signs suggest that this is exactly what is occurring.

Fundação Escola Nacional de Seguros (Funenseg), an educational institution, believes that the reinsurance market has much room to grow and that insurance companies in Brazil will reinsure 14% of written premiums by 2011, compared to 5.7% in 2007. In other Latin American markets, insurers reinsure 20-25% of written premiums. It must be noted, however, that many of those countries are subject to natural disasters absent in Brazil, such as hurricanes in Mexico or earthquakes in Peru. Nevertheless, certain sectors of the country could still benefit from more extensive reinsurance coverage; in agriculture, for example, Brazil periodically experiences droughts in the northeast and frosts in the southeast.

The prospects for growth are excellent and the general reinsurance market is expected to outpace overall economic growth, with European and other international reinsurers introducing new products and new practices, satisfying segments previously underserved by IRB. During the first half of 2008, SUSEP, the insurance regulator, had authorized ten international reinsurance companies to set up operations in Brazil, and it anticipated authorizing 40 or 50 more by the end of the year.

Supplementary Law 126 of January 2007, which ended IRB's monopoly, allowed for the creation of three categories of reinsurers:

- Local reinsurers – headquartered in Brazil and writing only reinsurance;
- Admitted reinsurers – headquartered abroad but with a Brazilian representative office;

- Eventual (occasional) reinsurers – headquartered abroad with no Brazilian representative office, but with approval to provide reinsurance products within Brazil.

As of this writing, SUSEP has authorized J Malucelli Resseguradora, a venture of Paraná Banco, a domestic bank, and Germany's Munich Re to also write business as local reinsurers. Mapfre Re and XL Re, part of XL Capital, are still awaiting approval to begin operations as local reinsurers, but Mapfre Re has already received authorization to operate as an eventual reinsurer.

Table 2: Reinsurers in Brazil

Reinsurance Firm	Category
IRB BRASIL RESSEGUROS S.A.	LOCAL
EVEREST REINSURANCE COMPANY	EVENTUAL
HANNOVER RÜCKVERSICHERUNG AG	EVENTUAL
J. MALUCELLI RESSEGURADORA S.A.	LOCAL
LLOYD'S	ADMITTED
MAPFRE RE, COMPAÑIA DE REASEGUROS, S.A.	EVENTUAL
MÜNCHENER RÜCK DO BRASIL RESSEGURADORA S.A.	LOCAL
MUNCHENER RUCKVERSICHERUNGS-GESELLSCHAFT AKTIENGESELLSCHAFT (Munich)	EVENTUAL
SCOR REINSURANCE COMPANY	ADMITTED
SWISS REINSURANCE AMERICA CORPORATION	ADMITTED
SWISS REINSURANCE CORPORATION	ADMITTED
TRANSATLANTIC REINSURANCE COMPANY	ADMITTED

Source: SUSEP

Local reinsurers will retain the right of first refusal of 60% of new business until January 2010, as stipulated in the law, and 40% thereafter barring any change in the law. And, as noted earlier, any notion of privatizing IRB has been discarded for the time being (Haddad, 2008).

The recently authorized local reinsurers undoubtedly had their sights firmly on the 60% right of first refusal, especially as a local reinsurer can write up to 100% of a reinsurance contract. An interesting case is that of the local firm J Malucelli Resseguradora. Last year, J Malucelli passed along 87% of premiums to reinsurers, paying approximately 150 million reais for reinsurance coverage, primarily from IRB. Now it expects to increase retained premiums to 35-40%, from 13% in 2007. According to its CEO, it has modest ambitions, at least to begin with, intending to act as a captive reinsurer for J Malucelli's surety bond business for the first three years. Thereafter, it plans to make a move towards becoming a key reinsurance player in Latin America. J Malucelli Resseguradora estimates that it will bring in 200-300 million reais in reinsurance premiums in its first year of operations. Surprisingly, competing surety bond providers were also signing contracts with the company (Paraná Banco, 2008). This was a clear indication that niche players offering specialized levels of expertise stand to make quick inroads into the market, and should offer further incentive for smaller European insurers and reinsurers to consider this market carefully.

But it was not only the local reinsurers that were optimistic. Although local reinsurers have preferential access to 60% of business for the next 18 months, even eventual reinsurers, such as Mapfre Re of Chile, have potential. They could add value through niche expertise, thus allowing for a dispersed risk distribution among interested reinsurers, whether local, admitted

or eventual. Furthermore, the legal stipulation forbidding companies less than five years old, or those based in tax havens, from registering as reinsurers in Brazil should ensure that the market will not be overrun with dubious operators.

A number of regulatory issues still cause concern to potential market entrants, but one that has already led reinsurers to complain relates to capitalization requirements. Supplementary Law 126 stripped IRB of its role as the reinsurance market's regulator and handed the responsibility over to SUSEP, an arm of the Finance Ministry. SUSEP's draft proposal for regulating the sector, released in October 2007, met with the general disapproval of market participants. Here, SUSEP proposed that local reinsurers have at least 60 million reais in capital and admitted reinsurers have 100 million reais in capital and deposits of at least US$5 million in a local bank account. Occasional reinsurers were to hold 150 million reais in capital.

Unsurprisingly, Brazilian insurance companies complained that the proposed measures would discourage international reinsurers from participating in the domestic market. Lloyd's of London initially reacted with a warning that it might have to postpone plans to come to Brazil as a result. Although Lloyd's eventually relented and signed on as an admitted reinsurer, it was not before Brazil's National Council of Private Insurance (CNSP)[3] took onboard some of the concerns of insurers and reinsurers alike. After some consultation, CNSP ratified (in December 2007) a somewhat less onerous version of the regulations.

Current regulations require local reinsurers to have at least 60 million reais in starting capital. However, in other categories, those that were rated A+ to A- would not have to keep additional funds in Brazil. Those rated BBB+ have to keep 10% of premiums as additional capital, while firms rated BBB have to keep 20% and those rated BBB- 30%. For admitted reinsurers, the regulations require that they deposit 5 million US dollars in a domestic bank for writing P&C coverage and 1 million US dollars for life.

These regulations are stricter than those of other Latin American countries, but clearly not so much as to keep foreign reinsurance companies away (Hollingworth, 2008). Nevertheless, requiring a rating above investment grade for preferential treatment was more conservative than in other countries in Latin America, as most are content with an investment grade rating. Clearly, this was unlikely to discourage the larger European reinsurers from coming to Brazil, as they were in any case already rated above investment grade. But reinsurance companies not so highly rated might think twice before coming to Brazil, despite being financially capable of writing business in the country. Smaller European niche players might be put off from entering the Brazilian market, and by extension the other, smaller markets of Mercosur. Once the market is more settled, it would make sense to revisit the rules governing capitalization to ensure that smaller players are not being left out and that premiums are not too high as a result.

Opportunities in the Reinsurance Sector

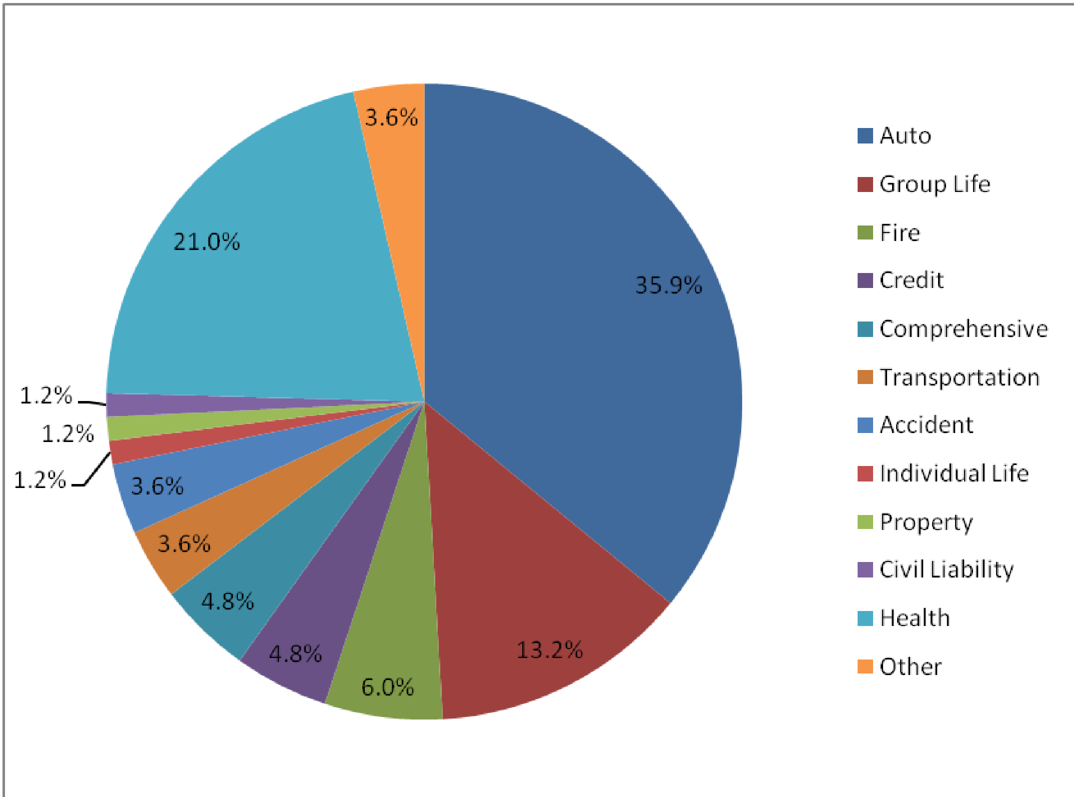
Industry optimists believe that reinsurance premiums in Brazil could double in less than 5 years, implying yearly growth of some 15% p.a. And while others doubt premiums will rise so quickly (perhaps in light of the fact that *insurance* premiums are not slated to retreat very much, at least initially), no one suggests anything other than that Brazil's reinsurance sector will grow substantially over the next few years.

[3] The National Council of Private Insurance (CNSP) is the insurance sector's deliberative body and it is responsible for the settlement of the Brazilian Government policies' guidelines and directives for insurance and capitalization companies and open private pension entities in Brazil.

SUSEP has set its sights on doubling general market and reinsurance premiums within the next four years, an implied growth of 19% p.a. For 2008, SUSEP forecasts that general market premiums will rise 20.6% to 70.7 billion reais, not including health premiums monitored by healthcare regulator Agência Nacional de Saúde (ANS). Brazil's National Federation of Insurers, Fenaseg, estimates that insurance premiums in Brazil will grow 13.5% to 96.4 billion reais, including health premiums, before going up 10.0% to 106 billion reais in 2009 and then 9.20% to 116 billion reais in 2010. As noted earlier, different organizations define the 'insurance sector' in slightly different ways, so all figures must be used with care.

SUSEP's latest figures show a premium growth of 18.4% in the general market, to 21.3 billion reais, in the first four months of 2008 compared to the same period the previous year. Consensus forecasts suggest that the general market will continue to outpace GDP growth over the medium term, thus increasing insurance penetration in Brazil and spurring higher demand for reinsurance. However, in discussions with industry analysts, most were reticent about precisely defining the 'medium term', noting instead that the general liberalization of financial markets, favourable economic conditions – domestically and internationally – and a fundamental strengthening of the currency all work in favour of a significant expansion of the insurance/reinsurance market in Brazil.

Figure 1. Brazilian Insurance Premiums (2007). USD 16.2 billion (excludes Private Pensions and Redeemable Life Policies)



Sources: SUSEP, Swiss Re and Author

Of course, even if *insurance* premiums double within four years, as SUSEP supposes, it is no guarantee that *reinsurance* premiums will double as well. Automobile insurance, for example, represents roughly a third of all premiums in Brazil but depends less on reinsurance

coverage than other lines do. On the other hand, automobile insurance is one of the slowest growing lines of insurance, so its share should decrease quite quickly.

Fenaseg is confident reinsurance premiums will top 3.5 billion reais in the first year of a liberalized market, but believes that most of it will come from big policies for big companies. For the moment, it sees reinsurance in Brazil as being for large risks; not for retail products. But that might be due to the lack of new products and new technologies, whose introduction could unleash a repressed demand for reinsurance. Nevertheless, the retail consumer portion of the insurance sector is unlikely to experience burgeoning growth, as this subsector will not suddenly splurge their discretionary income on products that they have managed so long without.

In 2007, IRB received 51.3% (1.68 billion reais) of its reinsurance premiums from property coverage, with fire coverage accounting for 36.7% of its premiums (1.2 billion reais). International reinsurers expect property coverage will continue to represent the bulk of reinsurance premiums in Brazil, but are looking to diversify into specialty or niche lines unavailable from IRB. Property, including large industrial risks, has grown modestly over the past five years, but is likely to meet with growing demand as moderate (4%-5% p.a.) economic growth continues.

European firms have led the charge in entering the Brazilian reinsurance market. Swiss Re, the world's largest reinsurer, has been authorized to operate as an admitted reinsurer and believes that increased government investments in infrastructure projects will fuel demand for insurance covering engineering projects. This thinking is in accord with what many economists think: that Brazil lacks investment in infrastructure to accommodate sustained non-inflationary growth. The country needs many more ports, airports, roads and hydroelectric plants. And while the present government clearly sees the need for this, its preference for financing large-scale infrastructure projects through private-public partnerships has not resulted in an investment boom.

Other promising areas for insurers and reinsurers over the longer term include agricultural insurance both for crops and livestock, and life insurance, especially individual life policies. Needless to say, agriculture is still a significant contributor to the Brazilian economy (5.6% in 2007, according to the Brazilian Statistical Institute, IBGE), but patchy infrastructure means that it is not fully exploited.

In the short to medium terms, smaller, niche players, in the reinsurance arena would do well to focus more on property, liability, marine, energy and aerospace lines. European firms with specialized expertise in these areas would stand a good chance of growing with the market, as well as helping to shape and develop it.

Competitive pricing

Conventional economic wisdom states that prices will tend to fall in an open market. IRB charges too much for reinsurance (especially given the distinct lack of environmental or natural disasters in Brazil), so direct competition should lead to price cuts that benefit end users. IRB had an extended combined ratio[4] of 67.5% in 2007, which, is significantly better than the 90%+ that most major reinsurers the world over enjoyed during the same period.

[4] A measure of the profitability of an insurance company. The combined ratio equals expenses and losses divided by revenue from premiums. A value greater than 100% means the company is paying out more than it's taking in, and a value less than 100% means it is taking in more than it is paying out. The Extended Combined Ratio includes financial gains from the reinvestment of premiums.

This number suggests that IRB is either a highly efficient reinsurer or an expensive one. As the latter is more likely, prices could fall even in the short term as ceding companies[5] negotiate terms and conditions more aggressively, rather than just accepting what IRB gives them. But because of IRB's existing agreements and contracts, it might take a year or more for an impact to be felt in the market as a whole.

Reinsurance sector prospects

In its monopolistic days, IRB tended to treat all ceding companies more or less in the same manner. It realizes, of course, that those days are over and that it will have to compete more effectively if it is to retain business and diversify into new areas.

Smaller insurance companies might have a more difficult time buying reinsurance coverage at the same prices as before, and might therefore prompt a consolidation of the primary insurance sector.

As an arm of the state, IRB traditionally helped smaller insurers through lower prices, but this is likely to come to an end – and sooner rather than later. IRB's customary tariff-based pricing will give way to differentiated underwriting, leading to higher reinsurance rates for small and midsized insurers. Large insurers, however, will increasingly be able to negotiate lower prices with international reinsurers, putting smaller insurers in Brazil at a further disadvantage.

The consolidation of the primary insurance sector, therefore, spells a coming boom in M&A activity over the medium term, both for foreign insurers looking to gain a foothold in the Brazilian market, and for large local insurers looking to expand. European insurance companies, many of which have already undergone competitive consolidation in their own home markets, will have the experience and resources necessary to compete in the liberalized Brazilian market.

In addition to higher reinsurance rates, smaller insurance companies in Brazil face the challenge of coming to grips with new solvency margin rules mandated by SUSEP. These give insurers until end-2011 to have 15 million reais in base capital and raise additional capital to a stipulated percentage of premiums, depending on their segment.

Insurance companies could turn to reinsurance to improve solvency margins[6] , but the new capital requirements could also reduce their profitability, limit future growth and convince smaller insurance companies to subsume their operations to the activities of a larger player.

IRB in a liberalized market

IRB has been living with the threat of losing its monopoly for over ten years now, but until recently it did very little to change its operations. However, once deregulation became inevitable, IRB has shown that it is willing to change its ways and compete in an open market. As a result, few predict that it will lose its market leadership any time soon. It naturally expects to lose some of its market share, but also expects to make up for it in volume as the market grows. IRB believes that the growth potential is so great that it will gain business through new products and new niches; its financial solidity underscoring its confidence. IRB

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[5] Insurance company that transfers a risk to a reinsurance company.

[6] The solvency margin is a minimum excess on an insurer's assets over its liabilities, as set by regulators. It is roughly similar to the capital adequacy requirements for banks.

hired a consultancy in early 2008 to draw up a new business plan and hinted that it could work with foreign partners to bring specialty lines to Brazil.

IRB certainly has the potential to consolidate its position as the largest reinsurance provider in Latin America, provided the government and its regulator employs a light touch and permits IRB to operate as a normal, non-monopolistic concern. For the moment, the state-owned company still retains a certain inflexibility, such as in its procurement practices, where it must hold auctions for practically everything. But, it must be remembered that its knowledge base concerning the national economy and the insurance sector is second to none, and its capital base puts it on a different plane to its competitors. So, it starts the race from a competitive position, but cannot afford to become complacent.

Impact assessment

Insurance/reinsurance companies, as de facto institutional investors in corporations, not only help advance capital allocation but also promote financial market stability through the monitoring of their exposure. The broader insurance industry's portfolio has large long term components, with attendant liquidity needs, and thus constitutes a natural complement for capital market development. Large cash inflows and reserves (linked to premium payments) are largely invested in liquid instruments such as government and blue-chip corporate bonds (equities do not feature prominently in Brazilian and most Latin American insurance portfolios, although they are typical instruments of developed capital markets). With growing demand for insurance, and by extension reinsurance, services it follows that the array of financial instruments (bonds, equity and structured securities, for example) available in the domestic market will also increase.

In the context of financial market development, then, insurance services play a crucial role in financial product development, risk management and in the allocation of savings. The development of robust, modern and open insurance markets is an essential component of financial reform and capital market development in any emerging economy.

Impacts on core economic indicators

Liberalization of Brazil's reinsurance market should impact the EU positively, albeit modestly, on all three core economic indicators (real income, employment and fixed capital formation). The potential benefits and associated risks are larger in Brazil and, through proximity, the other Mercosur countries, as summarized below. In addition, in the absence of effective strengthening (both in Brazil and the wider Mercosur) and coordination (biregionally) of regulatory systems, liberalization of the reinsurance market is likely to be accompanied by increased risks of instability, but in view of the large size of the EU economy and its financial services component the effect on the EU is likely to be small.

<u>Real Income</u>

In the short term, quantifiable gains in the real economy are likely to be positive, but too small to be significant. Larger long term gains will accrue regardless of whether the opening of the reinsurance market is complemented by domestic regulatory reform and effective coordination between Mercosur and the EU. However, in the absence of further regulatory strengthening and transparency, the gains will be tempered by a higher than necessary risk environment, detrimental to both EU and Mercosur countries. It is true that the implementation of appropriate and effective regulation would entail both costs and time to

Mercosur governments, but the EU would be remiss in its obligations were it to relegate this most important of considerations to the backburner.

Fixed Capital Formation

In the case of the Brazilian reinsurance market, its exposure to foreign entry and competition may reasonably be expected to result in a negligible decline, if any, in domestic investment in the sector, accompanied by expanding commercial presence on the part of EU companies. Indeed, given the lack of competition in the market until recently and the high prices prevailing even now, the robustness of the sector and its growth is practically assured, even in the short term.

Employment

In the context of reinsurance, there is unlikely to be any negative adjustment effects on employment in the short-run, despite a partial transfer of activity to EU suppliers. The sole supplier of reinsurance services in Brazil was a state-owned concern and its employees were thus civil servants with heightened employment stability. The end of the monopoly should not affect IRB's employees' job status. The overall outlook for employment in the sector, then, is highly positive as efficiency and productivity gains will be accompanied by new services and products requiring more specialized talent, both domestic and foreign.

However, it should be noted that without a corresponding strengthening (both in scope and in independence) of the domestic and international regulatory regimes, the growing clout of the sector will bring increased risk of financial instability in its wake. One need only refer back to the myriad financial crises of the recent past to note that almost all were triggered by failures in regulation and/or oversight.

Impacts on core social indicators

The social impacts will be closely linked to the economic impacts. In the EU they are expected to beneficial but small, through indirect effects on poverty and on health and education. Impacts on equity are also expected to be small, and neutral overall. Larger potential impacts are expected in the Mercosur countries.

Poverty

Employment in the financial services sector is primarily of professionals and high skilled workers, with little direct influence on poverty. The short term impact on wage rates in the sector is expected to be fairly neutral, associated with a small decline in employment in local firms and increased demand in international firms.

The main impacts in Mercosur of liberalisation are expected to occur through indirect effects on other economic sectors. Provided that liberalisation achieves the desired effect of stronger economic growth, it can be expected to have a significant long term impact on poverty alleviation. However, if carried out without effective measures to strengthen the regulatory regime, the greater risk of financial instability would carry corresponding risks of severe adverse impacts on poverty in both the short term and the long term.

Health and Education

Impacts on health and education will be similar to those on poverty, occurring indirectly rather than directly. If stronger economic growth is achieved, this can be expected to deliver long term benefits in the provision of health and education services. Conversely, any increase in the risk of financial instability could result in severe adverse impacts on expenditure and hence on the provision of these services.

Equity

The potentially adverse short term effects and beneficial long term effects on employment in financial services will have corresponding effects on female employment, which tends to be relatively high in the sector. The gender effects and other distributional impacts are not, however, expected to be significantly large.

Impacts on core environmental indicators

One of the insurance subsectors identified for significant growth is agriculture. On the face of it, it bodes ill for Brazil, which is always battling against illegal deforestation for agriculture, to suddenly find that it can insure against the unexpected more cheaply – the cost of entry and operating in the agricultural sector would fall, which might be a bad thing. Actually, the opposite is true. Only legitimate and environmentally conscious firms would be able to access lower cost insurance, which will drive the cost differential between legitimate concerns and shady ones wider, driving marginal operators out of business.

Over the longer term, the beneficial impact on the environment is likely to contribute positively to economic growth. All three core indicators (biodiversity, environmental quality and natural resource stocks) are likely to benefit from the growing sophistication and falling costs of agricultural insurance.

Impacts on process indicators

Consistency with sustainable development principles

The effects of financial services liberalisation are assessed as being neutral, except in so far as they influence long term economic growth. Growth is in principle highly consistent with goals of socio-economic transformation and poverty reduction, while at the same time intensifying the need for change in unsustainable patterns of consumption and production.

Institutional capacity for effective sustainable development strategies

The effects of financial services liberalisation on sustainable development strategies are assessed as being relatively neutral, in that they neither add to nor detract from Mercosur countries' capacity to implement effective strategies. The impact in the EU is also assessed as neutral.

Table 2. Sustainable development impacts of reinsurance liberalisation in Brazil

Impact	Countries / sectors affected	Causal factors	Factors affecting significance	Potential significance	
				short term	long term
Economic					

Impact	Countries / sectors affected	Causal factors	Factors affecting significance	Potential significance	
				short term	long term
Real income	All	Economic growth Risks of greater instability	Coordinated regulatory reforms	-	⇧
Fixed capital formation	Brazil	Exposure to competition, increased competitiveness		⇧	⇧
Employment	Brazil	Economic growth	Coordinated regulatory reforms	⇧	⇧
Social					
Poverty	Mercosur	Economic growth. Risk of instability	Coordinated regulatory reforms	-	⇧
Health and education	Mercosur	Economic growth	Parallel policy measures	-	⇧
Equity	Small impacts, non-significant			-	-
Environmental					
Biodiversity	Brazil			-	⇧
Environmental quality	Brazil			-	⇧
Natural resources	Brazil			-	⇧
Process					
SD principles	Positive for socio-economic change and poverty reduction, adverse for consumption and production, otherwise neutral.	Economic growth	Parallel policy measures, environmental regulation.	-	⇩
SD strategies	Neutral impact			-	-

Legend: 🡹 positive greater significant impact, 🡻 negative greater significant impact, ⇧ positive lesser significant impact, ⇩ negative lesser significant impact, ⇧⇩ positive and negative impacts likely to be experienced according to context (may be lesser or greater as above), **?** or ? uncertain positive or negative impacts of greater or lesser significance, - non-significant impact compared with the base situation.

Final thoughts

To date, EU and Mercosur negotiators have made much progress towards eliminating barriers to trade in financial services; both parties have shown an inclination for replicating a GATS-like approach to bi-regional discussions.

There are a couple of areas worthy of further progress in negotiations, each with broad scope for policy innovation:

1. Enhancement of the rules governing trade and investment in services, and specifically in the following areas:

- Domestic regulation (regulatory environment) – confining discussions to specific sectors, sub-sectors and distribution channels. Specifically, emphasis should be on promoting regulatory competence and independence (i.e., freedom from political interference), as well as balance and a level playing field.
- Transparency – prior right notification before the enactment of any proposed measure affecting the sector(s) in question. Lack of transparency is in itself a risk and is priced

accordingly by the market; greater transparency of processes and expectations would therefore lead to lower prices and greater efficiency.

2. By extending the liberalization (process) beyond what has been hitherto possible under the GATS. This can refer to both an improvement in current levels of access and renewed commitments to new sectors or distribution channels. In the context of this report, particular attention should be paid to the following area:

- Further liberalization (broadly defined) in the core of financial services, especially with regard to market reserve issues. While market reserves can help to smooth out transitions and enable small firms to gain critical mass before facing full-on competition, they can also stifle competition/innovation and raise prices if left in place for too long. Clear rules and timetables are therefore essential.

Finally, and no less importantly, the prospect of Mercosur insurance and reinsurance companies competing in the European market should act as both a spur and an incentive. By repeatedly holding out the carrot of access to the larger European market (which itself has some way to go on the financial services integration front), it will be less necessary to use the regulatory stick.

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ANNEX 3. THE IMPACT OF EU-MERCOSUR TRADE LIBERALISATION ON THE EU FINANCIAL SERVICES SECTOR

By

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1. Introduction

The EU financial services sector has been deregulated since the opening of the ‘single financial space’ in 1993, with the purpose of stimulating competition in the financial services sector in the EU. Update and give current status. Further liberalisation of EU financial services is associated with the proposals brought forward by the World Trade Organisation (WTO) in 1995 for the liberalisation of financial services trade as part of the General Agreement on Trade in Services (GATS).

In the context of the GATS, financial services are broadly divided into two main categories (Article 5 of the GATS Annex): (i) *insurance and insurance-related services*; (ii) *banking and other financial services*. Each of these two categories includes a more specific list of activities that illustrates, rather than defines, the possible contents of the notion of financial services.

At present, EU financial services, specifically international banking activities, face another major new initiative, Basel II, which proposes a revision of the Basel Agreement on required capital-asset ratios. We evaluate the likely impact of this new agreement on international trade in Banking and the likely financial service provision and location decisions of international firms operating in Europe and emerging financial markets.

In this context, the EU-Mercosur trade liberalisation agreement offers a new perspective in terms of EU financial services entry (or exit) into Mercosur (Argentina, Brazil, Paraguay, Uruguay and Venezuela) as well as the entry (or exit) of Mercosur financial services into the EU.

This paper is part of the Sustainabiliity Impact Assessment study on EU – Mercosur trade negotiations. The paper focuses on the potential effects of trade liberalisation on the financial services sector in the EU. The idea is to assess how the trade aspects of the Association Agreement under negotiation between the EC and Mercosur is likely to affect sustainable development in the EU. The paper uses a standard methodology which involves making an ‘evidence-based’ assessment of the potential economic, social and environmental impacts of trade liberalisation on the EC member countries. The ‘evidence’ is entirely secondary but provides a balanced assessment of likely effects, based on the existing literature, experience and knowledge.

2. WTO, GATS and financial services liberalisation in the EU

In this section, we examine the EU-Mercosur trade liberalisation in the context of WTO and GATS and the recent developments in the financial services sector in Europe. Here, we explain what the EU-Mercosur trade liberalisation really means in the context of WTO and GATS provisions on opening up the financial services sector to foreign competition. What are the provisions, protocols and the exemptions that EU countries or Mercusor countries may negotiate? We discuss possible scenarios.

Following the growth in international trade in goods, as a result of the reduction in tariffs and quotas negotiated through the General Agreement on Tariffs and Trade (GATT), a number of countries attempted to develop a similar agreement on free trade in services in the Uruguay Round. The objective of the General Agreement in Trade in Services (GATS) was to remove the barriers which restricted the ability of service providers and customers located in different countries to enter into international contracts for services, and to remove restrictions on the ability of foreign service-providers to locate freely in other countries. The GATS followed the general principles behind past international trade agreements. It envisaged three key aspects. First, it envisaged that trade restrictions should be made open and transparent, and thence, through a series of negotiated rounds, member countries should make binding commitments to progressively liberalise markets. Second, it is envisaged that when making concessions, a country should treat all foreign countries symmetrically, and therefore a

privilege offered to one should be extended to all.[1] The so-called Most Favoured Nation or MFN-clause. Third, governments should treat foreign and domestic firms operating in a national market symmetrically, the so-called National Treatment clause.

The aim in liberalising financial services was to encourage more competition in a sector frequently regarded as uncompetitive. As a consequence, it was argued, competition would improve operational efficiency and project selection. Depositors would also enjoy higher rates and be more willing to save, while borrowers, particularly commercial borrowers, would enjoy lower rates and there would be an overall increase in economic growth. In its most general form, the liberalisation of financial trade under the GATS envisaged that signatory states would:

- Grant "market access" to all, that is, subject to fulfilling appropriate prudential criteria, foreign banks could establish in, or otherwise freely service, the national market.[2]
- Ensure "national treatment," that is, the authorities should seek to treat all banks, regardless of country of origin, on an equal basis, and make all banks subject to the same regulatory and tax regimes.
- Make capital-account restrictions transparent and non-discriminatory, and allow the capital flows necessary to fulfil the commitments above. In the limit the GATS would envisage the complete removal of barriers to cross-border supply and consumption abroad[3].

In addition, the GATS envisaged that signatories would take steps to ensure that the regulatory and supervisory regime conforms to best international practice, though these requirements need not be specified in the agreement.[4] At that stage this effectively meant conformity with Basel I, a voluntary code with about 100 signatories.

The agreement on financial services, as finalised in 1997, required developed countries to implement the GATS within a year, but allowed emerging and developing countries to take exemptions. From a practical viewpoint, the way these exemptions were established was very important. Instead of a general commitment to the agreement with exemptions claimed for non-conforming measures as in the GATT (a so called "negative" list), the GATS followed what is called a "hybrid" list. This required signatories to opt into specific sectors (and/or sub-sectors) and then to list a set of negative exemptions where appropriate. However, many countries dis-aggregated their sectors in such detail that their specific commitments amounted more to a positive list of "opt-ins" for a particular mode, rather than any kind of general commitment to freer trade in financial services. Furthermore many countries chose to be "unbound" in a particular sector, meaning that they were making no commitments, and then specified what they would nevertheless allow. This further reinforced the perspective that the agreement was essentially a "positive" list of low-level commitments.[5]

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[1] There is an exemption for Common market areas.

[2] Unlike other service sectors, it is argued that market access in banking cannot be unregulated as monetary authorities (who often offer consumers certain deposit guarantees) have to be concerned with the systemic risk associated with bank failures. Thus they typically reserve the right to vet market entrants.

[3]. Commitments under Article 1, particularly, paragraphs 2(a) and 2 (c) require (Articles IX and XVI) that accommodating financial must not be restricted. However, countries also have the right to impose restrictions in times of balance of payments crises and to take appropriate prudential and regulatory measures as they see fit (see particularly Article XII).

[4]. Some countries have listed non-discriminatory exemptions (regarding licensing etc) in their schedules which are essentially regulatory in nature.

[5]. The GATT originally worked on the basis of a general commitment combined with a negative list of exemptions. This approach made the trade restrictions in place transparent and thus allowed the GATT to monitor any attempt to engage in further restrictive practices and formed the basis for future negotiations. While in theory a positive list and a negative list could be the same, in practice with a positive list measures not made explicit are not transparent and there is essentially no means of preventing countries of implementing new restrictive measures.

This bottom-up approach had the effect of making the agreement a piecemeal collection of opt-ins which broadly corresponded with the *status quo ante* for many countries. Thus, many signatories only agreed to continue what they were already doing, although some of the emerging market countries engaged with the process more fully.

For many of the countries, the restrictions on commercial presence amounted to a case by case decision by the monetary authorities about whether it was in the country's economic interest to admit a specific applicant, rather than a set of rules whereby anyone satisfying these rules could enter. It appeared that, in practice, emerging and developing countries had little idea what liberalization entailed and felt they were being rushed into a commitment they did not understand. Thus, they had no clear vision of what the implications of the agreement might be, nor even what full compliance might entail, and privately at least, did not take the proposed time-schedule for the removal of exemptions seriously.[6]

The subsequent financial crisis in the Far East appeared to compound the problem with many developing countries arguing that the effect of the GATS would be to leave them susceptible to a similar sort of crash (Murinde and Ryan, 2002). Ironically, as the data now shows (see Table 1), the Asian financial crisis in fact resulted in an expansion of banking activity by international banks, predominantly EU-based banks, in these countries. The Latin-American crisis and collapse of the old Soviet bloc had similar effects.

Table 1 shows loans to the Asia-Pacific zone by members of the EU banks in particular and 30 reporting countries in general to the Bank of International Settlements fell by approximately 5 % per anum over the period 1998-2002 before making a recovery in 2003/4.[7] Over the same period assets and liabilities of local subsidiaries rose by approximately 20% per anum. The explanation for these phenomena is, of course, complex but broadly the fall in international activity (cross-border supply) was driven by a systematic unwinding of the short-term loan boom of the early 90's and a growth of domestic foreign reserves (despite the fact that most countries had opted for a floating regime post crises). The rise in activity by international subsidiaries located in emerging markets ('commercial presence') arose due to the differential impact of the Asian crises on domestic and international banks. Domestically, it was the local non-international banks which found themselves in most difficulty as a result of the domestic credit defaults and short-run obligations to international banks denominated in foreign currency. By comparison, international subsidiaries with better access to international capital were in a relatively healthy position. Thus, EU banks and international banks in situ were in a position to expand existing operations while, in other cases, other international banks new opened offices in these market (often by specific government invitation, rather than in a response to opportunities afforded by GATS commitments). This led to an increase in domestic lending activity by international subsidiaries, financed largely by domestically raised deposits. The growth in these banks as deposit takers is due, no doubt, to the perception of domestic (largely commercial) depositors that they are a relatively safer option in the event of future instability. We will return to this theme in our discussion of Basel II.

Table 1: Lending Patterns by EU and International Banks

	Jun-98	Jun-00	Jun-02	Jun-04	Annual %	Annual %	Annual %	Annual %
	(US$ bn)	(US$ bn)	(US$ bn)	(US$ bn)	98-00	00-02	02-04	98-04

[6] For example, in contrast to the GATS vision of a five–year exemption, some developing countries put in a specific commitment to eliminate restrictions by 2020.

[7] The 30 reporting countries are: Australia, Austria, Belgium, Brazil, Canada, Chile, Denmark, Finland, France, Germany, Greece, Hong Kong SAR, India, Ireland, Italy, Japan, Luxembourg, Mexico the Netherlands, Norway, Panama, Portugal, Singapore, Spain, Sweden, Switzerland, Taiwan(China), Turkey, the United Kingdom and the United States.

Europe								
Cross-Border Loans outstanding	n/a	4214	5238	7324	n/a	11.49%	18.25%	9.65%
Local Loans by subsidiaries*	n/a	806	1012	1519	n/a	12.05%	22.51%	11.14%
Local Liabilities of subsidiaries	n/a	832	854	1378	n/a	1.31%	27.03%	8.77%
Emerging Europe								
Cross-Border Loans outstanding	133	171	189	279	13.39%	5.13%	21.50%	13.14%
Local Loans by subsidiaries*	21	43	103	163	43.10%	54.77%	25.80%	40.71%
Local Liabilities of subsidiaries	16	39	99	135	56.12%	59.33%	16.77%	42.68%
Developed Countries								
Cross-Border Loans outstanding	n/a	6009	7237	9801	n/a	9.74%	16.37%	8.50%
Local Loans by subsidiaries*	n/a	2235	2836	4334	n/a	12.65%	23.62%	11.67%
Local Liabilities of subsidiaries	n/a	1821	2051	3486	n/a	6.13%	30.37%	11.43%
All developing countries								
Cross-Border Loans outstanding	736	863	809	992	8.28%	-3.18%	10.73%	5.10%
Local Loans by subsidiaries*	221	340	524	689	24.03%	24.14%	14.67%	20.87%
Local Liabilities of subsidiaries	176	291	456	584	28.58%	25.18%	13.17%	22.13%
Developing Asia								
Cross-Border Loans outstanding	324	287	254	327	-5.88%	-5.92%	13.46%	0.15%
Local Loans by subsidiaries*	72	103	140	223	19.61%	16.59%	26.21%	20.73%
Local Liabilities of subsidiaries	57	85	111	174	22.12%	14.28%	25.20%	20.44%
Latin America								
Cross-Border Loans outstanding	296	282	244	216	-2.39%	-6.98%	-5.91%	-5.12%
Local Loans by subsidiaries*	134	173	247	258	13.62%	19.49%	2.20%	11.54%
Local Liabilities of subsidiaries	102	148	215	227	20.46%	20.53%	2.75%	14.26%
Africa & Middle East								
Cross-Border Loans outstanding	115	122	119	169	3.00%	-1.24%	19.17%	6.63%
Local Loans by subsidiaries*	15	21	33	44	18.32%	25.36%	15.47%	19.64%
Local Liabilities of subsidiaries	16	19	31	48	8.97%	27.73%	24.43%	20.09%
Source: BIS (2005)								

While it is possible to rationalise the role of financial crises as the driver in expanding the role of international banks in emerging economies, the European experience over the period also provides an interesting contrast. Local loans and liabilities of foreign-owned subsidiaries grew at a comparatively low 11% (Table 2), although this was still greater than the increase in cross-border activity (approximately 9%) between 1998 and 2004. Significantly, the cross-border to 'market access' ratio for Europe reported in Table 2 has only changed marginally over the period, down to 4.8:1 from 5.2:1, while the growth in local lending by international banks has driven the ratio in most developing regions close to (or in the case of Latin America below) 1:1.

Table 2: Cross-border activity to Commercial Presence Ratio*

	Jun-98	Jun-00	Jun-02	Jun-04
All developing countries	3.3	2.5	1.5	1.4
Developing Asia	4.5	2.8	1.8	1.5
Latin America	2.2	1.6	1.0	0.8
Africa & Middle East	7.7	5.8	3.6	3.8
Emerging Europe	6.3	4.0	1.8	1.7
Europe	n/a	5.2	5.2	4.8
Developed Countries	n/a	2.7	2.6	2.3

Source: BIS (2005)
*Cross-border loans outstanding to Lending by Local Subsidiaries

The European environment in the wake of the GATS, however, was very different to that in the rest of the world. European governments had effectively pre-empted the GATS, at least in respective of granting market access to EU banks, by its Single European Market exercise in 1992. Prior to the implementation of the single market, measures of efficiency suggested widespread differences across member countries (up to 200 per cent) even after making adjustments for differences in levels and types of services (see Ryan, 1992, p103). There was also considerable evidence of differences in levels of efficiency within countries. The European Single Market, like GATS was designed to ensure that banks would have rights of entry into domestic markets at no less favourable terms than domestic providers. Given the pre-liberalisation measures of efficiency there was a presumption that there would be both a shake-out as well as a shake-up as a result of market integration. In particular, there was an expectation that the French and Italian markets might see significant entry by the more efficient providers, mainly Belgium, Germany and to a lesser extent the UK and the Netherlands.

This is not what happened. The prospect of the single market provided an impetus for internal bank reorganisation and significant labour shedding in the less efficient markets, rather than provoking widespread take-overs or new entrants. There has been some evidence of joint ventures and buy-ins but interestingly, the level of intra-EU mergers and acquisitions have not been significantly greater than those with banks from outside the EU. Indeed, the level of activity between EU countries is probably less than the level within countries, where smaller banks have frequently merged to compete more effectively with their larger competitors in terms of regional coverage and product range. Murinde and Mullineux (2003) and Murinde, Agung and Mullineux (2004) suggest that levels of efficiency within the EU converged in the wake of the 1992 Single Market, but the impetus for rationalisation and efficiency gains was due as much to the *threat* of mergers, acquisitions and new competition as to actual outside entrants. Thus, the European integration experience seemed to suggest that developing countries signing up to the GATS, albeit with significant short-run exemptions, would fairly rapidly respond to the possibility of further future liberalisation, but there would not be any major restructuring.

The other story in Europe over the period 1998 – 2004 was the push into Eastern Europe ('Emerging Europe' in BIS speak) of European based banks. There domestic activity by international banks rose 8 fold in the period (Table 1), equivalent to a 40% growth rate per anum. The number of international banks (or banks owned by international consortia) similarly rose over the period (see Table 3). Cross border lending over the same period (Table 1) rose by a comparatively lower 13% per anum. However, with a cross border to market access ratio of 1.7 (Table 2), Eastern Europe looks remarkably similar to Asia Pacific (1.5) in the international provision of its financial market structure.

Table 3A : Majority domestic owned versus majority international owned banks in selected emerging European Countries

	Domestic Jan-98	International Jan-98	Domestic Jan-00	International Jan-00	Domestic Jan-04	International Jan-04
Bulgaria	12	7	12	9	12	12
Croatia	37	8	32	7	17	13
Czech Rep	22	8	11	7	10	20
Estonia	11	0	4	0	3	3
Hungary	18	13	12	12	9	23
Latvia	17	7	4	6	8	9
Lithuania	9	2	7	2	3	6
Poland	29	17	21	17	11	26
Romania	8	6	13	12	8	16
Total	163	68	116	72	81	128

Table 3B : Majority domestic owned versus majority international owned banks in selected emerging European Countries as a percentage of total banks

	% Domestic Jan'98	% Foreign Jan'98	% Domestic Jan'00	% Foreign Jan'00	% Domestic Jan'04	% Foreign Jan'04
Bulgaria	63%	37%	57%	43%	50%	50%
Criatia	82%	18%	82%	18%	57%	43%
Czech Rep	73%	27%	61%	39%	33%	67%
Estonia	100%	0%	100%	0%	50%	50%
Hungary	58%	42%	50%	50%	28%	72%
Latvia	71%	29%	40%	60%	47%	53%
Lithuania	82%	18%	78%	22%	33%	67%
Poland	63%	37%	55%	45%	30%	70%
Romania	57%	43%	52%	48%	33%	67%
Total	71%	29%	62%	38%	39%	61%
Source: Bankscope						

It is clear now why the experience of the EU economies with the single-market experiment differed from that of the emerging economies as a result of the liberalisation of financial services. Given the pre-announced policy of financial trade liberalisation and a stable economy, the European banks largely got their houses in order prior to '1992' yielding economic efficiencies, and what mergers did take place were often ones of scope rather than Salant-Switzer dominant firm, market-concentrating mergers. The banks in Asia-Pacific had no such luxury. Arguably, these banks were already living on the edge of Basel I, and as countries were considering signing up to the GATS, their economies were already tethering on the edge of financial crises. Despite the fact that their governments only half heartedly acceded to the agreement and placed restrictive provisions on entry, these measures could not protect domestic banks from the real threat to their viability - excessive and unsafe lending, not international competition. Thus in the wake of the international crisis the Asian banking system was significantly damaged and entry of international banks represented a real alternative to cash-strapped domestic banks. Entry into Eastern Europe appears to have been similarly opportunist in response to the failure of the local banking system. The influx of international banks is sometimes attributed to banks following multi-national enterprises (MNE's) and there was, of course, a considerable expansion of multinational firms into Eastern Europe over this time period (particularly in Poland and the Czech Republic). However, this explanation is not valid for Asia, and it is tempting to conclude that the expansions of activities by banking subsidiaries in both markets owed more to economic opportunism rather than the need to service existing multi-national clients.

Recent research, however, does not entirely support the view that international banks were more technologically-advanced and cost-efficient and thus in a position to exploiting a market opportunity. Previous research (see Murinde and Ryan, 2002, p.106) had pointed to relatively poor measures of performance for banks in developing countries. However, the expansion of the international banking in the 1990's has resulted in new data which has allowed economists to test whether foreign banks do indeed perform better than their domestic counterparts in emerging economies and whether they have the predicted effects on margins and profits of domestic firms. Using a mixed data set of developed and developing countries, Claessens, Dermiguc-Kant and Huizinga (2001) demonstrated that there was some evidence that increased foreign competition tended to improve the cost effectiveness of domestic banks and to reduce interest rate margins, and bank profits. More recently, Hermes and Lensink (2003) have repeated the analysis separating out developing from developed countries and report evidence which conflicts with Claessens et al. (2001). The explanation offered is that productivity spillovers associated with more competition in fact increases domestic profits, however, cost also rise due to increased provision for bad loans since

domestic firms can only compete in the residual high-risk element of the market. Of more specific interest to this paper is the recent research by Green, Murinde and Nikolov (2003) which investigates the efficiency of banks in Central and Eastern Europe with a view to assessing the comparative effectiveness of 273 foreign and domestic banks. Using a sample from 1995-1999 and an augmented translog cost function (and two cost share equations) they mostly reject the hypothesis that foreign banks were more efficient than domestic banks or that the nationality of ownership was an important factor in reducing bank's total costs. This lack of observed cost differences would seem to lend itself more to the 'follower' explanation of developed Europe's expansion into Emerging Europe (that is, it is client relationships rather than economic efficiency that drives international expansion). Perhaps, Eastern Europe is unique given the wholesale change that has occurred there. However, the data may also reflect the fact that only the most efficient banks survived (and it has to be noted that even locally owned banks have had considerable outside expert assistance).

Detragiache and Gupta (2004) provide some evidence from Asia. In a study of Malaysia during the financial crises, they find that non-Asian International Banks were more profitable than their domestic counterparts or international banks whose main sphere of business was Asia. However, the Malaysian market is not a particularly instructive case-study for changes in market access as it has always been relatively open to international banking and the higher profits and margins of non-Asian Banks obtained despite higher overhead to assets ratios (though no other cost measures are reported).

It is worth pointing to one other 'myth' of the GATS. Some governments argued that because they had no restrictions on international capital movements, granting market access was unnecessary. They further argued that existing inward capital flows indicated that all was well with the financial structure in their economies. The absence of regulations limiting capital flows however, does not necessarily mean that the market operates efficiently. The extent of capital flows in and out of a country depends, to a large extent, on the ease with which domestic residents can gain access to projects abroad, and foreign investors can gain access to domestic projects. In the case of domestic investors, this depends on the accessibility of the international capital market. For wealthy individuals, this may be relatively easy but, for the vast majority, this depends upon domestic financial intermediaries and is therefore predicated on the latter's level of efficiency and/or biases. Similarly, in practice, local entrepreneurs are restricted in their access to funds by the extent to which foreign banks can locate in the domestic economy or by the exposure and efficiency of their local intermediary in operating in the international market. In spite of a lack of prohibitions on the flows of funds, distortions and lack of efficiency in the local market may therefore result in the misallocation of resources. In Asia and in many developing countries national and regional governments exert a significant influence over elements of the financial sector and their desire to promote local development may be leading to an inappropriate level of regional investment. Of course, if the investment decisions of these governments really reflect the tastes of the local population towards regional and political risk and the population is well informed, then they will choose to invest their monies in a bank which reflects this investment strategy without the need for political interference. However, whether past domestic investment patterns reflects these preferences is open to question. There is some evidence that liberalisation, and the expansion of international banks, has resulted in outward capital flows. Hawkins (2002) reports that net deposits from emerging economies, at 2% of GDP, are currently at their highest levels since the oil revenue boom of 1979-80. Thus the growth in international bank's access to emerging markets has been associated with a significant growth in the holding of international deposits. How much of this is due to capital flight and how much is due to appropriate diversification is another matter. It should also be noted that oil revenues are still an important component of these deposits; however, two of the main sources of the current outflow are Taiwan and mainland China.

The analysis above of the GATS and its consequences suggests that where banks have an opportunity to adapt to changes in the competitive environment (i.e. European Single Market), the growth in trade in international banking services (whether cross-border via market access) will be small. However, where countries experience extreme economic conditions, then changes in the mode of delivery is likely to be much more radical, and the main contribution of GATS to this process was that it probably ensured that international banks were already primed to pursue expansionist strategies.

Overall, it may be argued that the potential implications for trade in, and modes of supply of, banking services in the EU is a result of the current significant directives for regulating the banking sector, namely Basel II.

3. A Case Study of the EU Banking Sub-sector: Basel II

We focus on the banking sub-sector of the EU financial services sector. Specifically, we focus on the likely impact on bank performance and on competition in the banking market in the EU countries. We evaluate existing evidence and literature on trade liberalisation in the banking sector and the impact in terms of changes in competitive conditions in the UK and other selected EU member countries. We argue that banking is expected to be affected disproportionately by the liberalisation measures that are assumed in the EU Mercosur liberalisation scenario. However, the 'devil is in the details'. On the basis of the existing evidence on past liberalisation efforts, the interesting story line is that trade liberalisation in banking services has not changed the nature of competitive conditions in the banking sector in terms of on-balance sheet service provisions i.e. the 'bread and butter' of banking in the UK and some EU countries. But it may be argued that the impact of The EU-Mercosur trade liberalisation will be significant in terms of off-balance transactions (e.g. derivatives, hedging, bank trading in foreign exchange and capital market instruments, etc..), hence we consider Basle II implications.

Strictly speaking, the Basel Agreement is a voluntary agreement covering the members of the Committee on Banking Supervision. This is a committee of the banking supervisory authorities of the thirteen 'Group of Ten' countries, Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. The original Basel I agreement provided for a standard level of capital, 8%, to be held as reserves to cover possible shortfalls in the bank's loan portfolio (the bank's assets) due to failures in repayments (credit risk) or perhaps sudden currency movements or rises in interest rates (resulting in a fall in the asset value of a fixed interest-rate, long-term loan on secondary markets) – so called market risk.

The standard was developed in response to two issues. First, and most importantly for many of the European and US international banks, it was felt that in the absence of such an accord, banks from jurisdictions with loose regulatory regimes faced an unfair advantage in the international market place since they did not have to hold as many costly capital reserves. The European and US international banks thus needed either to establish a badge of quality (to justify their premium rates) or else join the other banks in a race to the bottom by availing themselves of whatever loopholes where available in their domestic supervisory regimes. Second, from the perspective of the international regulatory authorities, there was a realisation that, in the absence of such an accord, competitive pressures could lead to poor holdings of capital reserves and thus, in a crises, to bank failure followed by contagion. Indeed, it is the fear of contagion as a consequence of bank failures that provides the primary motivation for the unique regulation of this sector.

Despite the fact that the original Basel I accord was voluntary, and primarily aimed at international banking, the Committee hoped that the underlying principles would be adopted by national jurisdictions as the underlying principles of their regulatory frameworks. Indeed over 100 countries adopted the 1988 Accord, and the Committee anticipates that Basel II will

eventually have a similar wide-ranging impact, although, as we will see, this is likely to take much longer.

The original Basel I agreement was relatively crude in its treatment of the credit risk faced by banks, failing to distinguish between different riskiness associated with various types of private loans (e.g. relatively safe developed-country commercial bills versus risky corporate- project loans) and ignoring the effects of cross-correlations. The former is relatively obvious, surely banks should hold more reserves for high-risk loans and less for safe ones. Cross-correlations are also important because we are interested in the risk properties of a portfolio of loans rather than the riskiness of the individual loan components that make up the portfolio. This is because if one asset is expected to give a high yield, when the other is low or negative, then the portfolio is providing natural insurance against poor outcomes. Because of this crude treatment of risk and correlations under Basel I, banks had an incentive to play off their lending strategy against the rules. Thus, if they were prepared to take more risks, perhaps seeking to gain a competitive advantage on their international rivals, they could focus on high-risk, high-return loans and still remain within the 8% capital-asset ratio band.

As a consequence, in countries where prudential supervision was seen as strict, banks perceived themselves as being at a disadvantage both relative to some of their international competitors and domestic non-bank financial intermediaries (who are not subject to the Basel I requirements and can therefore undercut them). Hence there was significant pressure for a modification to the rules from within the Group of Ten. The Basel Committee also had concerns about other aspects of evolving banking practice such as the rise in off-balance sheet activities and the risk to banks as a result of exposed trading positions - so called operations risk - either due to problems completing trades or rogue operators like Nick Leeson.[8]

Basel II seeks to address all these issues. The proposals are more stringent than Basel I in that banks must assess their risk on a consolidated basis including holding companies and other off-balance sheet activities.[9] However, the proposals are more liberal in the way they treat credit risk, allowing banks to hold reserves supposedly closer to what a 'prudential' bank would voluntarily choose to hold.[10] There are three proposed approaches, the standardised approach, and two variants of what is called the internal-ratings based approach (IRB approach). In the standardised approach, banks are now able to classify their sovereign and commercial risks according to a series of 'buckets' with weighting of 0% (sovereign only) , 20%, 50% 100% and 150%, depending on external credit-ratings of the borrower. Thus a loan to a relatively low-risk corporate enterprise with a weight of 50% will only require capital reserves equal to 8% x 0.5 or 4%, half of that required in the past. Conversely, the highest risks require capital reserves of 12% (8% x1.5).

The alternative IRB approaches go even further and allow banks to adopt more sophisticated risk measurement methodologies, subject to certain rules, in line with developments with internal bank-risk measurement during the last few years.[11] Very crudely,

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[8] There is some argument about whether regulatory authorities should be concerned with operations risk. GOODHART, C (2004) argues that bank-specific operations problems do not have contagion implications, and points to Baring/ING as an example. Nevertheless the Enron case shows how auditor failures can have knock-on effects on confidence in all the big four accounting companies and contagion effects cannot be ruled out.

[9] Although modifications to Basel I had already attempted to deal with this.

[10] The voluntariness of reserves is a tricky concept. If the interests of managers and banks are aligned and they are risk averse then a bank will naturally hold sufficient capital (given its risk profile) to make failures rare events (and render contagion unlikely) and regulatory intervention unnecessary. However, there is a vast literature on the misalignment of incentives in the banking sector and thus prudential regulation can be thought of as encouraging banks to behave in a competition-consistent risk-averse manner to avoid destructive competition, notwithstanding the moral hazard and adverse selection problems often associated with banking and banking contracts. Thus the presumption that capital is 'willingly' held presupposes something about the motives of all parties to the banking operation.

11 For example RiskMetrics a Value-at-Risk (VaR) product developed by JP Morgan or Moody's KMV RiskAnalyst

these methods allow a bank to evaluate the distribution of returns across various activities and asset classes. The bank then focuses on the losses that might occur as part of its normal business practices (Expected Losses) and losses that may occur due to some exceptional event or series of events (Unexpected Losses). We might expect the former to be covered by the price of services or the interest-rate differential between borrowers and lenders, with any default paid out of current revenues (this, of course, depends in part on how one chooses to define the appropriate time period). Despite the expectation that these will be covered by normal market pricing, Basel II requires standard provisioning for these expected losses, due in part to the danger that provision may not be high enough in times of heightened competition or where government intervention distorts interest-rate margins. But the crux of the IRB approach is the analysis of unexpected events that will require an extraordinary call on reserves (Unexpected Losses). Having mapped the returns in a specific asset class, the bank then evaluates the probability density of the lower tail to determine the probability of default (PD) and (under the advanced approach) the losses which occur as consequence of the unexpected default.

The upshot of these measures is that banks with relatively lower risks will now be required to hold lower, costly capital reserves, thus eliminating the implicit cross-subsidisation of high risk loans associated with Basel I. Overall, the Basel committee is at pains to stress that it sees the Basel II exercise as reserve neutral and in the calibration prior to the implementation of the scheme it will determine whether a scaling factor is required 'to broadly maintain the minimum capital requirements.'[12] Thus, banks are being offered an incentive to adopt a more–risk sensitive approach to reserves, while at the same time attempting to maintain the aggregate minimum level of reserves in the system as a whole. The scheme thus shifts the burden of reserves onto higher-risk or non-diversified risk lending.

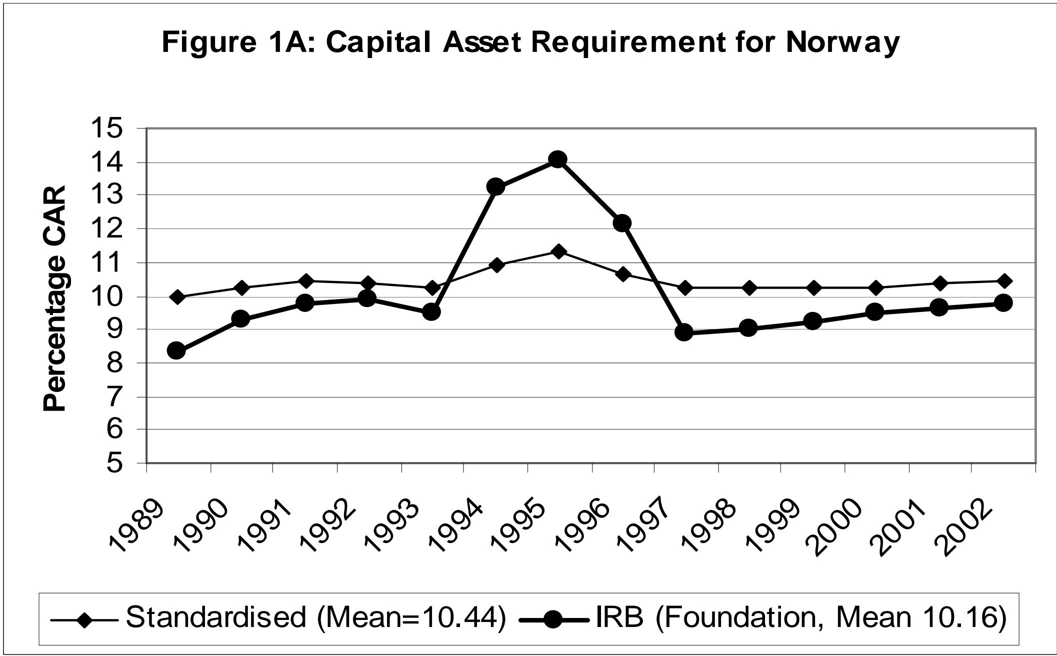
There have a been a variety of articles (see for example, Danielson and Zigrand, 2001; and Danielson, 2002) which question the appropriateness of the IRB approach, particularly the realism of the assumed statistical properties necessary for the analysis to be valid, and the likely breakdown in behavioural patterns in times of crises. They argue that risk data is not an exogenous process such as the weather, but rather the result of endogenous behaviour on the part of market participants. Thus while the apparent normality of the data in non-crises times arises from approximately random nature of normal buy & sell patterns, in a crises these patterns are likely to breakdown and be influenced by herd actions when agents react simultaneously to emerging financial news. Hence, we side-step these issues but instead seek to consider the implications for EU economies of the proposed financial liberalisation changes, which are implicit in the Basel II.

4. Basle II and the Implications for Trade in Banking Services in the EU

In this section, we seek to explore the implications of Basle II for trade liberalisation in banking services in the EU.

Basel II is voluntary for countries outside the thirteen-member 'Group of Ten' and, given the associated costs and information requirements, the uptake is expected to be significantly slower than the original Basel accord. Thus, Basel II is has been mainly adopted in the most developed economies; in the short to medium term and most developing countries continue to operate under the Basel I framework. Within the developed world, banks in countries signing up to Basel II are free to choose either the standard approach or one of the IRB approaches. So which method are banks likely to prefer? Figures 1A & 1B reports simulations by Goodhart and Sergoviano (2004) of a representative bank's portfolio in Norway and Mexico using the two evaluation methods.

[12] Basel Committee, para 44.



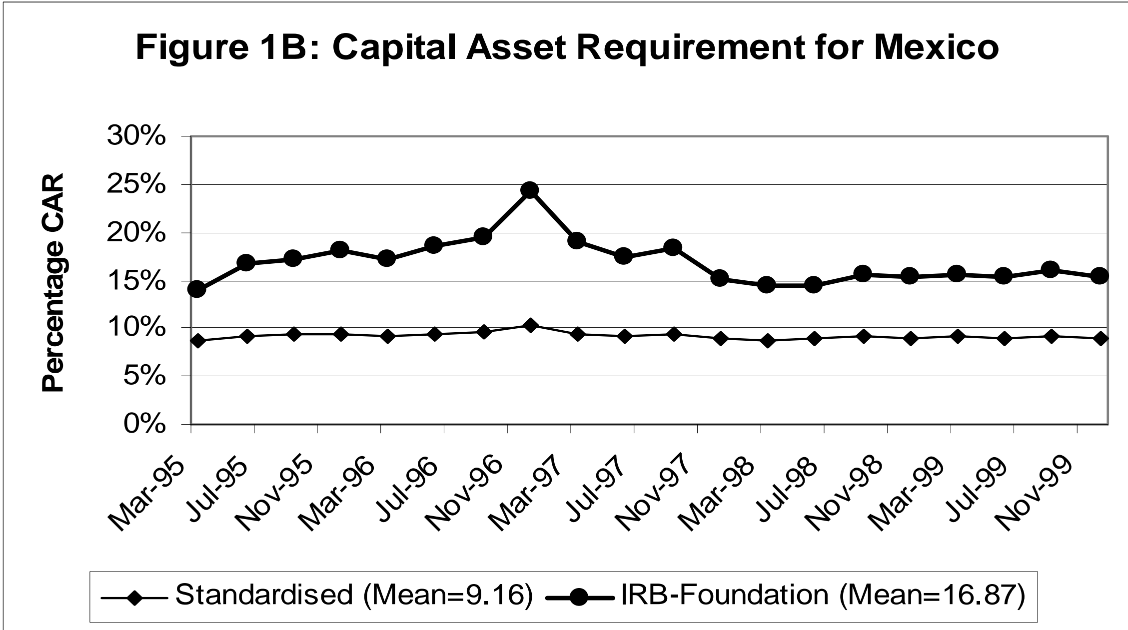


Figure 1A shows that in Norway, with a relatively stable banking system and low risks, that the IRB foundation method results in lower capital requirements, except during the problem period, 1994-1996. The average capital-asset requirement under IRB was 10.16% as opposed to 10.44 under the Standarised method. By contrast, the CAR for an emerging economy, as measured for a representative Mexican bank (Figure 1B), is higher under IRB throughout the full time period, when compared with the standardised method, reflecting the greater risk premia associated with the higher-risk loans in its portfolio. Garside and Pederson (2003) similarly predict an increase in capital requirements for emerging markets of 20-25% using the standard approach and 70-80% under IRB. This suggests that, for developed economies at least, the capital requirements under the IRB will be lower than the standard approach except during significant downturns in the economy. So banks which operate mainly in developed countries and can avail themselves of the IRB approach are likely to enjoy a competitive advantage over their competitors. However, the IRB approach requires a

large amount of information on the past performance of assets in order for a bank to be able to implement it. In addition, the existing expertise developed in the use of VaR, KMV or other IRB approaches largely resides in the largest international banks, and so given the information requirements and expertise, they are best placed to exploit the potential savings in costly reserves. However, the fact that not all banks will be in a position to implement the IRB approach and that banks in developing countries are likely to do worse under this method has implications for competition and international trade patterns.

We have argued previously (Ryan, 1990, p.363; Murinde and Ryan, 2002, p.94) that conventional Heckscher-Ohlin analysis was not an appropriate model for trade patterns in banking if all banks comply with the Basel I capital requirements (a key input to producing banking services) and international financial capital is relatively accessible. Rather we argued that learning-by-doing was the crucial source of comparative advantage. Thus, worker expertise was the key input and the big winners in the provisions of financial services under the GATS would be the existing international banks as they were best placed to capitalise on their past production-based expertise.[13] The fact that expertise in the IRB approach and the associated data sets are also concentrated in the large international banks suggests the Basel II will also benefit these banks at the expense of smaller banks. In addition, international differences in cost structures are now likely to result from the fact that some countries will be on Basel II while some are still on Basel I, thus inducing greater variance, internationally, in reserves held by banks against specific types of lending.

Are these effects in themselves likely to influence trade patterns in banking services? In so far as lending in developed countries is concerned, international banks employing one of the IRB approaches are likely to enjoy an advantage, but this is a market which is not currently threatened by emerging-country banks. Pre-Basel II, the threat to the large, but regulated, international banks in developed countries was the competition from non-bank intermediaries. The effect of Basel II should be to improve the relative competitiveness of these banks domestically, but this will have few implications for trade patterns.

However, the situation in emerging economies is more complex. First we should note that despite the claim that international subsidiaries operating in emerging economies will be evaluated on a fully consolidated basis, it is unclear how feasible it will be to operate a consolidated IRB approach in practice. Further, the accord allows various transition arrangements for the implementation in areas of business where data coverage is poor and it is again unclear how long these arrangements will operate in practice. These caveats notwithstanding, it is likely that local banks, operating under Basel I, will have lower reserve requirements relative to large international banks and thus may be able to lend more competitively. To do this local banks will need to raise deposits locally (since cross-border funds will probably be priced at higher IRB-determined rates reflecting the higher perceived risk). The lower reserve costs of banks operating under Basel I may also mean that they can offer relatively higher deposit rates; however, local depositors may prefer the apparently safer international banks operating with lower deposit rates, greater (IRB required) reserve capital and access to international capital in crises. So in emerging countries, Basel II will present depositors with a real option.

Basel II is also likely to influence the possible gains from trade predicted under the GATS. GATS may have the effect of improving bank efficiency and reducing margins in emerging markets, while the higher cost of financing risky loans under Basel II is likely to widen margins. Predicting which way the margin changes will affect domestic borrowers and lenders is likely to be quite complex. If GATS means that local residents have improved access to international deposit accounts (whether directly or indirectly) then domestic deposit rates will reflect this resulting in gains where rates have previously been repressed. In

[13] However, host economies would still gain through concomitant gains in allocative efficiency.

addition if international deposits rates reflect improved international risk-management further gains will follow.

By contrast, if GTS ensures that the financial market in an emerging economy is relatively open, then despite efficiency gains as result of GATS, borrowers may face higher rates due to the greater risk provisions associated with Basel II (ceteris paribus). However, Basel II may induce other equilibrium cost adjustments which, when combined with GATS, result in net gains even to borrowers. Thus, for example, if, as a result of Basel II, depositors in emerging economies see the international subsidiary banks as more stable, and this mobilises growth in domestic savings (or at least savings available to the intermediation sector), or if the higher reserve requirements on riskier loans leads to improved risk analysis and better identification of profitable projects (hence downward pressure on margins), then the borrowers who receive finance may still gain. Conversely, if the domestic market is reasonably insulated and interest rates rises are sticky, due perhaps to adverse selection problems, then to the extent that the market is influenced at all, it may be the case that the burden of the new Basel II regulations will be borne by depositors.

Can these effects be quantified? It is difficult to speculate on what the impact of something like the GATS might mean to financial margins. In the run up to European Singe Market in 1992, ex ante simulations in Ryan (1992) suggested a fall in margins of 27% on average due to efficiency gains, although the distribution of the gains varied considerably depending on the characteristics of each market (and borrowers or lenders in some countries experienced losses). There is no reason to believe that the ex ante differences in efficiencies in Europe were any less than would be expected in emerging countries and thus we might expect the gains to be, at least, of a similar order. Quantifying the effect of Basel II is equally difficult, but just to give a sense of the possible magnitudes, the Basel Committee estimates that while AA rated borrowers would only require 1.18% % capitalisation compared to 8% at present, B rated corporate borrowers would require 20.8%. Thus, emerging country borrowers (who have a ranking at least one notch lower than the corresponding sovereign regardless of the merits of the project) are likely to experience substantial rate increases on cross-border borrowing.

Does Basel II contribute in any way to the changes in the data outlined in Section 2? The evidence we cited above suggests that lending to emerging economies is likely to become more expensive, and thus, ceteris paribus, we might expect Basel II to reinforce the relative decline in cross-border lending we saw in Tables 2 and 3. However, while commercial borrowing across borders from international banks is relatively common, the other possible outcomes we cited, such as deposit collection and improved evaluation of local projects tends to require market presence. Hence, if international banks believe that Basel II will indeed enhance their business prospects in these markets it is most likely that this will involve doing business via local subsidiaries rather than across borders (thus reinforcing the trends observed in Tables 1 & 2) and these opportunities will possibly be at the expense of domestic banks as reflected in Eastern European data in Table 3.

5. The EU Single Market and the GATS agreement: Specific Impact and Implications

A relevant question here is the the degree of compatibility between regional liberalization of financial services in the EU and multilateral liberalization under GATS. According to Mohieldin and Wahba (1998), the question depends on "whether regional agreements effectively lead to significant liberalization and if such arrangements go substantially beyond what is already feasible in the multilateral context". As noted by Bongini (2003), it is broadly recognized that regional agreements exert many positive influences on multilateral integration and openness, since they act as useful laboratories for experimenting what could be achieved at a higher, and more complex, level. Hence, regional integrated areas are considered "as

important mechanisms for ensuring forms of international governance, contributing to a more liberal multilateral trading system" (Falautano and Guerrieri, 2000).

In general, Bongini (2003) points out some global implication of liberalization in the EU financial services industry. First, it is argued that the EU route towards liberalization in financial services has the potential for serving as a blueprint for opening up markets worldwide, especially in the context of multilateral liberalization within the WTO framework. Second, it is shown that the EU model highlights the degree of compatibility between regional agreements and multilateral commitments. Third, the EU regional experience underscores the importance of the supranational legislative, judicial and administrative structure of the European Community; hence, the intra-EU approach – minimum harmonization, mutual recognition and home country control – has a potential for widespread validity with the proviso that local conditions be taken into account.

Some recent studies try to model and measure specific impacts. Lejour, Rojas-Romagos and Verweij (2008) use a CGE model to study the impact of opening financial services markets within the EU. In the study, financial liberalisation is considered in terms of foreign direct investment (FDI) in financial services. The key argument of the paper is that firms which establish affiliates abroad also transfer firm-specific knowledge. The model is applied to the proposals of the EU to open up services markets. It is found that even when FDI in services could increase by 20% to 35%, the overall economic impact is limited; see the results in Table 4 below. Further, the evidence obtained by the researchers suggests that GDP in the EU25 could increase up to 0.4%. Moreover, it is shown that these effects could be up to 0.8% higher if foreign capital also increases the overall productivity of the services sector. However, the specific impact with respect to the financial services sector is not isolated.

Table 4: Effects of different FDI liberalization scenarios on GDP and national income (NI)

	Lower bound (benchmark, see also Table 5)		Upper bound		Upper bound and no revenues from tax equivalents		Lower bound and productivity effects	
	GDP	NI	GDP	NI	GDP	NI	GDP	NI
EU25	0.1	0.0	0.1	0.1	0.4	0.3	0.8	0.8
EU15	0.0	0.0	0.1	0.1	0.3	0.3	0.7	0.7
Germany	0.0	0.0	0.0	0.0	0.3	0.3	0.6	0.6
France	0.2	0.1	0.3	0.1	0.7	0.5	1.3	1.2
United Kingdom	0.0	0.0	–0.1	0.0	0.1	0.1	0.3	0.4
Italy	0.0	0.0	0.0	0.0	0.1	0.0	0.1	0.1
Spain	0.1	0.0	0.1	0.1	0.3	0.3	0.7	0.6
Netherlands	–0.1	0.0	–0.2	0.0	0.1	0.2	0.9	1.0
Belgium—Luxembourg	–0.1	0.3	–0.1	0.5	0.5	1.1	1.8	2.0
Denmark	–0.2	0.0	–0.3	0.0	0.1	0.3	1.2	1.4
Sweden	0.0	0.0	0.0	0.0	0.3	0.3	1.0	1.0
Finland	0.1	0.1	0.2	0.1	0.4	0.3	1.2	1.2
Ireland	–0.1	0.0	–0.1	0.0	0.2	0.3	0.7	0.8
Austria	0.2	0.1	0.4	0.2	0.6	0.4	1.4	1.3
Greece	0.0	0.0	0.0	0.0	0.1	0.1	0.2	0.2
Portugal	–0.2	0.0	–0.3	0.0	0.0	0.2	0.9	0.9
New Member States	0.5	0.2	0.8	0.4	1.2	0.8	1.8	1.5
Poland	0.5	0.2	0.9	0.4	1.2	0.8	1.9	1.6
Czech Republic	0.5	0.2	0.8	0.4	1.2	0.9	1.8	1.6
Hungary	0.5	0.2	1.0	0.4	1.5	1.0	2.0	1.7
Slovakia	0.3	0.1	0.5	0.3	0.7	0.5	0.9	0.8
Slovenia	0.0	0.0	0.0	0.0	0.1	0.1	0.4	0.3
Rest EU25	0.5	0.2	1.0	0.5	1.3	0.9	2.2	1.8

Source: Lejour, Rojas-Romagos and Verweij (2008), Table 6.

6. A Case Study of the Competitive conditions among the major British banks following Liberalisation

Matthews, Murinde and Zhao (2007) undertake an empirical assessment of competitive conditions among the major British banks, during a period of major financial liberalisation changes during the period 1980-2004. The evidence suggests that the intensity of competition in the core market for bank lending remained approximately unchanged throughout the 1980s and 1990s. However, competition appears to have become less intense in the non-core (off-balance sheet) business of British banks.

The liberalisation of the banking sector in the UK dates back to the Competition and Credit Control Act of 1971. The abolition of exchange controls in 1979 and the abolition of the last of the quantitative controls on bank lending heralded a period of rapid deregulation and increased competition in British banking during the 1980s. The Corset was abolished in 1980, required reserves were abolished in 1981 and Hire Purchase controls, which had restricted consumer borrowing, were abolished in 1982. Furthermore, the Building Societies Act (1986) enabled the Building Societies to compete directly in the retail banking market. The 1980s saw a number of mergers of Building Societies. Several of the larger Societies de-mutualised and converted into banks. The deregulatory trend was extended to the financial markets. With the 'Big Bang' in 1986, the banks became more aggressive in the marketing and positioning of their off-balance sheet products and services. Many banks entered the securities business by acquiring stock broking and jobbing firms. Non-banking financial institutions, such as insurers, retailers and building societies, challenged the banks on their traditional balance sheet activity.

The most pronounced impact of financial liberalisation in the UK was the transformation of the financial services sector; for example, the period from 1987 - 2003 saw a number of demutualizations and mergers and acquisitions (M&A). There were also trends towards consolidation and diversification. Abbey National was the first Building Society to convert to plc status in 1989. Banks took over Building Societies (Lloyds with Cheltenham and Gloucester). After 1995, there were a number of demutualizations of Building Societies (Halifax, Alliance and Leicester, Northern Rock, Woolwich and Bradford and Bingley) and Building Society acquisitions by banks (Bristol and West by Bank of Ireland Group and Birmingham and Midshires by Halifax). In 1995 Lloyds and TSB merged to form the Lloyds-TSB group. Barclays acquired Woolwich in 2000, and Royal Bank of Scotland acquired National Westminster in the same year. In 2001 Bank of Scotland and Halifax merged to form the HBOS group.

Table 5: Concentration Ratios and HHI for the Biggest Two and Biggest Five Banks (Assets-based)

Year/Measure	CR2	CR5	HHI
1986	0.421	0.767	1428.470
1991	0.441	0.738	1423.817
1996	0.316	0.630	1051.831
2002	0.383	0.688	1249.696

Source: Matthews, Murinde and Zhao (2007), Table 1.

Matthews, Murinde and Zhao (2007) presents concentration and Herfindahl-Hirschman Indices (HHI) during 1986 to 2002. The number of mergers, consolidations and

acquisitions that occurred during the 1990s and in the new century might suggest an increase in concentration and a reduction in the intensity of competition. However, the market structure indicators in Table 5, including the asset-based 2-bank concentration ratio, 5-bank concentration ratio and HHI[14], show a modest decline in the second half of the 1990s. Hence, it can be seen that market concentration did not alter appreciably over the sample period.

However, studies by Heffernan (1993, 2002), which examine the deposit rate, loan rate, mortgage rate, and credit card rate setting behavior of individual banks and Building Societies during financial liberalisation in the UK, find results which indicate an increase in competition in the mortgage market and low interest checking accounts, but there is evidence of price discrimination behavior in other products. The findings suggest that the retail banking sector in Britain is best characterised by the model of monopolistic competition, particularly in the case of unsecured loans and credit card rate setting behavior.

In addition, a government enquiry into competition in UK banking (Cruikshank, 2000) concluded that while the market for personal retail banking was consistent with monopolistic competition, as evidenced by sustained abnormal returns, there were signs of 'new entry and increased competition' that would improve information flows and result in a convergence of pricing. The report recognized that banking involves 'joint products' or 'bundled' services that can lead to overpricing and underpricing on different products. However, new entrants target specific banking products. Although they may form part of a larger banking group, entrants often specialize in products such as mortgages, unsecured loans and credit cards. This entry activity tends to increase the intensity of competition in these niche markets.

It is useful to note that the British experience of evolution in market structure and the regulatory environment since the 1970s differs markedly from that of other European countries. Deregulation in France, Spain, and Italy took place later than in the UK, and was typically carried out at a more controlled and slower pace. In contrast, the British experience is often characterised as ‘big bang’. The implication is that the UK banking market may have evolved more rapidly than its continental counterparts, increasing the possibility of transitional disequilibrium.

Overall, the existing studies offer a number of implications of the impact of financial liberalisation in the UK. First, some studies suggest that following financial liberalisation the UK banking market is competitive in general but non-competitive in specific sub-markets, which conclusion has been recognised by the Competition Commission (2002) and the Cruikshank (2000) report. Second, it appears that individual sub-markets have seen a deterioration of competition (credit cards, interest cheque accounts) while others have seen a strong improvement in competition (mortgages), which may have left the aggregate position unchanged. The implications for policy suggest a stronger focus on transparency of bank charges and fees, which in turn may eliminate consumer inertia that arises from the 'bundling' of bank services. However, it could be also argued that any such policy would be short term as the openness of the UK banking market suggests that non-competitive behaviour in specific sub-markets would be eliminated by competitive pressure over the long period. The re-focussing of British banks in the non-interest earnings capacity of their enterprise will eventually attract competition from new entrants or create the potential for the threat of entry.

7. Conclusion and Recommendations

We make some key recommendations on how to alter financial liberalisation in the EU-Mercosur trade liberalisation in order to maximise different economic outcomes in the financial services sector in general and in the banking sector in particular.

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[14] The U.S. Department of Justice considers a market with a result of less than 1,000 to be a competitive marketplace; a result of 1,000-1,800 to be a moderately concentrated marketplace; and a result of 1,800 or greater to be a highly concentrated marketplace. As a general rule, mergers that increase the HHI by more than 100 points in concentrated markets raise antitrust concerns.

We have surveyed the main developments due to, and implications of, the WTO initiative to liberalise trade in financial-services trade as part of the GATS. We find that in spite of the apparent half-hearted commitment of emerging economies to the process that there has been much greater and much faster market penetration than was previously envisaged. These changes probably owe more to the special economic events that affected emerging European and Asian markets than to the GATS initiative (although this is less true of Africa and the Middle East). However, the GATS project probably ensured that the large international banks were better geared-up to respond to the opportunities when they arose.

In our analysis of Basel II we conclude that the new IRB approaches are likely to reinforce the learning-by-doing expertise available in the larger international banks further reinforcing the benefits conferred by the GATS. The concomitant rise in the cost of lending to higher-risk creditors, especially in emerging markets, is likely to reduce such lending and may negate many of the expected benefits of the original GATS proposal to emerging country borrowers. However, from a welfare perspective this may represent an overall improvement in allocative efficiency, at least in global terms, and there are also possible beneficial savings-mobilisation and project-selection advantages to emerging economies. In so far as the larger international banks are perceived as being safer and, as a result, prosper, this is likely to result in more local subsidiary rather than cross-border banking, further reinforcing recent trends in the data.

We would expect large potential gains from liberalisation of financial services policies in the EU because services are activities in which these economies with highly distorting agricultural policies have substantial export interests. But this is not the case. So, the question remains as to why there has been little progress and little impact of financial services liberalisation in the EU. In a global political economy context, Hoekman, Mattoo and Sapir (2007) give some explanations for the absence of dynamism in multilateral services negotiations and the benefits that accrue from these negotiations. The arguments include: (i) technological changes that allow ever more services to be traded cross-border unaffected by policy; (ii) strong incentives to pursue liberalization on an autonomous basis (unilaterally) in key sectors of export interest to OECD services firms; (iii) perceptions that bilateral or regional cooperation is a good substitute for the WTO; (iv) adjustment costs and erosion of rents accruing to incumbents; (v) concerns that multilateral disciplines will affect the ability of regulators to enforce national norms; and (vi) shared or overlapping regulatory competencies between federal and regional/provincial entities. It is useful to note that some but not all of them easily explain the case of the EU in a political economy context.

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