

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

SECTOR STUDY: FINANCIAL SERVICES

MIDTERM REPORT

Consultation Draft

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**Interested Parties are invited to comment on this Consultation Draft:
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CONTENTS

- ABBREVIATIONS iv**
- 1. INTRODUCTION 1**
- 2. METHODOLOGY 2**
 - 2.1. Methodological framework 2
 - 2.2. Indicators 3
 - 2.3. Impact significance 4
 - 2.4. Scenarios 4
 - 2.5. Assessment of impacts 4
 - 2.6. Mitigation and Enhancement 5
 - 2.7. Consultation 5
- 3. TRADE AND NEGOTIATION ISSUES 7**
 - 3.1. Financial services liberalisation by mode of service supply 7
 - 3.2. Financial Services in the EU 8
 - 3.3. Financial Services in Mercosur 8
 - 3.4. Status of Financial Services Liberalisation 12
 - 3.5. Key Issues 15
- 4. PRELIMINARY IMPACT ASSESSMENT 16**
 - 4.1. Economic modelling results 16
 - 4.2. Financial stability 17
 - 4.3. Potential costs and benefits to Mercosur industries 18
 - 4.4. Impact on SMEs in Mercosur 18
 - 4.5. Effects of inter-country differences in economic and financial structures 20
 - 4.6. Regulation, supervision and management skills 21
 - 4.7. Impacts on core sustainable development indicators 22
 - 4.8. Summary of principal impacts on sustainable development 24
- 5. CASE STUDIES 26**
- 6. FURTHER WORK TO COMPLETE THE STUDY 28**
- REFERENCES 29**

ABBREVIATIONS

BNDES	Banco Nacional de Desenvolvimento Econômico e Social
CCA	Causal Chain Analysis
CGE	Computable General Equilibrium
EC	European Commission
EU	European Union
GATS	General Agreement on Trade in Services
SIA	Sustainability Impact Assessment
SME	Small and Medium Sized Enterprises
TPR	Trade Policy Review
WTO	World Trade Organisation

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 Mid-Term Report presents the results of the study to date.

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 programme¹, 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 provides the basis for the initial assessment that is presented in this Mid-Term Report.

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 presents an initial impact assessment for the sector, and Section 5 describes proposals for three case studies that will be carried out to illuminate the SIA findings. Section 6 describes the further work that will be undertaken to complete the study.

¹ IARC (2008a)

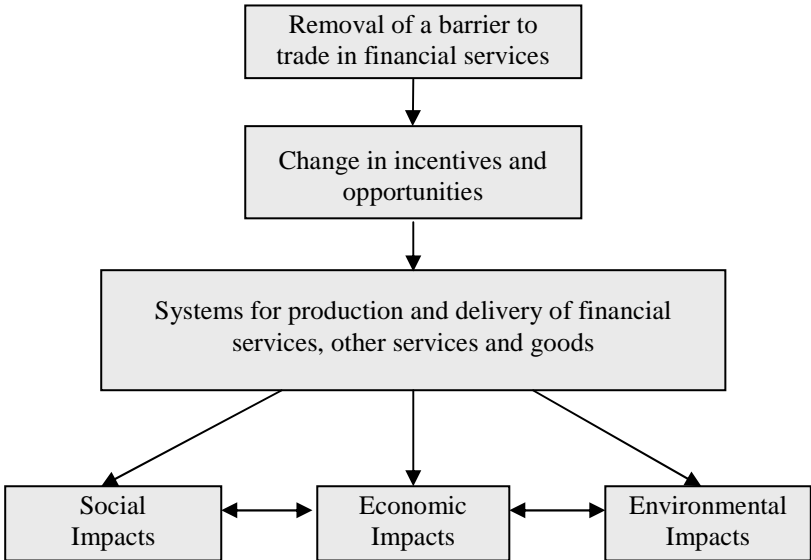
2. METHODOLOGY

2.1. Methodological framework

The methodological framework for Trade SIA is described in the EC’s Handbook for Trade Sustainability Impact Assessment², and its application to the EU-Mercosur negotiations is described in the Mid-Term Report for the Final Overview SIA³. 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

² EC, 2006
³ IARC (2008b)

the full complexity of the linkages between each stage in the causal chain or of the cross-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 model⁴. 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

⁴ The EU-Mercosur CGE model is described in the Mid-Term Report for the Final Overview SIA.

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.

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 Mid-Term 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 Mid-Term 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”⁵. 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 outflows⁶.

⁵ OECD (1999)

⁶ Contreras and Soonhwa (2004)

Cross-border trade also generates needs for a higher degree of regulatory symmetry than may be necessary for Mode 3⁷. 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 2010⁸, 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 2007⁹.

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.

In relation to the US sub-prime crisis and other recent instabilities, the 2007 integration report confirmed the importance of 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 country to country. The following review summarises the situation in each of the Mercosur countries at the beginning of 2008.

Argentina

⁷ Contreras and Yi *ibid*

⁸ Commission of the European Communities (2005)

⁹ Commission of the European Communities (2007)

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 (BNDES¹⁰) 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.
- 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.

¹⁰ BNDES = Banco Nacional de Desenvolvimento Econômico e Social

- 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 below 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 N° 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 conducive 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

Modes of supply:	Market access				National treatment			
	1	2	3	4	1	2	3	4
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	□	■	■	□	□	■	■	□
(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	□	□	□	□	□	□	□	□

Modes of supply:	Market access				National treatment			
	1	2	3	4	1	2	3	4
Cross-border supply	1				1			
Consumption abroad		2				2		
Commercial presence			3				3	
Presence of natural persons				4				4
Paraguay								
A. Insurance								
(Excluding reinsurance and retrocession)	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Reinsurance and retrocession	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
B. Banking								
Acceptance of deposits and other repayable funds from the public	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Lending of all types, including consumer credits, mortgage credit, etc.	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Other services auxiliary to financial intermediation	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Uruguay								
A. Insurance and insurance-related services								
a. Direct insurance								
Life insurance and personal insurance	-	-	-	-	-	-	-	-
Motor vehicle insurance	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Transport insurance	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Freight insurance	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
b. Reinsurance and retrocession	-	-	-	-	-	-	-	-
c. Insurance intermediation	-	-	-	-	-	-	-	-
d. Services auxiliary to insurance								
Insurance and pension consultancy services	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Actuarial services	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
B. Banking services								
a. Acceptance of deposits and other repayable funds from the public	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
b. Lending of all types								
Personal instalment loans	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
c. Financial leasing with purchase option	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
d. All payment and money transmission services								
Credit card services	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input type="checkbox"/>
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 than 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

3.5. Key Issues

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.

The Phase 1 study identified the following key issues for investigation in more detail:

- 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.

A preliminary examination of these issues is presented in the following section.

4. PRELIMINARY IMPACT ASSESSMENT

4.1. 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 Mercosur¹¹. 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 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 indicative¹².

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.

¹¹ Mode 1 only was covered in the model estimates

¹² Dihel (2002)

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 considered 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.

4.2. Financial stability

The potential benefits of financial services liberalisation depend strongly on effective regulation¹³. 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 system¹⁴.

The World Bank's report on Finance for Growth¹⁵ presents a strong case that entry of foreign financial institutions improves the efficiency of the domestic financial sector, strengthens its stability, and increases access to lending for small and medium-sized enterprises (SMEs). The report cites Argentina as a prime example of the positive impact foreign entry has had on the efficiency and competitiveness of local banking systems, and as a case where foreign-owned banks have proved a stabilising force. 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 collapse¹⁶. 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 for disadvantaged groups and regions. Strong regulation and a controlled pace of liberalisation are likely to be key factors in mitigating potential adverse impacts.

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 and lead to a financial crisis. The Asian and Mexican crises have been attributed to such causes¹⁷.

Financial service liberalisation may therefore have severe adverse effects on financial stability unless accompanied by greater international integration, sophistication and complexity of the regulatory regime. No clear empirical evidence has yet emerged of the extent to which

¹³ Brownbridge and Kirkpatrick 2002

¹⁴ Hodge (2002)

¹⁵ World Bank (2001)

¹⁶ Stiglitz (2002)

¹⁷ Contreras and Soonhwa (2004)

liberalisation may have contributed to the current global financial 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 liberalisation.

4.3. Potential costs and benefits to Mercosur industries

The main economic benefits of financial services liberalisation are expected to come from dynamic effects rather than from static efficiency gains, with the EU and Mercosur countries both standing to benefit. The different levels of development of the sector in the two groups are such that 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 small 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 countries¹⁸. 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 advancement¹⁹.

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.

4.4. 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 growth²⁰. SMEs contribute about 60 percent of manufacturing production in Brazil and over 30 percent in the other Mercosur countries, except Venezuela, where the oil industry is the main producer²¹ (Table 6). In all five countries SMEs make an even bigger contribution to employment. In Argentina SMEs provide about 70 percent of total employment²², while for manufacturing the share ranges from 40 percent in Paraguay and Venezuela to over 65 percent in Brazil (Table 6).

¹⁸ Mattoo et al (2001)

¹⁹ Jalilian, Kirkpatrick and Parker (2006).

²⁰ World Bank (2004)

²¹ Peres and Stumpo (2000)

²² World Bank (2002)

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 economy²³. The problem of “credit rationing” can arise when banks have difficulty in distinguishing good risks from bad risks and in monitoring borrowers²⁴. 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.

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 institutions²⁵. The sub-prime crisis raises doubts about the efficacy of these methods.

²³ OECD (2006)

²⁴ Stiglitz and Weiss (1981)

²⁵ World Bank (2001)

Changes in international bank policy following the crisis may strengthen the counter-argument than dominance by foreign banks can decrease rather than increase the availability of credit to SMEs²⁶.

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 SMEs²⁷. Meanwhile, bank lending may itself be relatively unimportant. SMEs 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 internally generated funds or loans from family and friends at lower rates than are commercially available²⁸. The use of bank loans by SMEs in Brazil is among the lowest in Latin America, with a considerable use of personal savings. It has been argued that SMEs that rely more on personal funds may have better chances of survival than those that rely on banks²⁹.

It may therefore be concluded that the overall impact of financial services liberalisation on the performance of SMEs in Mercosur will be determined primarily by the impact on the economy as a whole rather than through any distinct influence on SMEs themselves.

4.5. 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 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 goods³⁰. 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

²⁶ Stiglitz (2002)

²⁷ World Bank (2002)

²⁸ OECD (2006)

²⁹ Rivera (2007)

³⁰ IARC (2006)

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 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.

4.6. 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 supervision, including needs for better training of regulators and supervisors and greater support from foreign supervisory institutions³¹. 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 priority³². 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 crisis³³. The revised Basel principles (Basel II)³⁴ were intended to correct problems identified with the original principles³⁵, 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 procyclical³⁶, which may have exacerbated the depth of the current crisis.

Emerging economies have been broadly resilient to the effects of the crisis so far, including in Mercosur, but dependence on external sources of funding leaves them vulnerable. The IMF

³¹ Stallings and Studart (2002)

³² Centro de Economica Internacional (2003)

³³ Stallings and Studart (2002)

³⁴ Bank for International Settlements (2006)

³⁵ Bank for International Settlements (1997)

³⁶ Stallings and Studart (2002)

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 strengthened³⁷.

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 regulations³⁸. 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. A supportive international environment is 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 Europe³⁹. 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.

4.7. 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

³⁷ IMF (2008)

³⁸ Stallings and Studart (2002)

³⁹ CEC (2001)

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. These adjustment impacts could be of major significance for Paraguay's small financial services sector, but elsewhere they are expected to be small and not likely to be more than minor in significance.

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 be 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.

4.8. 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	All	Economic growth Risks of greater instability	Coordinated regulatory reforms	?	↑?
Fixed capital formation	Mercosur	Exposure to competition,		↓	↑

Impact	Countries / sectors affected	Causal factors	Factors affecting significance	Potential significance	
				short term	long term
		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	-	↑
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.

5. CASE STUDIES

In the light of the above findings and after a review of existing studies of the sector and of the availability of data, the following three case studies are being undertaken to give greater insight into some of the key potential impacts of EU-Mercosur financial services liberalisation and into potential mitigation and enhancement measures:

1. A study on impact of EU Mercosur trade liberalisation on credit markets in Mercosur, focusing particularly on SME sector and infrastructural finance

The case study consists of an impact assessment of the potential impacts (economic, social and environmental) on credit markets in Mercosur (particularly as pertaining to SMEs and longer term infrastructure finance) of EU-Mercosur trade liberalisation. It will include:

- Description of the development and current structure of credit markets in each of the four Mercosur countries;
- Specification of an EU-Mercosur ‘liberalisation scenario’ for the financial services sector, as it relates to credit markets;
- Detailed assessment of the likely impacts (economic, social and environmental) of the liberalisation scenario on credit markets in Mercosur countries;
- Discussion of policy implications, including proposals for preventative, enhancing and/or mitigation measures.

The report is intended to inform trade negotiators and policy makers in Mercosur and the EU, and will be context specific, analytical and evidence based. Sources of quantitative and qualitative evidence will be cited.

2. A study on the impact of EU-Mercosur trade liberalisation on the financial services sector in Mercosur, with a particular focus on the reinsurance sector in Brazil

The case study consists of an impact assessment of the potential impacts (economic, social and environmental) on the reinsurance services sector in Mercosur (and in particular, Brazil) of EU-Mercosur trade liberalisation. It will include:

- Description of the development and current structure of reinsurance services in each of the four Mercosur countries
- Specification of an EU - Mercosur ‘liberalisation scenario’ for financial services sector, as it relates to reinsurance
- Detailed assessment of the likely impacts (economic, social and environmental) of the liberalisation scenario on the reinsurance market in Mercosur countries
- Discussion of policy implications, including proposals for preventative, enhancing and/or mitigation measures.

The report is intended to inform trade negotiators and policy makers in Mercosur and the EU, and will be context specific, analytical and evidence based. Sources of quantitative and qualitative evidence will be cited.

3. A study focusing on the impact of EU-Mercosur financial services liberalisation on the EU financial sector, with a particular focus on the banking sub-sector

The study will examine the potential effects of trade liberalisation on the financial services sector in the EU, with a particular focus on the banking sub-sector. It will assess the

potential economic, social and environmental impacts of trade liberalisation on the EC member countries. The case study will include:

- a discussion of possible scenarios;
- a preliminary impact assessment of the general financial services sector in terms of selected core indicators;
- the likely impact on bank performance and on competition in the banking market in the EU countries;
- an exploration of the implications of Basle II for trade liberalisation in banking services in the EU.

The study will present key recommendations on how to alter financial liberalisation within 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.

6. FURTHER WORK TO COMPLETE THE STUDY

Further work:

The final stage of the study will:

- implement the three proposed case studies;
- refine the assessment presented at this mid-term stage;
- incorporate the case study findings into the analysis;
- assess alternative measures for mitigation and enhancement;
- prepare conclusions and recommendations.

Final report:

The final report will include the following elements:

- The methodology used for the Trade SIA
- The outcomes and results of the assessment
- Proposals of flanking measures and policy recommendations
- Communication actions and networking
- Conclusions
- References and key sources

The provisional timetable for the Final Report is:

- Draft Final Report: October 2008
- Revised Final Report: November 2008

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