Financial Integration in the Pacific Alliance

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Preface

At a time of global and regional economic slowdown, protectionist sentiment has been on the rise in many countries and areas of the world. Latin America has, for the most part, been an exception to this trend. Since its founding, the Pacific Alliance (PA)—formed by Chile, Colombia, Mexico, and Peru—has been widely celebrated as an example of "open regionalism" based on liberalized trade intra-regionally and with the rest of the world. The Framework Agreement of the Pacific Alliance signed in 2012 specifically calls for increasing "the free circulation of goods, services, capital, and people" among member countries and sets as a common goal a deeper integration with Asia. Forty-nine countries have observer status in the PA, several countries have begun the process of becoming full members, and the countries of the South American Common Market, Mercosur, have shown new-found interest in deepening the dialogue with their PA neighbors.

The PA countries are among Latin America's top performers even at a time of turbulent headwinds. Their economies grew on average by 2.6 percent between 2014 and 2016, more than double the rate for the rest of the region. Together the PA countries constitute almost 40 percent of regional Gross Domestic Product but a greater share—fully 55 percent—of the region's exports. At their mid-2016 meeting in Puerto Varas, Chile, the four PA presidents heralded the entry into force last May of a trade liberalization agreement eliminating tariffs on 92 percent of goods and harmonizing rules of origin to promote regional value chains; established a $100 million fund to provide capital to new entrepreneurs; outlined steps to expand public-private partnerships in the field of innovation and to promote the export capacity of small and medium-sized enterprises; and committed to deeper financial integration, a process involving the respective finance, not just foreign affairs and trade, ministers of member countries.

As this study by Guillermo Perry and Diego Auvert indicates, the potential for PA financial and capital markets integration is large, but for the most part, unrealized. Despite the size of their combined capital markets and the annual turnover of bonds, derivatives, and other financial products, the Integrated Latin American Market (MILA) remains marginal in terms of the total value of traded shares in the combined stock markets. Perry and

Auvert lay out the advantages of deeper integration as well as the concrete steps needed in the medium and long term in order to achieve a single stock exchange with regulatory harmonization. They argue forcefully that political leadership on the part of various governmental authorities will be needed if this is to occur.

We would like to acknowledge the support and insights of Juan Antonio Ketterer, Chief of the IDB's Capital Markets and Financial Institutions, in the preparation of this report. This is the first in a series of papers by the Inter-American Development Bank and the Wilson Center's Latin American Program aimed at a deeper understanding of the dynamics within the Pacific Alliance and the policy approaches needed to realize its full potential.

Cynthia J. Arnson
Director
Latin American Program
Woodrow Wilson International Center for Scholars

Antoni Estevadeordal
Manager
Integration and Trade Sector
Inter-American Development Bank

Executive Summary

Background and Scope:

- The Pacific Alliance (PA) is a pragmatic and dynamic integration process whose members—which currently include Chile, Colombia, Mexico, and Peru—seek the free circulation of goods, services, capital flows, and people among them, as well as cooperation in a wide variety of other areas. The PA subscribes to the modern view of "open regionalism," because it promotes trade and capital flows with other regions—in particular, with East Asia and Mercosur—and it remains open to new members. Several other Latin American countries have indicated their potential interest in the PA, and Costa Rica is currently advancing in the process of joining.
- Financial integration is, thus, one of the PA's main goals. Financial institutions within the region, in particular of emerging financial *multilatinas*, already have important cross-investments.
- But the best-known development so far in this area is the Mercado Integrado Latino Americano (MILA) platform, a partial integration of the four current PA members' stock exchanges which, together with significant advances in capital markets' regulatory harmonization, already permit:
    1. Listing in all four markets through any of the MILA exchanges;
    2. Simultaneous issuing and secondary trading of all types of securities approved by any of the four exchanges' regulators, using standardized prospects in all PA markets;
    3. Provisions that allow brokers from any PA member exchange to access the other three exchanges through a local sponsor; and
    4. Access to a single trading screen for Colombia, Chile, and Peru.
    - However, in spite of these advances, actual operations through MILA remain marginal. So far, there has only been secondary trading of shares through MILA, representing less than 1 percent of their total value traded on the four PA stock exchanges, and the initial enthusiasm seems to be fading away.
    - This paper discusses, first, why financial integration, and in particular capital market integration, may provide large benefits to

the PA's members, especially in the current external environment. It then focuses on the potential for the integration of capital markets within the region and on how a significant push toward regulatory harmonization can contribute to meeting this goal and reenergizing MILA.

The Potential Benefits of Financial Integration in the PA

- Deeper regional financial integration in the PA would potentially have significant long-term advantages. On one hand, it would broaden opportunities for access to long-term finance by governments, public entities and private firms in PA member countries. And this access to finance would also depend less on each individual country's business and credit cycles. On the other hand, it would offer broader risk diversification opportunities for both institutional and individual regional investors.
- These potential advantages have become much more important in the current global and regional environment. Indeed, capital flows to all of Latin America slowed down and become more volatile since the global financial crises of 2008–9, the end of the commodity price supercycle, and Brexit. This trend, temporarily reversed in recent months, may be reinforced whenever the US Federal Reserve implements its announced interest rate adjustments. Furthermore, there has been a significant retrenchment of large international financial institutions from the region and from emerging markets in general, due both to the lasting effects of the global financial crises and Basel 3 regulations.
- In this environment, many PA private and public firms may face difficulties in raising required long-term funds. This may be especially worrisome for investment in infrastructure, given that overcoming the significant existing lag in this area appears to be crucial for regional medium- and long-term growth. Indeed, aggressive and well-designed public–private partnerships (PPP) in infrastructure could help mitigate the recent drops in aggregate demand, in the short run, and contribute to higher productivity growth, in the medium and long terms.
- Regional financial integration can help mitigate such potential financial shortfalls, in particular in the infrastructure sector. Capital market integration appears to be crucial, because the high concentration of institutional investors (e.g., pension funds and the insurance industry) in each country is having the paradoxical effect that many sound PPP infrastructure projects do not find enough long-term funding, while

at the same time institutional investors do not have enough local opportunities for risk diversification.

The Potential of Full Integration of Capital Markets in the PA

- The combined PA capital markets today represent the second-largest stock market among emerging countries, in terms of the market capitalization of shares, after that of China. In terms of annual turnover, it ranks fifth, after those of China, South Korea, Brazil, and Singapore. Similarly, it represents one of the largest emerging markets for bonds, derivatives, and other financial products.
- Furthermore, the PA's current combined market cap and turnover could rapidly become significantly larger than today with full integration through a single regional stock exchange. In particular, a single PA capital market would be significantly more attractive than the current individual markets to large international and domestic investors, because the size of capital markets is crucial for risk diversification and liquidity and hence for market growth opportunities.
- A single capital market could be especially important for achieving more competition and better risk diversification within the large, but locally concentrated, regional pension fund industry. It would also facilitate the growth of regional mutual investment funds and of the relatively underdeveloped and conservative regional insurance industry.
- To achieve these goals, however, the four PA members would be required to fully integrate their stock exchanges and, even more important, make significant progress toward the regulatory harmonization of their capital markets and institutional investors' investment regimes.

Next Steps

- **A medium-term agenda for regulatory harmonization**
  1. ***A MILA VIP market with higher standards.*** Establishing a MILA VIP or signature market with high corporate governance standards for issuers would significantly increase the interest of foreign investors in the PA's markets and securities. It would be an important complement to the following recommendations.

2. ***A MILA passport for administrators of mutual investment funds.*** International and domestic fund managers would find very attractive the possibility of operating, distributing, and trading their products simultaneously in the four PA markets under common rules and requirements, by registering only once, or by achieving automatic registration if they were to proceed from "recognized" jurisdictions with high standards of regulation and supervision.
3. ***Remote access for brokers and investors to the four MILA Markets.*** This would significantly reduce the transaction costs of operating in the PA markets and eliminate the remaining credit risks of operating through correspondent brokers. Brokers should be encouraged to facilitate direct access of their clients to their trading screens, thus facilitating investors' inquiries, orders, and claims and significantly reducing their transaction costs.
4. ***Harmonization of issuance, clearing, settlement, and operational procedures.*** In order to reduce the transaction costs of operating in the four PA markets, and the remaining credit risk associated with payments through local brokers, it is desirable to have a common framework for clearing and settlement.
5. ***Granting local status to PA pension funds (and, later, to insurance companies).*** Ideally, the PA member countries should grant full pension portability within the region (Chile and Peru already have arrangements in place, and there are current discussions about bilateral agreements among all four members) to facilitate labor mobility, a major objective of the PA. Likewise, the long-term objective should be full harmonization of the regulations for investment portfolios and the tax treatment of pensions and pension funds. However, given that this long-term objective would take time to be agreed upon and implemented, in the short term it would be critical to grant local status to other PA members' pension funds, so that they could freely buy and sell regional securities within relatively ample common limits. Simultaneously, regulators should facilitate the development of infrastructure bonds, which would fit especially well with the long-term nature of pension obligations and facilitate an aggressive development of PPPs in badly required infrastructure investment.
6. ***Tax harmonization.*** Differences in the tax treatments of financial products appear to have been a major factor in limiting operations

through MILA. In addition to some minimum harmonization of tax norms for investors in different financial products, it seems necessary to complete the web of bilateral double taxation agreements among the PA member countries, to avoid the double taxation of profits realized in the extended market.

7. **The longer term: full harmonization and a single stock exchange.** As mentioned above, in the longer term the objective should be the full harmonization of capital markets' regulation and a single stock exchange, given the significant economies of scale (in terms of liquidity and opportunities for risk diversification) that characterize these markets. This process should be based on a general agreement to adopt higher standards and "material" harmonization, as well as mutual recognition and delegation of authority to the country of origin.

- **The need for political leadership.**
  - Further advances in capital markets' integration in the PA are urgently requiring a shift in leadership. Initial developments in MILA were the result of private sector initiatives. Regulators and supervisors have agreed since 2011 to support this process through the required regulatory harmonization and cooperation in supervision, and have since made considerable advances toward meeting these goals. However, this process seems to have reached a limit in the absence of a major push from the governmental authorities.
  - It is imperative that the presidents and ministers of finance of the PA member countries now take the lead to agree on a broad and ambitious vision for regional financial integration and give regulators and supervisors a clear and forceful mandate to achieve full regulatory harmonization and cooperation in supervision. Otherwise, MILA will stall and languish. In this context, it is encouraging that the last PA presidential meetings in Paracas and Puerto Varas agreed on some important next steps for the process of financial integration and that the PA ministers of finance have begun to consider several initiatives in this regard, in particular with respect to the regulatory aspects of the pension fund industry.
- **The need for a technical secretariat**
  - However, a forceful political decision to truly integrate the PA capital markets is a necessary but not a sufficient condition for achieving such an objective. Indeed, it is unlikely that the existing

cooperation channels among policymakers, regulators, and supervisors will be enough to achieve a rapid pace of advance in the regulatory and tax harmonization agenda sketched above, given its broad scope and high degree of technical complexity.

- It thus seems necessary to establish a Technical Secretariat for Financial Integration, under the guidance of the PA ministers of finance and financial regulators and supervisors, that would have the following main functions:
  - Build a detailed road map for financial integration in the PA.
  - Monitor and disseminate advances toward financial integration.
  - Conduct studies, supported by international experts, on the areas requested by the PA ministers of finance and financial regulators and supervisors.
  - Present specific proposals for ministers', regulators', and supervisors' approval and decisionmaking, in order to advance the harmonization of market and tax regulations, according to the agenda sketched above and priorities previously agreed upon.
- Such an arrangement would have several advantages, as it would:
  - Provide the required high-level political support for the process of financial integration, and facilitate policy agreements, given the active guidance and participation of ministers of finance.
  - Assure the quality and timely elaboration of required studies and proposals for decision.
  - Overcome the natural tendency of local regulators to think that each of them has developed "the best" regulatory framework and, thus, that regional harmonization should be based on their own local standards.

Abbreviations

ABRAPP	Associação Brasileira das Entidades Fechadas de Previdência Complementar
ARCO	Latin American Pacific Rim countries
Asofondos	Asociación Colombiana de Administradoras de Fondos de Pensiones
BVC	Bolsa de Valores de Colombia
FIAB	Iberoamerican Federation of Exchanges
GDP	gross domestic product
IMF	International Monetary Fund
IPO	initial public offering
LA-7	Brazil, Chile, Colombia, Mexico, Panama, Peru, and Uruguay
MILA	Mercado Integrado Latinoamericano
PA	Pacific Alliance
PPP	public-private partnership

Introduction and Scope

This paper discusses the advances toward financial integration in the Pacific Alliance (PA) and its future challenges. It focuses on the integration of capital markets through the Mercado Integrado Latino Americano (MILA) platform, which is an initiative of partial integration of the stock exchanges of the PA's four member countries, and related requirements for regulatory harmonization and cooperation in supervision. Section 1 provides background on the PA's nature, objectives, and advances, including those related to financial integration. Section 2 discusses in detail why deeper financial integration, and especially capital markets' integration, could have significant short- and long-term benefits for the PA's members. Section 3 illustrates the potential for capital markets' integration in the PA. Section 4 discusses the advances in capital markets' integration through MILA and proposes an Agenda for Action for regulatory and MILA authorities, which could eventually enable the PA to enjoy all the potential benefits associated with full capital market integration.

The authors of this paper appreciate the invaluable cooperation of the Superintendencia Financiera de Colombia, Bolsa de Valores de Colombia (BVC), Iberoamerican Federation of Exchanges (FIAB), Banco de México, and Asociación Colombiana de Administradoras de Fondos de Pensiones (Asofondos) in obtaining, updating, and interpreting the information used in this study. They also thank the International Monetary Fund (IMF) for authorizing them to use some relevant figures from their publications. For guidance and comments on a first partial draft of the paper, they further thank Gerardo Hernández, Superintendente Financiero de Colombia; Jorge Castaño, director of research and Development in the Superintendencia Financiera de Colombia; Juan Pablo Córdoba, CEO of BVC; and Estefanía Molina, adviser to the BVC's CEO.

Background: The Pacific Alliance: A Promising Deep Integration Process

The Pacific Alliance is a pragmatic and dynamic deep integration process, more akin to Asian integration initiatives than to other Latin American processes such as Mercosur or the Andean Community. Indeed, it is proceeding by deepening previously existing bilateral free trade agreements among member countries in various ways: (1) Deepening trade through complete liberalization, as well as harmonization and *cumulation* of rules of origin,[1] thus facilitating not just trade but also the development of production chains within the region. (2) As important, by going well beyond trade objectives, promoting freer circulation of labor and capital, as well as cooperation in other areas.

Moreover, the PA process subscribes to the modern view of *open regionalism*, whereby regional integration is seen as part of a process of deeper global integration of its members. Thus, the PA is actively attracting new members and seeking to deepen economic relations with other trading partners, in particular with the countries in the Asia-Pacific region and the Mercosur countries.

The PA's current members—Chile, Colombia, Mexico, and Peru—have a total population of 224.6 million and an aggregate gross domestic product (GDP) of US$1.8 trillion, representing 35.5 percent of Latin America's total population, 36.3 percent of its total GDP, and 46.8 percent of its total imports. As a group, they represent the seventh-largest global market in terms of GDP (see figure 1 and table 1).

Just as important, these four countries share stable democratic government, good macroeconomic policies, and a similar pro-market orientation. Because of this, they withstood well the adverse external shocks of the 2008–9 global financial crises and the sharp fall of commodity prices from 2013 onward, and they have enjoyed significantly higher and more stable growth during this period than other large countries in the region (e.g.,, Argentina, Brazil, and Venezuela). In particular, they have kept their investment-grade risk classification with rating agencies and have continued to have good access to international capital markets, in spite of considerable market volatility since the global crises, the sharp fall in their terms of trade due to the collapse in commodity prices after 2013, and the recent effects of Brexit. Most analysts estimate that they have the largest regional growth potential.

[1] Bilateral free trade agreements permit free entry (or reduced tariffs) of goods originated in the partner country when there is a minimum degree of local value added in the exporting country; see Estevadeordal and Suominen (2009). Cumulation counts imports from other Pacific Alliance members as part of local value, thus facilitating the development of production chains within the region. For a detailed explanation of about this process, see Elliot (2010).

FIGURE 1/ The Pacific Alliance's Members

Source: Pacific Alliance archives.

In addition, as mentioned above, the PA member countries share a common interest in deepening their integration in the global economy, in particular with their counterparts in the Asia-Pacific region. The original idea was a trade agreement that would encompass all the Latin American Pacific Rim countries (the so-called *ARCO del Pacífico* initiative), but as those negotiations moved slowly, the presidents of the four countries that are now PA members, the largest in ARCO, decided to speed up the process on their own on April 28, 2011, leaving the door open for others to join later.

The PA process was greatly facilitated by the fact that its four member countries already had bilateral free trade agreements among them. Currently, the three largest Central American economies (Costa Rica, Panama, and Guatemala) are either beginning the process of joining the PA or have expressed interest in doing so. They, and all the other Pacific Rim countries in the hemisphere (including the United States and Canada), in addition to several other countries in Latin America and other regions, actively participate in the PA's meetings as observers.

Decisionmaking in the PA has been quite dynamic. On June 6, 2012, the presidents of Chile, Colombia, Mexico, and Peru signed the Framework Agreement, which, once approved by their respective legislatures, granted

TABLE 1/
The Size of the Pacific Alliance by 2014

	Brazil	Chile	Colombia	Peru	Mexico	Pacific Alliance (PA)	Latin America & Caribbean (LAC)	PA/ LAC
Stock market capitalization (USD billion)	843.9	236.6	153.2	121.2	831.8	1342.8	—	—
Value of domestic debt securities outstanding (USD billion)	1977.2	131.6	84.7	25.4	596.8	838.5	—	—
Average daily traded volume	2937	116	100	15	681	912	—	—
Listed domestic companies*	356	230	70	208	139	647	1,254	51.6%
GDP at market prices** (current USD billion)	1,774.7	240.2	292.1	192.1	1,144.3	1,868.7	5,148.0	36.3%
GDP per capita** (current USD)	8,539	13,384	6,056	6,122	9,009	8,321	8,133	—
Population** (million)	207.8	17.9	48.2	31.4	127.0	224.6	633.0	35.5%
Inflation rate** (annual %)	9.0	4.3	5.0	3.6	2.7	3.4	2.9	—
Unemployment rate (%)	6.8	6.4	10.1	4.2	4.9	5.8	6.6	—
Imports of goods and services** (current USD billion)	254.2	72.8	70.8	45.3	428.7	617.6	1,320.9	46.8%
Credit rating Sovereign Risk – foreign currency (S&P)	BB	AA–	BBB	BBB+	BBB+	—	—	—
Number of exchanges	1	3	1	1	1	6	—	—

Sources: World Bank; Iberoamerican Federation of Exchanges; World Federation of Exchanges database; Bank for International Settlements.
*For listed domestic companies' figures, aggregate data for the Latin America and Caribbean region are provided by the World Federation of Exchanges database, while individual country and PA data are provided by the Iberoamerican Federation of Exchanges.
**Data for 2015.

juridical status to the PA. Given that the deep integration sought by the Framework Agreement envisions the free movement of goods, services, capital, and labor within the region, the PA has achieved important

agreements in all these areas. Regarding financial services, there have been advances in facilitating and protecting cross-border investments originating in the partner countries, which can be particularly important given the rapid expansion of financial *multilatinas*, especially from Colombia and Chile, as discussed in section 2. However, the most ambitious initiative in this area is the ongoing process of integrating the stock exchanges of the four members through the MILA platform, a topic discussed in detail in sections 3 and 4 of this paper.

As the International Monetary Fund (IMF) states: "The combination of political and market enthusiasm may make the Pacific Alliance a more successful initiative than earlier regional attempts."[2] The diversity between Mexico, on one hand, as a large manufacturing country, and the other three, medium-sized commodity exporters (Chile, Colombia and Peru), on the other hand, suggests that their integration could bring particular synergies.

[2] See IMF (2016a).

Why Regional Financial Integration in the Pacific Alliance?

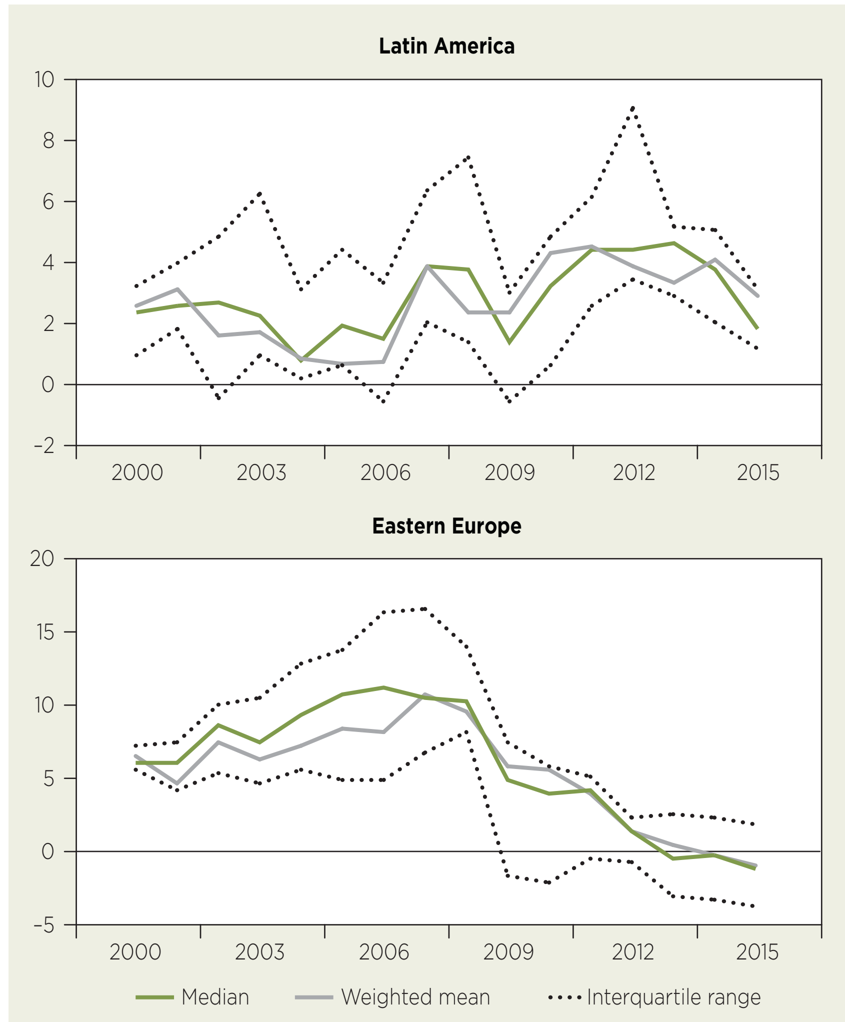
There are significant potential long-term advantages for promoting financial integration in the PA area, in terms of both broader and more stable access to finance by governments, public entities and private firms in these countries, and broader opportunities for institutional and individual regional investors to achieve better expected returns and risk diversification. These potential advantages have become much more important in the current global and regional environment, since the global financial crises of 2008–9 and the fall in commodity prices since 2013.

Indeed, capital flows to Latin America and other developing regions had a downward trend, amid significant volatility, starting in 2014 (figure 2), and, though there has been a temporary improvement in recent months, this trend may continue in the near future, for several reasons. First, growth in the developed world is picking up, while the growth prospects of Latin American and other emerging markets have slowed down. As a consequence, there has been a change in the expected profitability of real investments in both the North and emerging markets, which has adversely affected capital flows toward the latter. Second, the beginning of normalization of US monetary policy initially reinforced these effects for financial flows and will probably continue to do so in the future, with significant volatility induced by pauses and accelerations in announced policies of the US Federal Reserve System. The eventual normalization of monetary policies in Europe, if growth continues to consolidate in this region, will add to this effect. Third, the high level of uncertainty in global financial markets, recently exacerbated by Brexit, favors higher relative flows toward perceived safe heavens. Fourth, the ongoing process of global regulatory reform (especially, the new higher capital requirements for all banks, the systemic banks' capital surcharge requirements, the changes in effective resolution regimes, the over-the-counter reforms, and ring fencing requirements) are also affecting negatively flows toward emerging markets.[3]

In addition, we have recently been witnessing a significant process of retrenchment of global private banks from the region. Many of these were severely weakened by the 2008–9 global crises, and they are all being subject now to much more stringent regulatory requirements in their

[3] See IMF (2016a).

FIGURE 2/
Net Capital Inflows by Region, 2000–2015:Q3 (percentage of regional GDP)



(continued on next page)

host countries, due to the implementation of Basel 3 agreements. As a consequence, some have left the region or have reduced their exposures to it, and have not been replaced by other global banks. In many countries in the region, this has led to further concentration in the hands of leading local financial groups, undermining competitiveness, and a significant reduction of liquidity adversely affecting capital markets.

In this environment, many regional firms may face higher financial constraints, at a time when many manufacturing and service sector firms need to invest and expand in order to compensate for the slower growth of firms directly related to primary production. Furthermore, several

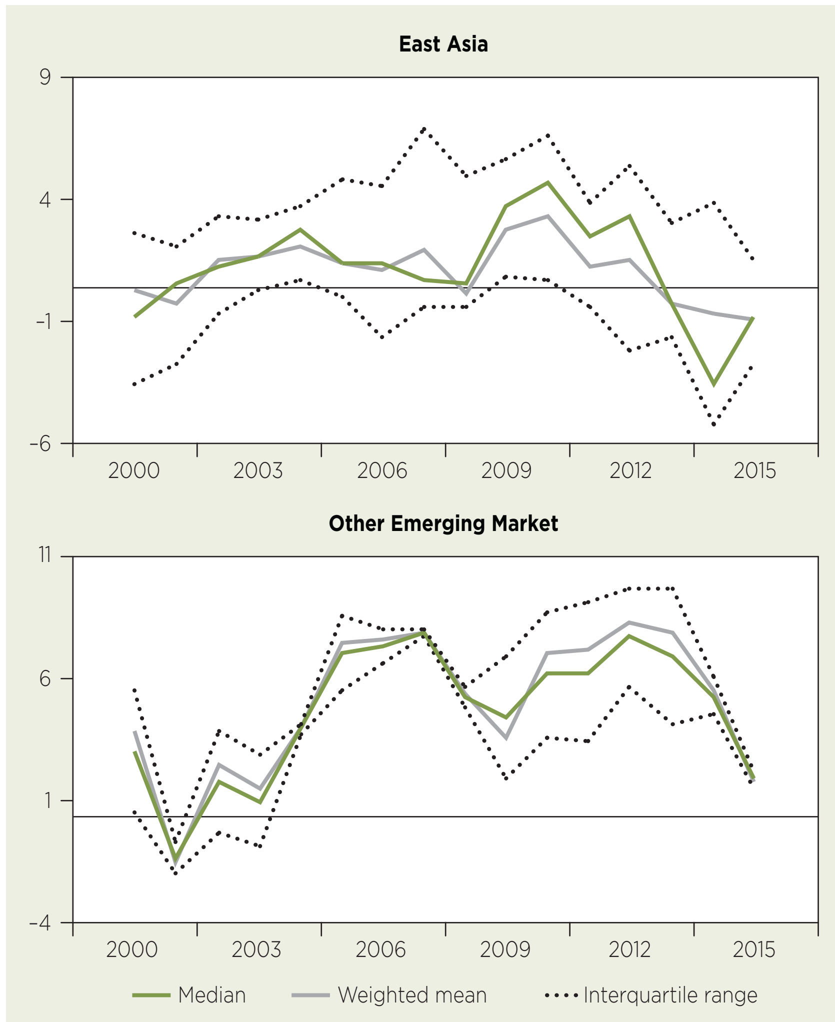


FIGURE 2/
Net Capital Inflows by Region, 2000–2015:Q3 (percentage of regional GDP)
(continued)

Source: IMF, *World Economic Outlook* April 2016.

countries in the region face considerable infrastructure lags, especially in transportation, which they are attempting to overcome with highly ambitious programs, with considerable private sector participation (through public–private partnerships, PPPs) due to tighter fiscal constraints. Such programs can help smooth the adjustment process in which economies are currently engaged, through a boost in demand, and contribute to higher long-term investment and productivity growth.

However, current circumstances may limit access to local or global long-term funds for such PPPs. In particular, new regulations penalize banks' maturity mismatches and may lead them to limit long-term lending

for privately led infrastructure projects. Thus, capital markets should have a larger role to play in this area. At the same time, new regulations on banks may also limit their provision of liquidity for capital markets, and this may negatively affect both the corporate bond markets and the development of infrastructure bonds for project financing of major investments in these areas. Although the PA countries are less affected by these developments than other large countries in the region, they cannot fully escape them.

Derivative markets, especially those designed to cover interest rate and exchange rate risks, are important to facilitate longer-term bank lending based on shorter-term deposits and to permit infrastructure and other longer-term investment projects in nontradable sectors to tap foreign capital markets without excessive currency risk exposures. However, new global regulations, which attempt to make derivative markets safer, may limit their future growth. These developments make more urgent than ever the development of local and regional derivative markets. Specifically, it would be especially important for MILA to develop instruments to mitigate currency risks for investors from one PA member country that buy bonds denominated in another member country's domestic currency.

The rapid growth of institutional investors' assets in several countries in the region, especially in the pension fund and insurance industry, and their need to find adequate long-term domestic investments, should provide an avenue for mitigating many of these financial constraints. However, ironically, the existing high levels of concentration and limits in exposure to individual large projects often imply that large infrastructure projects and other long-term investments may not find sufficient local financing, while at the same time these institutional investors face difficulties in achieving a good balance between required expected returns and risk diversification. Hence, regulators have been allowing increasing portions of their portfolio to be invested abroad. These, however, pose new problems, such as increased exposure to currency risks and global financial stress.

Regional financial integration may, in principle, help mitigate many of these problems, although it also faces new challenges in the current environment. To summarize: (1) It may mitigate scarcity of long-term finance that may develop as a consequence of the current reduction of capital inflows and the retrenchment of financial global players from the region, the latter due to the lasting effects of the 2008–9 global crises and the stricter Basel 3 requirements. (2) It may help institutional

investors, especially pension funds and insurance companies, to achieve greater portfolio diversification. (3) As a consequence of the previous two considerations, it may facilitate the financing of badly needed PPP infrastructure projects. And (4) finally, it may mitigate the risk of asset bubbles and reduced liquidity in domestic markets, as a consequence of the heavy current concentration of institutional investors in these markets and the fact that pension funds and insurance companies hold financial investments for long periods in their portfolio.[4]

Thus, it would contribute not only to a greater availability of finance but also to increasing competition, efficiency, and safety in domestic markets. In turn, more competition, liquidity, and efficiency may improve the transmission channels of monetary policy (IMF 2016a). Thus, speeding up regional financial integration may even have a higher expected value today than in the previous decade.

Regional financial integration is proceeding rapidly de facto, and there has been significant progress in the harmonization of regulations and cooperation in supervision, in particular with respect to capital markets. As mentioned above, capital market integration is being furthered by the partial integration of stock exchanges through MILA. This process can be particularly important, given the relatively small size of capital markets in Latin America (see figure 3) and the huge potential gains that could be achieved through integration, as a consequence of the considerable economies of scale (in terms of risk diversification and liquidity) that characterize these markets, as we discuss in the following sections.

The *superintendentes de valores* of the MILA countries have actively supported this private initiative since its start in 2011. They created the MILA's Consejo de Superintendentes, with the Superintendencia Financiera de Colombia acting as its technical secretariat, with the support from the multilaterals' agencies, in particular the Inter-American Development Bank. They hold annual meetings, have issued memorandums of understanding among all the member countries of MILA, guaranteeing close collaboration and the pursuing of the harmonization of regulations (International Organization of Securities Commissions, standards recommendations) and especially cooperation in supervision. They have also established workshops and *pasantías* in Colombia and Mexico for multilateral discussions on relevant topics for the development of financial integration. There are two additional workshops planned for the second semester of 2016, to be held on Peru and Chile.

[4] See IMF (2016a).

Notwithstanding this, there is a need for a significant further push in these directions. Capital markets' integration faces major challenges, due to severe infrastructure and regulatory harmonization requirements. Thus, it should not come as a surprise that actual transactions through MILA—which is just a platform for routing orders among individual stock exchanges, and thus is still very far from full stock exchange integration—are still very small. Section 3 illustrates the potential for capital market integration in the PA, and section 4 discusses both MILA's achievements and challenges and presents a set of recommendations, in particular with respect to further regulatory harmonization.

Banking and insurance sector de facto integration is also proceeding rapidly in the PA through the expansion of Latin American private banks, insurance companies, and other financial institutions (mostly of Brazilian, Colombian, and Chilean origin) across the region. In particular, Chilean financial institutions and pension fund administrators have invested in Colombia and Peru, the major Colombian insurance group already has a regional presence, and some Colombian banks are investing in Peru.

Often, as happened at the beginning of global financial integration, banks followed the expansion of some of their major local clients to other regional markets, as they are the most natural providers of financial services to them in new markets, given their informational advantages. Additionally, there are many synergies with financial services provided at home, such as trade finance and foreign exchange operations. At the same time, the location of national banks in foreign markets facilitates trade links and further real sector expansion, thus promoting a virtuous circle of integration and growth.

This process also has a major advantage of country (and often sector) risk diversification for the private financial institutions and their financial systems at home, reducing the likelihood and severity of financial stress due to local recessions, credit busts, and/or the concentration of casualties and losses for insurance companies. Host markets in turn benefit from increased competition and efficiency.

However, this process, as well as financial integration in general, also raises risks of regulatory arbitrage and financial contagion among both exporting and importing markets. Thus, it is urgent to speed up the regulatory harmonization of banks and insurance companies (which would further facilitate the process of financial integration and increase its efficiency), as well as cooperation in their supervision.

The PA is proceeding rapidly with harmonization and cooperation with respect to capital markets, as mentioned above. It is also important to proceed likewise with banking and insurance companies' regulatory harmonization and cooperation in supervision. Faster harmonization of financial regulations and cooperation in supervision in banking and insurance would not only speed up this highly beneficial process of cross-investment in the financial sector and financial cross-border flows but also make them safer. In this regard, the example of the Central American Council of Financial Supervisors could be relevant.[5]

The rest of this paper concentrates on the integration of capital markets and, in particular, of the PA stock exchanges through MILA.

[5] Because banking and insurance sector integration has been a long-standing process in Central America, their regulators and supervisors meet often and have made significant advances in the harmonization of regulations (most countries have adopted common accounting standards and applied Basel 2 recommendations), and especially, in cooperation in supervision, through the Central-American Council of Financial Supervisors, which has a technical secretariat and does joint reviews of some of the most important regional players in the financial industry. Since Colombian financial institutions have recently expanded vigorously in the region (holding today more than 25 percent of regional financial assets, which represent more than 28 percent of their total assets), Colombia actively joined the Central American Council of Financial Supervisors. The Pacific Alliance should follow this example, both because there is already an important and increasing process of cross-investment in the financial sector, and also because Central American countries are the most natural new candidates to join the Pacific Alliance. In fact, two of them are actually in the process of joining.

MILA's Potential: Capital Markets and Institutional Investors in the Pacific Alliance's Members

Size and Growth of Capital Markets in the Pacific Alliance

Figure 3 show comparative figures for capital markets' development in Latin America (in its seven largest economies), in relation to its GDP and in comparison with other regions. Equity market capitalization, the traded value of shares, and corporate bonds outstanding in the region significantly lag the corresponding values of both advanced economies and emerging

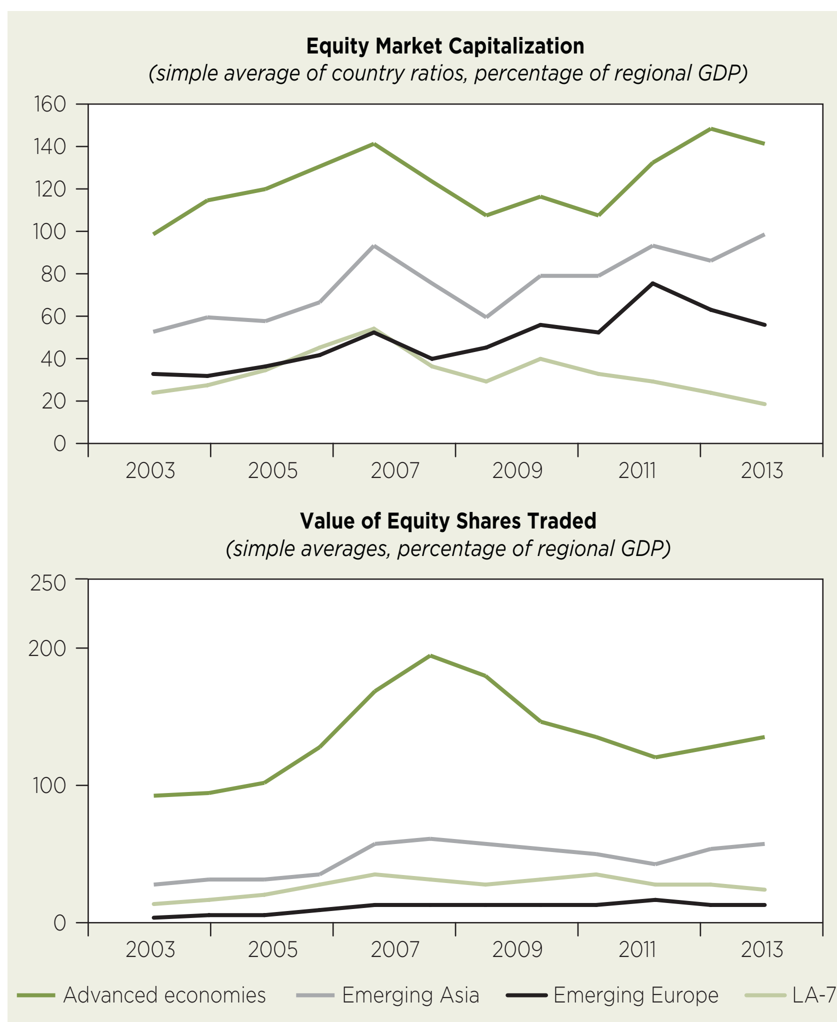


FIGURE 3/ Equity and Bond Markets: Comparative Regional Indicators*

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FIGURE 3/ Equity and Bond Markets: Comparative Regional Indicators*
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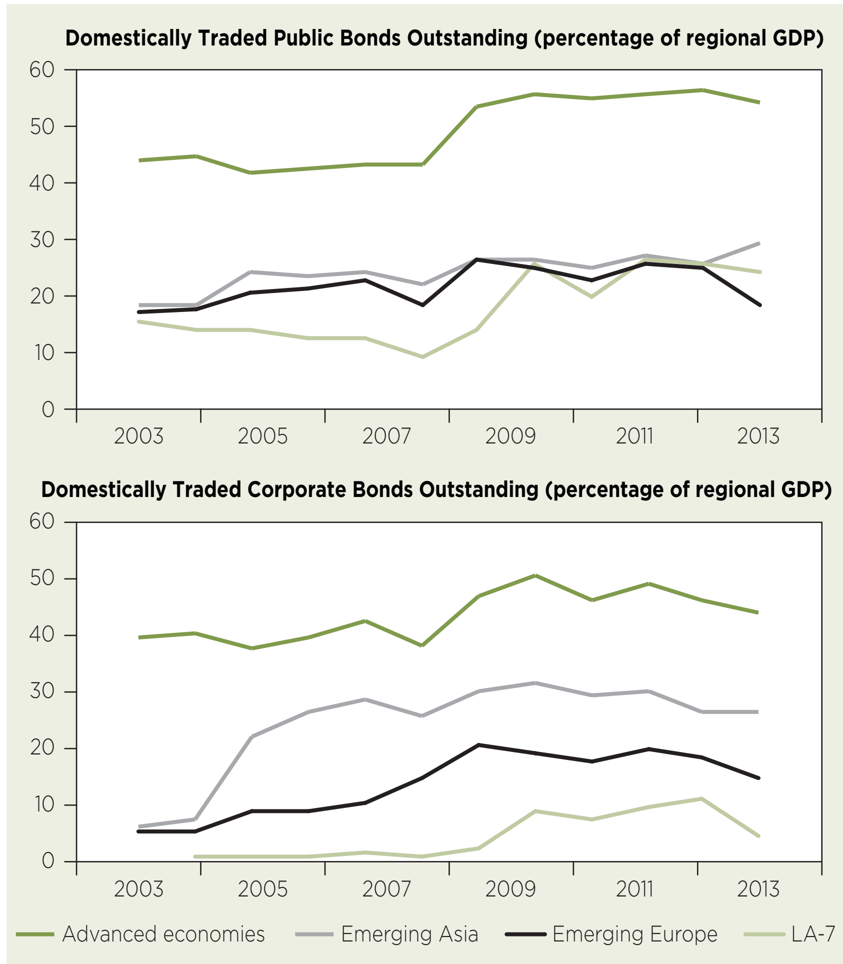


Source: IMF (2016a).
*Advanced economies include AUS, CAN, FRA, GER, HKG, ITA, JPN, KOR, NOR, SGP, ESP, SWE, TWN, GBR, and USA; emerging Asia includes CHN, IND, IDN, MYS, PHL, and THA; emerging Europe includes HUN, POL, RUS, and TUR; LA-7 include BRA, CHL, COL, MEX, PAN, PER, and URY.

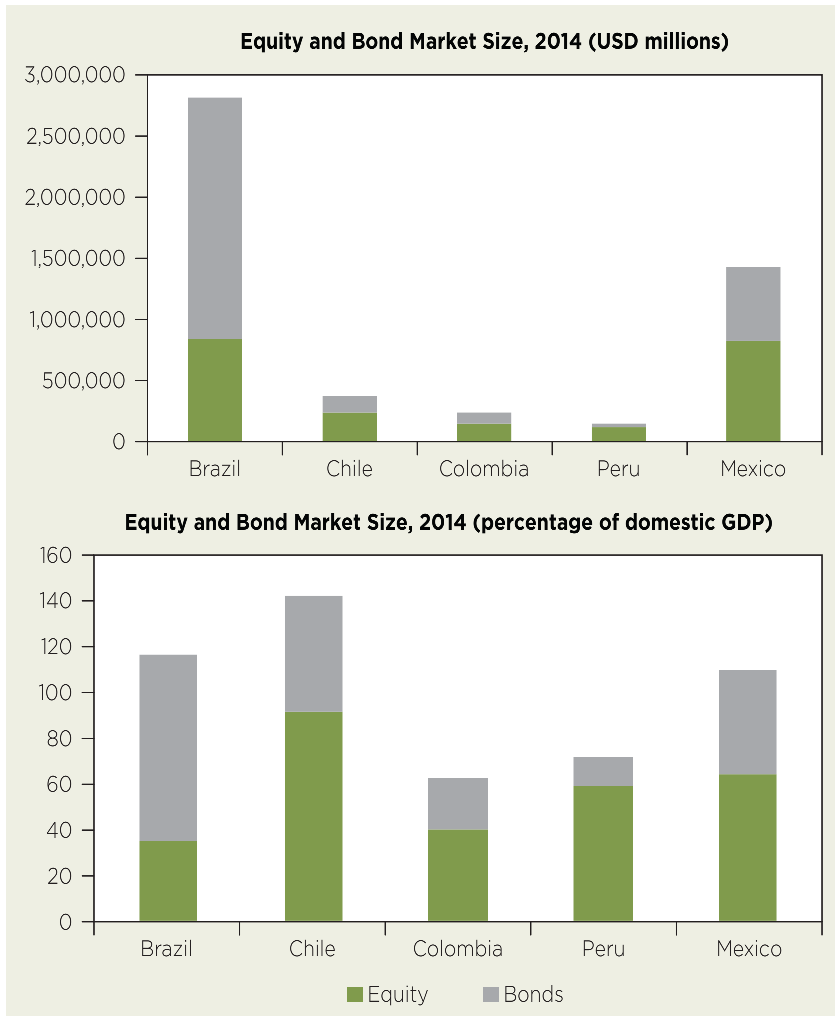
Asia. Only public bonds outstanding show similar values for emerging economies in Latin America and Asia.

The aggregate PA capital market is smaller in dollar terms than Brazil's, because of the larger Brazilian bond market (see figure 4).[6] However, the aggregate PA capital market is larger as a percentage of its aggregate GDP than Brazil's.

If the PA's stock exchanges were fully integrated today, MILA would become the second-largest stock market among emerging countries in terms of the market capitalization of shares, after that of China, and the

[6] Total capital market is defined as the sum of equity and bond market size. The size of the former is measured by debt securities amount outstanding, while the latter is measured by equity market capitalization.

FIGURE 4/
Equity and Bond Markets in Latin America

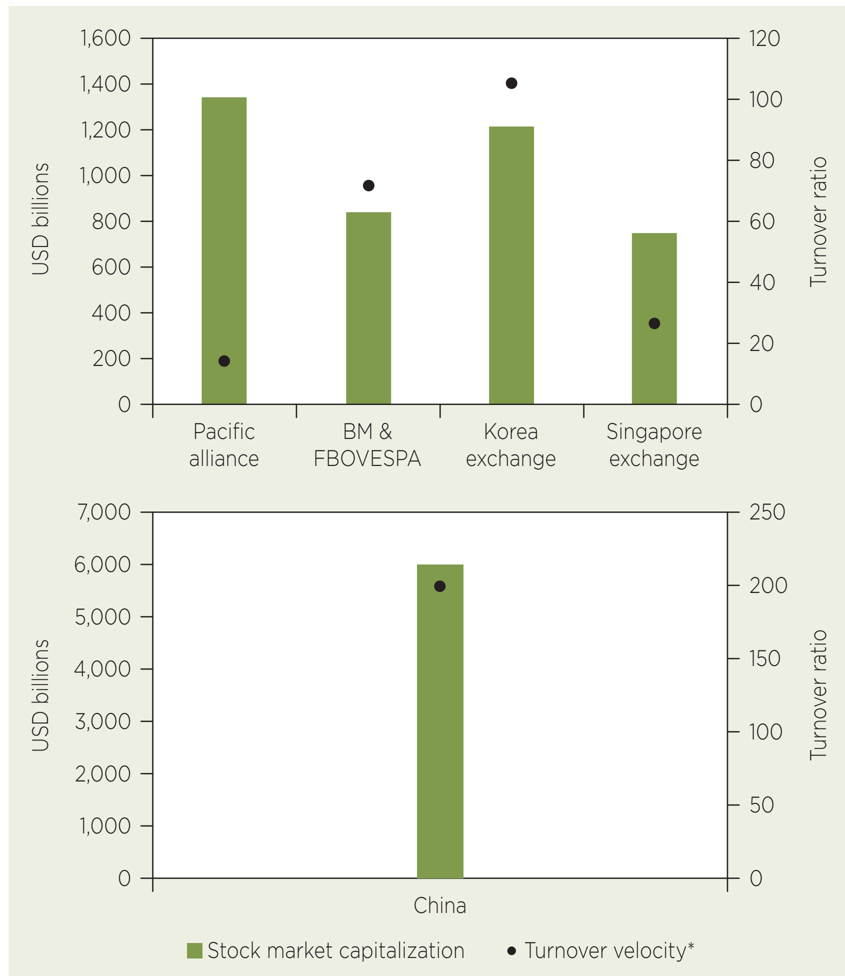


Source: Iberoamerican Federation of Exchanges, Bank of International Settlements.

fifth-largest in terms of annual turnover, after those of China, South Korea, Brazil, and Singapore (see figure 5). Further, as discussed in section 2, full integration would create important synergies, so the combined market cap and turnover would likely become significantly larger.

The aggregate domestic market capitalization of the PA's stock exchanges grew at an annual average rate of 14 percent from 2004 to 2014 (figure 6). Growth was especially fast during the recent Latin American boom from 2003 to 2012. Since 2012, there has been an important reduction in dollar terms, due to the combined effect of a slowdown in economic activity, local currencies' depreciation against the dollar, and global financial volatility.

FIGURE 5/ Size and Liquidity of Emerging Countries' Stock Exchanges in 2014*



Sources: FIAB for the Pacific Alliance and BM&FBOVESPA's data; World Federation of Exchanges and World Bank databases for the stock exchanges of China, South Korea, and Singapore.
*Turnover velocity (tradable value of shares over market capitalization) of the Pacific Alliance is the average ratio shown by country members in 2014.

In 2014, the Mexican stock exchange represented more than 60 percent of the combined size of the PA's aggregate equity market capitalization, followed by Chile (17.6 percent), Colombia (11.4 percent), and Peru (9.0 percent). The corresponding numbers in 2004, at the beginning of the recent boom, were 69.5 percent, 23.0 percent, 4.1 percent, and 3.4 percent, respectively, indicating that market capitalization has grown faster in Colombia and Peru (about 30 percent on average during the 2004–14 period).

As for size of the bond markets, amounts outstanding reached a combined USD 900 billion in 2014 and declined to USD 750 billion in

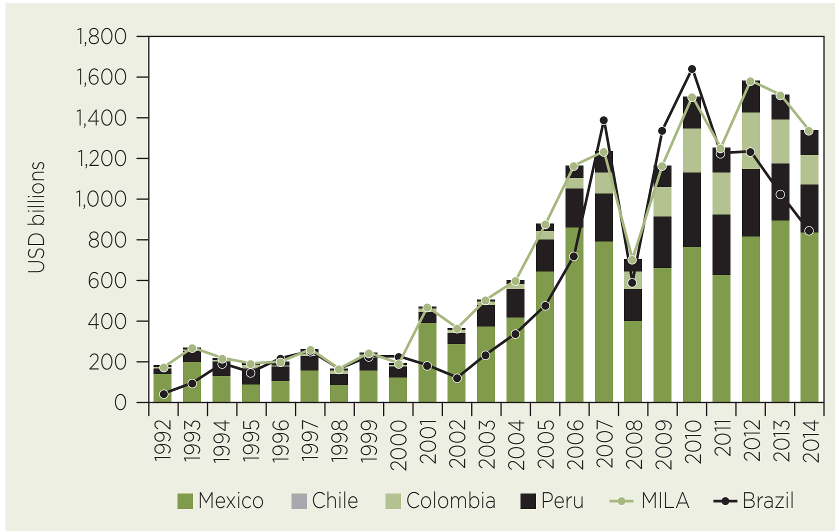


FIGURE 6/
Equity Market Capitalization in the Pacific Alliance and Brazil

Source: Iberoamerican Federation of Exchanges.

2015, representing about 60 percent of the total market value of stocks. Brazil's bond market is about 2.5 times the combined PA market. Mexico has represented about 75 percent of the PA bond markets. See figure 7.

The number of companies listed on the PA's stock exchanges is more than double the number listed on Brazil's exchanges. This fact, combined with a relatively larger market cap in Brazil, indicates a larger average size

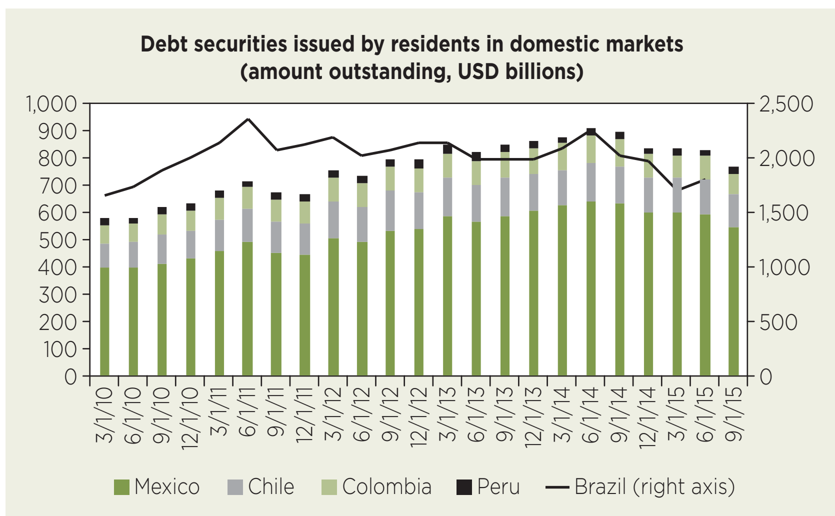


FIGURE 7/
Debt Securities Issued by Residents in Domestic Markets (amount outstanding, USD millions)

Source: Bank of International Settlements.

TABLE 2/ Number of Listed Companies in PA Markets and Brazil

		Brazil	Chile	Colombia	Peru	Mexico	Pacific Alliance (PA)
2013	Foreign	12	78	6	31	5	120
	Domestic	355	227	72	209	138	646
	Total	**367**	**305**	**78**	**240**	**143**	**766**
2014	Foreign	13	77	4	27	6	114
	Domestic	356	230	70	208	139	647
	Total	**369**	**307**	**74**	**235**	**145**	**761**

Source: Iberoamerican Federation of Exchanges.

for Brazil's listed companies (table 2). The large number of listed companies on Peru's exchange, in comparison with its equity market capitalization, is due to the fact that regulation requires mandatory listing on the exchange market of all supervised financial companies.

Two of the PA's stock exchanges (those of Mexico and Peru) are quite internationalized, in the sense that stocks issued by foreign companies represent a significant share of market capitalization (42.3 percent in Mexico and 35.0 percent in Peru), while the corresponding number is less than 5 percent in Brazil—and in Colombia and Chile (see annex 1).[7] Conversely, this is not true for the number of listed firms with shares or American Depositary Receipts on foreign securities markets or exchanges, which are roughly similar today in Brazil (where they have remained relatively stable) than in the sum of the PA's stock exchanges, where they have shown a downward trend (see figure 8).

Jointly, the PA's stock exchanges show a considerable degree of diversification by sector, in contrast to Brazil's stock exchange, which is highly concentrated in the consumption and financial sectors (62 percent in 2014); see annex 2. This is partly a consequence of the fact that Mexico is a more industrialized economy, while the economies of Colombia, Chile, and Peru are more dependent on natural-resource-based activities.

[7] The small fraction of foreign listed companies in Mexico showed in tTable 2, vis-à-vis the high fraction of transactions in securities of foreign origin in annex 1 figures, is probably explained by the fact that such transactions include total market capitalization of some foreign financial companies that are listed in many exchanges (e.g., BBVA, Citi Bank, Santander, and ABinBEV).

The Traded Value and Liquidity in the Pacific Alliance's Capital Markets

The total traded value of shares in the PA's capital markets has been in the range between USD 210 billion and USD 250 billion since 2011 (figure 9), less than half the value traded in Brazil's market. Brazil's market is much more liquid; its turnover velocity of shares (i.e., traded value over market

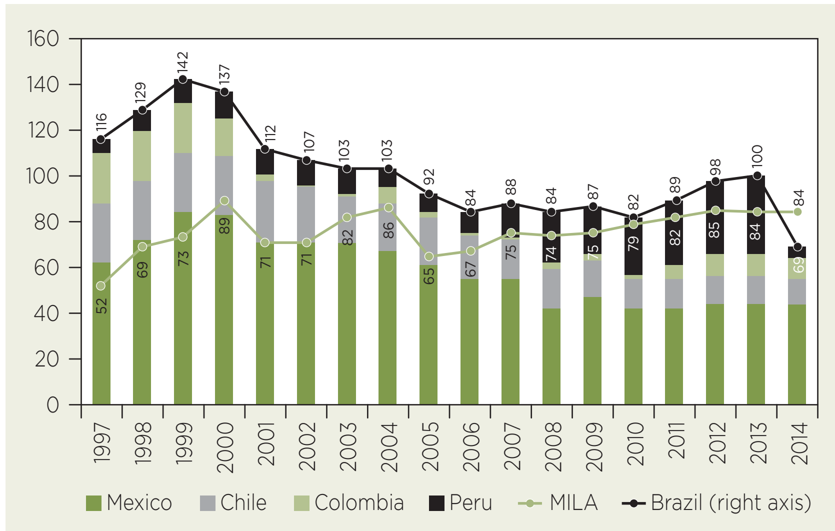


FIGURE 8/
Number of Listed Companies with Shares or American Depositary Receipts on Foreign Securities Markets or Exchanges

Source: Iberoamerican Federation of Exchanges.
*Between 1997 and 2000, Colombian data correspond to the sum of companies listed on the Bolsa de Valores de Bogotá, Bolsa de Valores de Medellín, and Bolsa de Valores de Occidente (Cali).

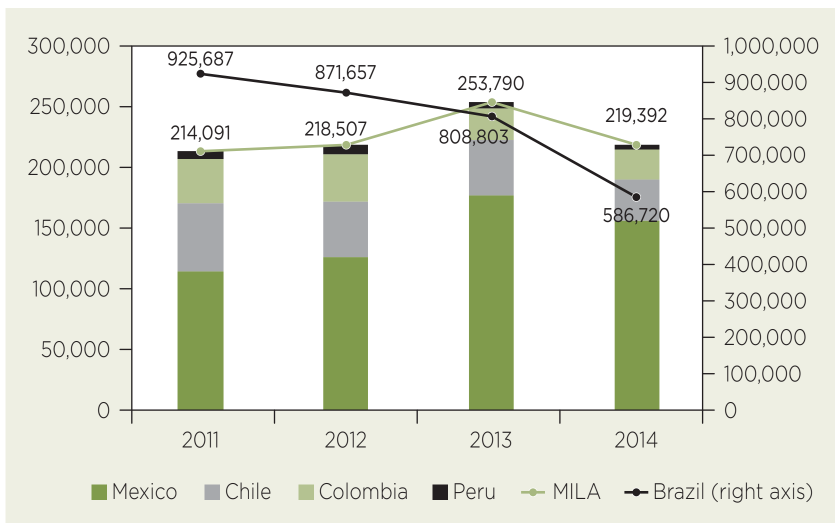
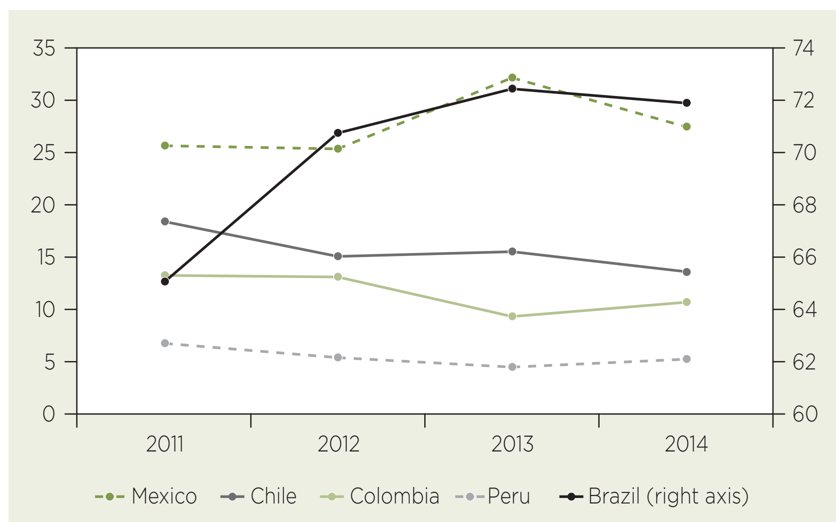


FIGURE 9/
Total Traded Value of Shares (USD millions)

Source: Iberoamerican Federation of Exchanges.

capitalization) is more than twice that of Mexico's market, which in turn is much higher than turnover indexes in those of Chile, Colombia, and Peru; see figure 10. Brazil's ratio of 71.9 percent in 2014 shows levels similar to Thailand, Canada, and Germany.

FIGURE 10/ Turnover Velocity of Domestic Shares (percent)



Source: Iberoamerican Federation of Exchanges.

Most share transactions in the PA take place in Mexico, which represented 71 percent of total traded value as of the end of 2014. Even though traded value in Mexico rose between 2011 and 2014 (by USD 42 billion), the aggregate PA traded value of shares has remained practically unchanged due to declining traded value in Colombia and Chile (in dollar terms) during the same period.

The composition of both Brazil's and individual PA members' equity markets shows that most traded variable-income securities are issued by domestic companies. In Brazil, Mexico, and Chile, they represented more than 90 percent of total traded value in 2014 (see annex 3), while Colombia and Peru had a larger proportion of traded value of securities issued by foreign firms (16.3 percent and 13.3 percent, respectively).

The traded value of bonds in the PA markets has revealed a steady tendency in recent years, as volumes have remained between USD 5.9 trillion and USD 7.3 trillion in the 2011–14 period (figure 11). MILA's fixed-income securities markets essentially fluctuate according to Mexican public debt behavior, since it accounts for about 85 percent of total bond transactions.[8] Matching equity market results, Peruvian traded value in bonds is quite small.

In all PA country members, as well as in Brazil, the most traded fixed-income securities are bonds issued domestically, while foreign debt papers have remained particularly underdeveloped. In Chile, domestic public bonds represented 53.5 percent of total traded value in 2014; and in Colombia

[8] This was the average mean between 2011 and 2014.

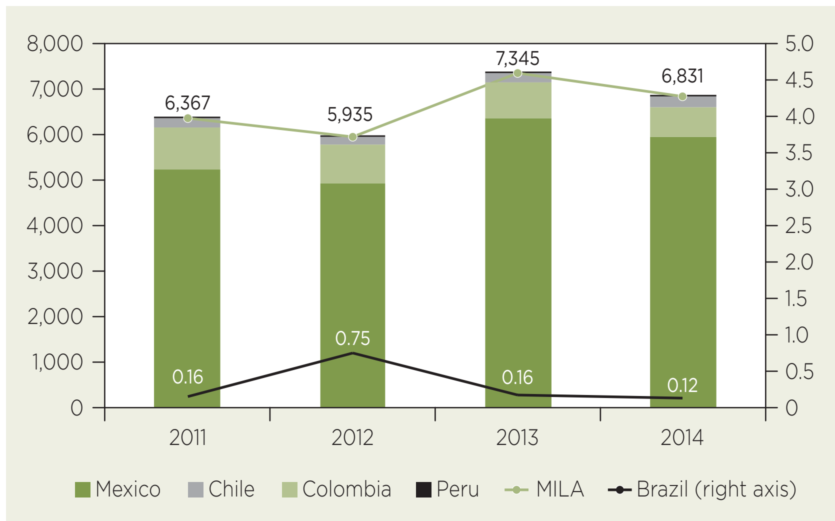


FIGURE 11/
Total Traded Value of Bonds (USD billions)

Source: Iberoamerican Federation of Exchanges; Banco de México.

and Mexico, this fraction was even higher (88.4 percent and 91.0 percent, respectively). Peru and Brazil have higher fractions of traded fixed-income securities from corporate origins: 90.6 percent in Peru and 73.1 percent in Brazil (see annex 4).

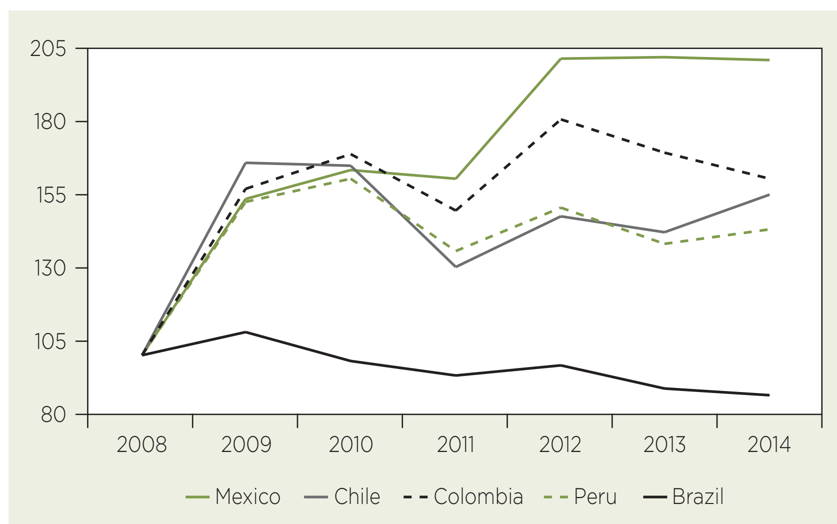
Institutional Investors

Pension Funds

Pension funds have been playing an increasingly important role in Latin American capital markets, given that they are the largest institutional investors in the region nowadays. Their assets increased significantly in value, as a share of each individual country's GDP, between 2008 and 2014, in most countries, except in Brazil (figure 12). The IMF estimates that Mexican pension fund assets doubled during this period, and those in Colombia, Chile, and Peru were augmented by about half. In fact, Mexican and Chilean pension fund holdings have been doubling every five to six years. Despite this positive development, total assets and participation rates within the LA-7 stand below advanced country averages, which suggests that pension funds across Latin America may grow at even higher rates in the coming years (IMF 2016a).

The PA pension funds' combined portfolio grew at very high rates (19.1 percent on average) during the recent boom years (2003–12), especially when expressed in US dollars, as a consequence of domestic currencies'

FIGURE 12/ Pension Fund Assets in Latin America (Index, 2008 = 100, percentage of GDP in USD)



Source: Asofondos, ABRAPP; calculations based on IMF (2016a).

appreciations vis-à-vis the dollar (see figure 13). The combined value of the PA pension funds investment was about USD 430 billion in 2014. Mexican and Chilean pension funds represented more than three quarters of this total, holding USD 167.7 billion and USD 165.4 billion at the end of the same year, respectively. Mexican portfolio have quickly expanded from 2010 levels, showing an annual growth rate of 52 percent, while expansion in Colombia and Peru was about 20 percent, and in Chile, where the industry is more mature, 11.4 percent.

Pension funds' portfolio composition varies widely across PA members. Both Colombian and Mexican institutions have large holdings of public debt (see figure 14 and annex 5), reflecting higher government financing needs than in Chile and Peru. As of the end of 2014, public issued securities represented 46.2 percent of Colombia's pension fund portfolio and 36.3 percent of Mexico's. Peruvian and Chilean pension funds display much higher exposure to foreign securities, especially variable-income assets (i.e., mutual funds and stocks). However, investments in assets from other Latin American countries are currently almost insignificant; Peruvian pension fund managers reported only 3.7 percent of total assets (and 9.3 percent of foreign allocations) were held in Latin American investments (IMF 2016a). Peruvian and Colombian funds also hold a large share of securities issued by corporations in the local market. Most pension fund assets in Latin America are in debt securities (domestic or foreign), due, in

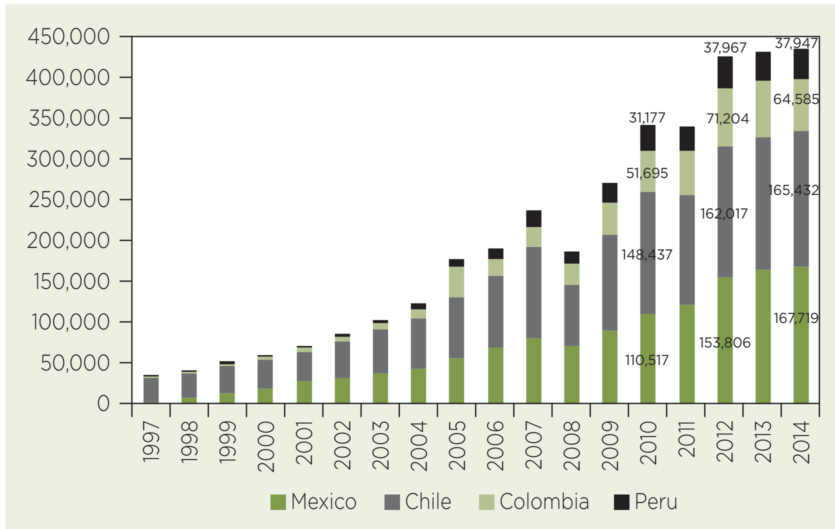


FIGURE 13/ Pension Funds' Investment Portfolios, by Country (USD millions)

Sources: Local authorities; Asofondos.

part, to the fact that regulators place stricter limits on equities due to risk considerations. However, countries with a multifund system—like the four PA members—have begun to ease these limits, and some of them (Peru and Colombia) already have a sizable share of their investment portfolio in equity (figure 14).

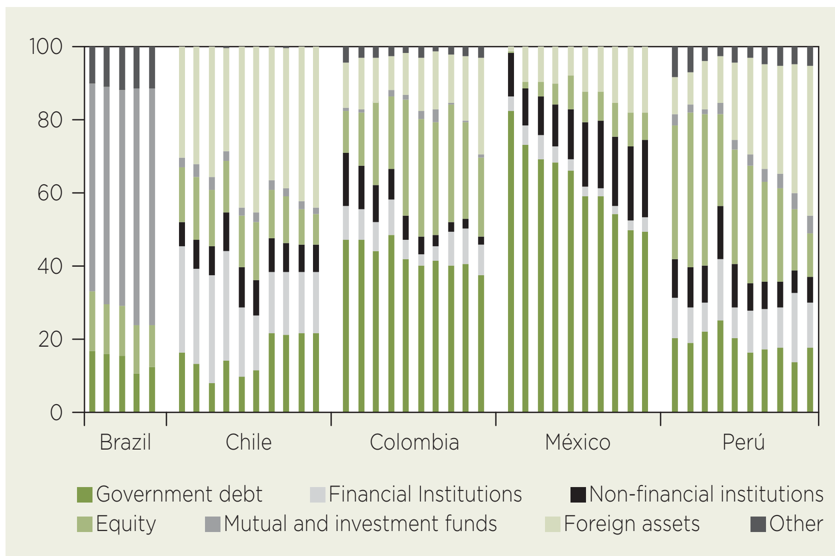


FIGURE 14/ Pension Funds' Investment Flows (percentage of total, 2005–14*)

Source: IMF (2016a).
* 2010–14 for Brazil.

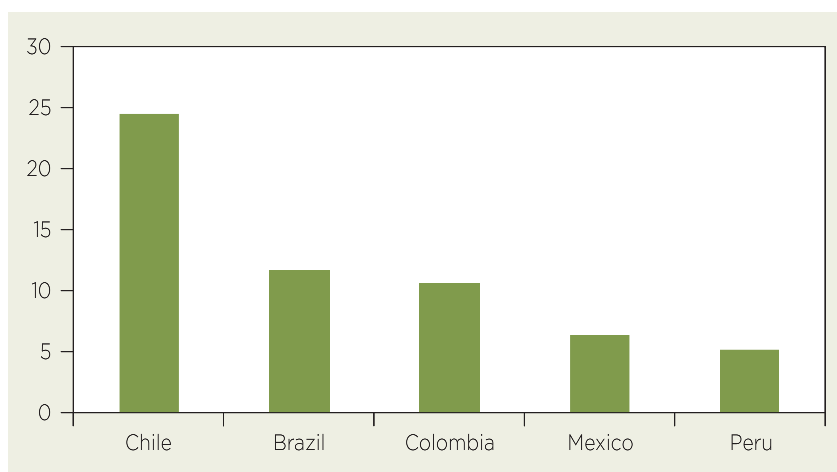
Insurance Companies

The insurance sector in Latin America grew at a considerably higher annual rate during the last decade, though it is still relatively underdeveloped when compared with other regions. Total assets increased from 4 percent of regional GDP in 2004 to almost 10 percent in 2014 (figure 15). Holdings of insurance companies of PA members are relatively small compared with the impressively large asset portfolio of Brazil, which represents more than

FIGURE 15/ Total Assets of Insurance Companies (percentage of LA-7 regional GDP)

Source: IMF (2016a).

FIGURE 16/ Total Assets of Insurance Companies (percentage of domestic GDP, 2014)



Source: IMF (2016a).

half of total regional numbers. According to the IMF, the insurance sector growth in the region is "partly stymied by the limited availability of long-term financial instruments denominated in domestic currencies, given that their demand for financial vehicles is often crowded out by pension funds."[9] This seems to be particularly the case in the Pacific Alliance countries, except for Chile, that shows a significantly larger portfolio of insurance companies as a percentage of its GDP, although in absolute terms Mexico is still nearly double.

Insurance companies' portfolios across PA members are concentrated in fixed-income domestic securities, with little presence of foreign and variable-income securities investments (see annex 6).

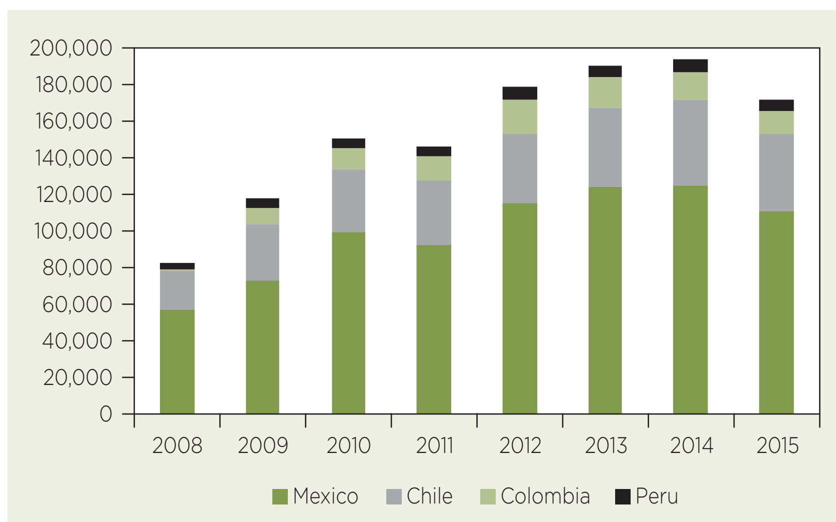
Mutual and Investment Funds

Compared with pension funds and insurance companies, investment funds have had relatively little participation and influence in the development of the PA's capital markets. Low liquidity and regulatory restrictions count among several limitations for further evolution of mutual funds.

However, the PA's mutual funds' combined portfolio has grown at considerably high rates in the past seven years (12.4 percent on average). The aggregate value of the PA mutual funds' investment was about USD 172 billion in 2015 (figure 17). Coinciding with pension funds' figures, Mexican and Chilean mutual funds represented the vast

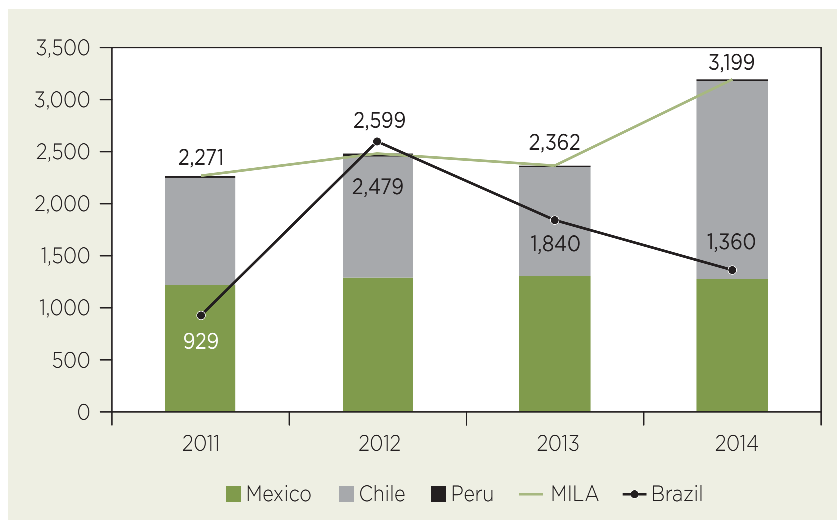
[9] See IMF (2016a).

FIGURE 17/ Mutual Funds' Investment Portfolios, by Country (USD millions)



Source: Local authorities.

FIGURE 18/ Trading Value Operated by Investment Funds (USD millions)



Source: Iberoamerican Federation of Exchanges.

majority of this total, holding, respectively, USD 111.2 billion and USD 42.8 billion at the end of the same year. Nonetheless, Colombian mutual funds experienced great expansion rates during the 2008–15 period (110.8 percent on average), while Peruvian funds observed a relatively moderate development (14 percent).

Mutual funds' portfolios across the PA are deeply concentrated in fixed-income securities, with very little investment in variable-income securities (see annex 7). Foreign papers are not very common among these portfolios, at least in Colombia and Chile.[10]

Traded volumes in Colombia and Peru have stayed at relatively insignificant levels. Even in Mexico, Chile, and Brazil, they remain low compared with advanced markets' standards. During the 2011–14 period, the total traded value of PA investment funds was between USD 2.2 billion and USD 3.2 billion, while Brazilian funds' operations ranged between USD 0.9 billion and USD 2.6 billion (figure 18).

In recent years, the number of investment funds listed on the PA's exchanges has not experienced considerable changes (figure 19). In 2014, the Mexican stock exchange listed 640 funds, which, by being added to the 136 Chilean funds listed in the same year, accumulated most of the total investment funds listed in the PA. Traded volumes in Brazil generally surpass those in Mexico, despite having a much reduced number of funds listed on its local exchanges.

[10] There are no data available to distinguish foreign securities from local securities in Mexico and Peru.

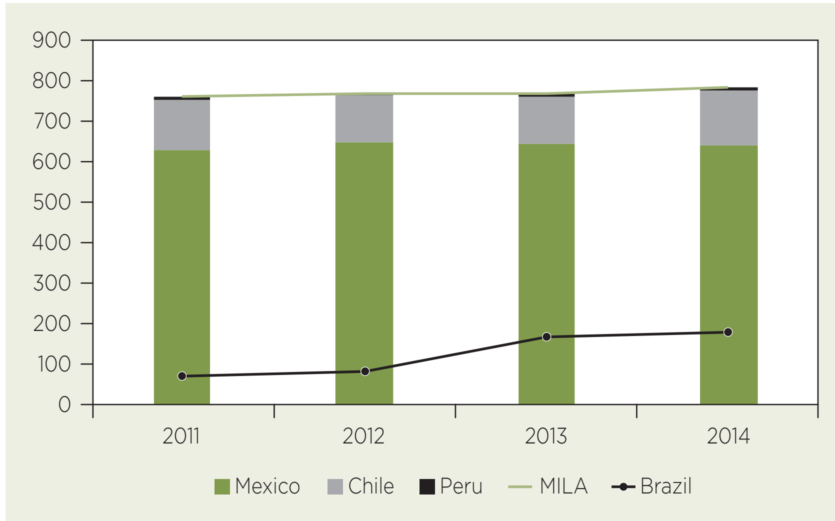


FIGURE 19/ Number of Investment Funds

Source: Iberoamerican Federation of Exchanges.

Derivatives

Only Mexico and Brazil have relatively developed futures markets for exchange and interest rates, although derivatives in interest rates had a sharp drop in Mexico in 2013 and 2014. A plausible explanation of this tendency is the relocation of these transactions from MexDer's platform to the CME Group's platform due to recent partnership agreements between these two exchanges. See figures 20 and 21.

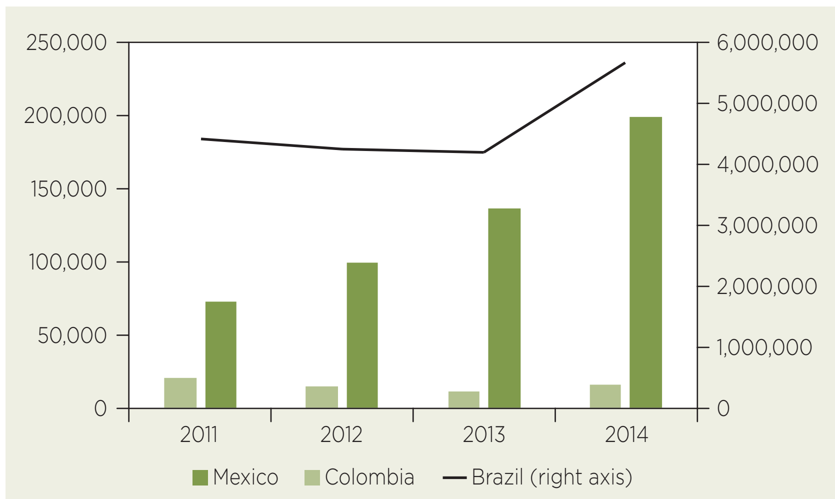
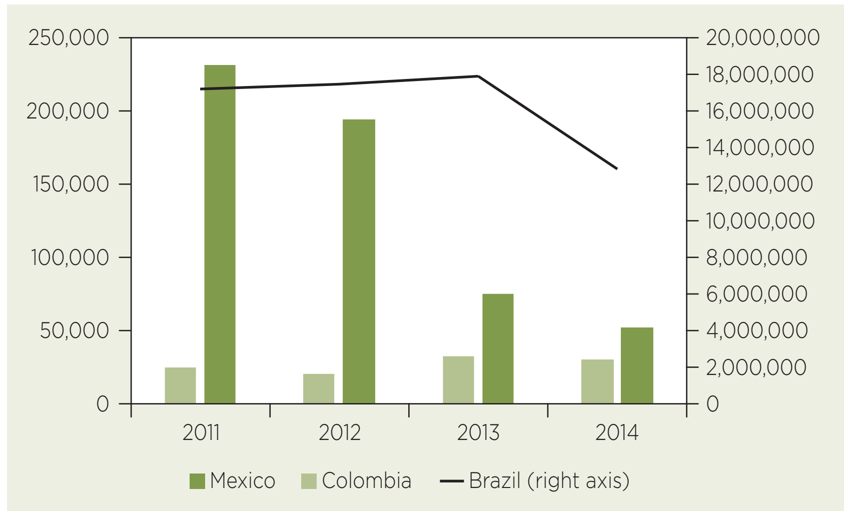


FIGURE 20/ Notional Value of Contracts Traded in Derivatives (Futures) on Exchange Rates (USD millions)

Source: Iberoamerican Federation of Exchanges.

FIGURE 21/ Notional Value of Contracts Traded in Derivatives (Futures) on Interest Rates (USD millions)



Source: Iberoamerican Federation of Exchanges.

Integration of Capital Markets and the MILA Initiative

Because capital markets' development and liquidity benefit significantly from economies of scale, individual small exchanges all over the world have looked for ways to integrate. However, only a few cases have succeeded, because significant problems stand in the way, such as jurisdictional issues, convertibility, and currency risks. Furthermore, they normally have a limited cumulative size and risk diversification potential in comparison with the large and well-established global stock exchanges (e.g., those of New York or London), to which most national governments, large firms, and institutional investors already have access.[11] In addition, stock exchange integration requires national regulators' support through considerable regulatory harmonization.

The first two previous successful cases were the integration of the Scandinavian stock exchanges as OMX, a process that began in 1998 and was concluded in 2006,[12] and the integration of the Amsterdam, Brussels, and Lisbon stock exchanges as Euronext in 2004.[13] The latter, however, was enormously facilitated by the single (euro) currency trade.

The successful development of Euronext offers several lessons that are highly relevant to the MILA process, given that it also began as a private initiative. Likewise, so does the integration of the Scandinavian countries' stock exchanges, which was done on the basis of technically compatible infrastructures, without being guided or pushed by the respective regulators. However, soon trading rules had to be harmonized, though regulation and supervision continued to be done at the national level. While Euronext monitored compliance with the harmonized trading rules, the national markets represented the "point of entry"; issuers, investors, and brokers continued to be regulated and supervised by the national authorities, according to their point of entry. Regulators and supervisors established agreements for active cooperation and, over time, it was realized that regulatory harmonization and supervisory cooperation were so crucial that the committees of regulators and supervisors assumed leadership of the process.

The more ambitious and highly successful case of stock exchange integration in the whole of the European Union actually built on several processes driven by private initiatives: Euronext-NYSE, the OMX Group, the Deutsche Börse Group, and the London Stock Exchange Group. Later

[11] See Perry (2015, 25–28).

[12] Purchased by NASDAQ in 2007.

[13] Purchased by the New York Stock Exchange in 2007.

on, regulatory harmonization became the main driver and was greatly facilitated by the adoption of the so-called Lamfalaussy process, which implies that after only general (i.e., “material”) directives are established in European laws, overall frameworks are agreed on by technical committees of regulators (which later on played the most important driving role in the process), and then adaptation to national legislation is promoted by local regulators and central banks.

The MILA Process

The MILA process started in 2009 when the stock exchanges of Bogotá,[14] Lima, and Santiago, and depositary agencies, announced their intention to integrate. Then, once the integration initiative had gained further recognition, their respective regulatory agencies gave their support. The Mexican stock exchange agreed to join MILA in 2014, and initial integration became operative in 2015.

Intermediated routing of orders for stocks in the secondary market payable in cash has been operative since May 2011 among the stock exchanges of Colombia, Chile, and Peru, though actual transactions have been quite limited due to remaining regulatory differences among the member countries, some of which are being addressed, as discussed below. This was intended to be a first step in a gradual process of deeper integration, which requires a considerable degree of regulatory harmonization. Recent advances in this process will also permit intermediated routing of orders for initial public offerings (IPOs) and for other variable-income securities, such as shares of portfolio investment funds, and for fixed rent securities. However, only Colombia and Chile now have a developed platform for secondary transactions of bonds through the local stock exchange, while in Mexico most of these transactions take place through the over-the-counter market and brokers.

Figure 21 shows the number and value of transactions undertaken through MILA since its inception. Figure 22 shows transaction volumes by country. It must be noted that the highest volume of transactions originated in Peru (where investors have lower investment opportunities in their domestic capital market), and most acquired securities originated in the Chilean stock exchange, which has a larger offer of corporate issues, as discussed in the previous section.

Compared with the combined size of the PA capital markets (section 3), it is clear that transactions through MILA today represent a very small

[14] The stock exchanges of Bogotá, Medellín, and Cali in Colombia had fully integrated in 2001.

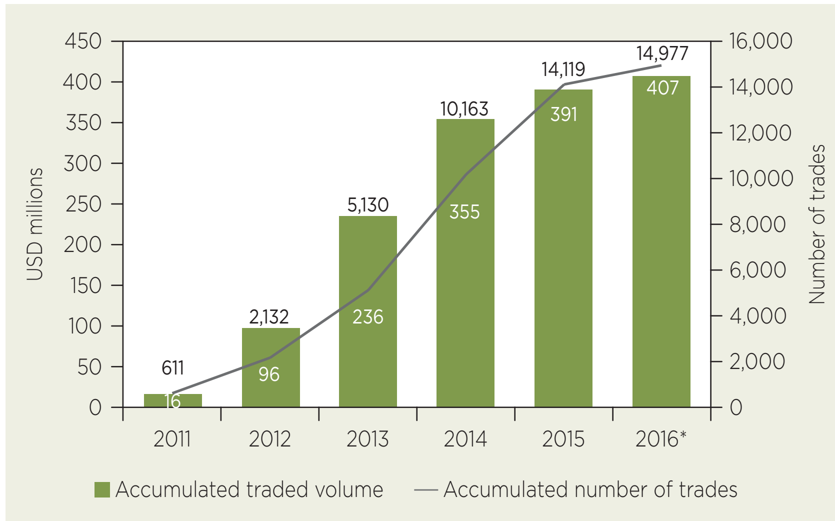


FIGURE 22/ Traded Volumes (USD millions) and Number of Trades through MILA (accumulated)*

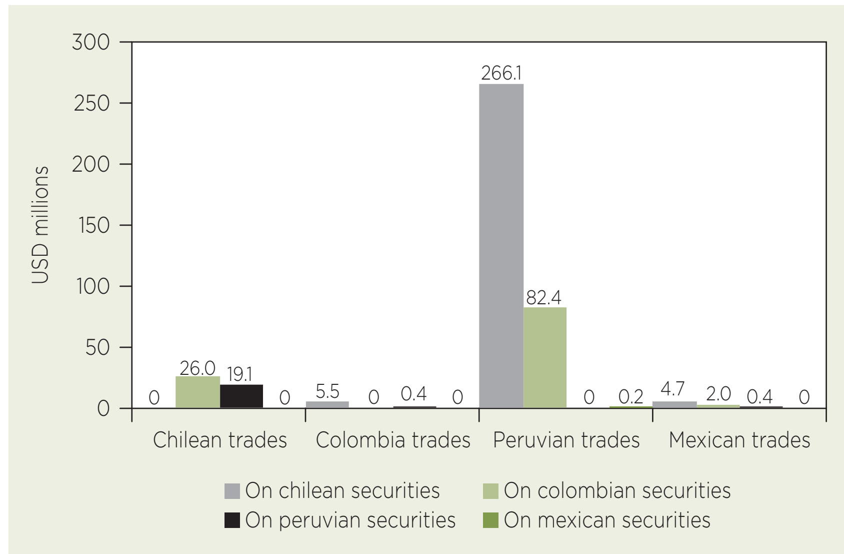
Source: MILA News Monthly Reports, BVC.
*Figures until March 2016.

fraction of the PA members' total transactions; in 2014, they represented less than 1 percent of total traded value in the combined PA equity shares markets,[15] and still nothing on bonds or other securities. Given the fact that, at this stage, MILA does not attempt a full integration of these countries' four individual stock exchanges but is just a platform to facilitate the routing of orders across the exchanges, it should not be expected that even with full regulatory and tax harmonization, cross-border securities transactions among the four members could come to represent more than a fraction of their total security transactions. Even then, some of these potential transactions might not occur through MILA, but either directly through local brokers or through other conduits (e.g., through funds registered on Wall Street or in Luxembourg). This would be especially be the case for those securities that are not traded locally through the respective stock exchange, as is the case for bond market transactions in Mexico, which are mostly traded through over-the-counter markets and brokers, as mentioned above.

It is beyond the scope of this paper to estimate the precise potential for cross-border securities transactions among the four PA members (an educated guess would place it between 10 and 15 percent of total transactions), whether through MILA or other channels, although it is clear for the MILA authorities and for all market participants that the current numbers are clearly just a very small percentage of this potential.

[15] Calculated as a share of traded volumes shown in section 3, figure 9.

FIGURE 23/
Traded Volumes through MILA, by Country (USD millions)*



Source: MILA News *Monthly Reports*, BVC.
*Figures until March 2016.

Furthermore, there is a broad consensus that approaching this potential would require technical advances within MILA itself, but it is clear today for all stakeholders that without a significant push toward broader regulatory and tax harmonization by both regulators and fiscal authorities, the PA's integration, in spite of its significant advances (see below), will remain well below its potential. In particular, it is felt that financial integration needs to become a political goal, with more active participation from the higher authorities, in particular the four PA countries' ministers of finance and presidents of central banks.

An indication of this recognition is that in the PA's meetings in Paracas, Peru, in 2015 and in Puerto Varas, Mexico, in 2016, the presidential agreements included important political decisions related to the integration of capital markets. The Paracas declaration agreed on (1) undertaking all regulatory harmonization requirements that would permit issuance and secondary trading of fixed-rent securities through MILA, a process that has basically been completed; (2) developing a PA "passport" for administrators of mutual and investment funds, so that they would be able to simultaneously distribute their products in all markets, which is being studied by regulators; and (3) evaluating the possibility of recognizing the "local status" of pension funds from PA partners, which would stimulate the inclusion of regional securities in pension funds' investment portfolios. The latter two would be

critical steps, as discussed below. The Puerto Varas Presidential Declaration reaffirmed these goals, insisting that "financial integration will permit developing more and better investment projects of high quality, including in infrastructure, to support development in the region," and it endorsed the advances in mutual recognition of issuers and the broadening of instruments and trading mechanisms in MILA, as well as the ongoing process toward homologating the tax treatment of pension fund proceeds when they are invested in another member country (annex 2).

As mentioned above, early on, supervisors signed a memorandum of understanding for exchanges of information and cooperation in supervision and initiated periodic meetings starting in 2010 to address the most urgent regulatory harmonization requirements for MILA. They have already held eight regular meetings, attended by the four supervisors and the regulatory units of the ministries of finance of Colombia and Peru. Since 2015, regulators have decided to work on regulatory harmonization going beyond MILA's specific requirements, as many cross-border transactions actually take place outside MILA, and are beginning to proceed accordingly. This is also a recognition of the need to substantially scale up harmonization efforts. Supervisors have also initiated temporary exchanges of staff members to enhance trust.

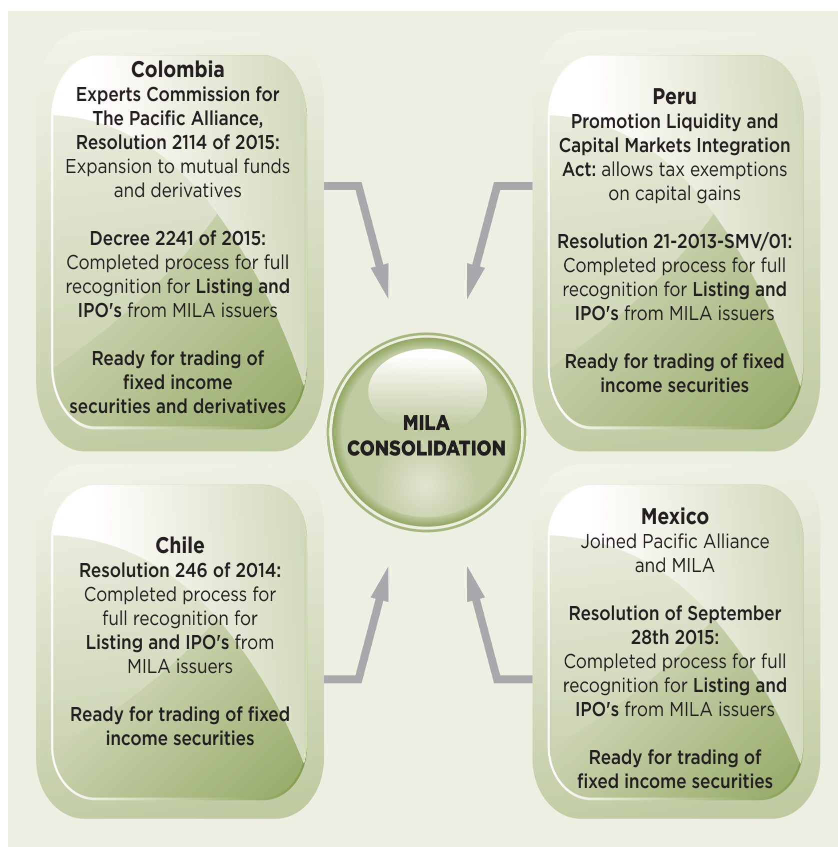
Advances and Strengths of MILA

It must be stressed that, in spite of the small volume of transactions actually happening through the MILA framework, advances have been substantial. In particular:

1. Listing on one stock exchange automatically permits operations in the other three.
2. It is possible to have simultaneous issuing and secondary trading of all types of securities in all markets, when approved by any local regulator, except for fixed-income securities in Mexico that are not traded through the stock exchange.
3. Any MILA broker can access the market through a local sponsor.
4. There is already one trading screen for Colombia, Chile, and Peru.
5. Standardization of prospects will soon be a reality.

Figure 24 shows some important recent steps toward regulatory convergence in each country, which are an indication of continued commitment.

FIGURE 24/ Recent Steps toward Regulatory Convergence



Source: BVC.

In addition, it must be noted that there have been general advances in regulation and supervision in the four PA markets, which facilitate further convergence. Thus, the Organization for Economic Cooperation and Development, IMF, and World Bank all have conducted reviews (the latter two through the Financial Sector Assessment Program process) concluding that corporate governance and financial regulation and supervision in the four markets have satisfactory standards and are rapidly progressing toward full convergence with international standards. All the PA countries have adopted the International Financial Reporting Standards for accounting and, with the exception of Chile (which needs to overcome legal impediments to full information disclosure), now conform with the Annex A requirements of the International Organization of Securities Commissions. All four countries have made important advances in adopting high standards in several key areas for capital market developments, such as

protection of minority shareholders, protection of debt securities holders, information disclosure, and more flexible requirements for inscription and public offers of foreign securities. There are still restrictions in all or some of these areas (e.g., in several cases the high standards apply only to qualified investors), but they are not so large as to impede integration. The four countries have also made advances in providing lighter regulation segments for small and medium-sized enterprises.

A Blueprint for Further Advances

An Agenda for Regulatory Harmonization

Deeper regulatory harmonization in the PA should be oriented toward the achievement of higher standards, in order to reduce regulatory arbitrage and a potential race to the bottom, as well as to limit the necessity of frequent legislative changes. This would promote efficiency by granting more security for investors, promoting more competition in local markets—key to extend benefits to retail investors and small issuers—reducing transaction costs, enhancing speed and security of transactions, and stimulating innovations. It should be stressed that regulatory harmonization does not require identical regulations, but harmonization of objectives and substance—that is, “material” harmonization, instead of identical norms.

The agenda should probably begin with the full regulatory implementation of the Paracas and Puerto Varas agreements: (1) Completing the already-well-advanced process of harmonization of regulatory requirements to permit issuance and secondary trading of all types of securities in the four markets through MILA; (2) developing a MILA passport for administrators of pension and mutual funds; and (3) granting “local status” to pension funds from PA members and harmonizing their tax treatment. In addition, it is recommended to (4) develop remote access for brokers (so-called remote membership) and investors in the four markets (today, brokers only have access through correspondents and investors through local brokers, which is a highly inefficient process), an objective that requires developing interoperability of custody, clearance, and settlements systems; (5) the creation of a MILA VIP market with higher standards and common regulations; and (6) advancing the harmonization of tax treatment for capital market products and actors. In the following subsections, we elaborate on the pending items of this agenda, and then end with some considerations for the longer-term agenda.

1. *A MILA VIP Market with Higher Standards*

Establishing a MILA VIP market with high corporate governance standards for issuers would significantly increase the interest of foreign investors in the PA markets and would be an important complement to the following recommendations in the agenda (a MILA passport for administrators of pension and mutual funds and remote access for brokers, intermediaries, and investors), as it would enhance the appetite of foreign funds and individual investors for PA securities. Some PA members, like Colombia, have already moved in the direction of such a "new" market (Brazil was the region's pioneer in establishing its so-called Novo Mercado).

Common high standards for corporate governance for this VIP market segment (or for receiving a MILA seal of high standards) should cover, among others,[16] (1) composition of the Board of Directors (especially, the percentage of independent members and definition of independence); (2) a Committee of Directors responsible for transactions with related parties, internal audits, the selection of external auditors, and other key decisions; (3) types of shares, including no preferential shares or nonvoting shares; (4) corporate control transactions, including the extension of conditions of sale (tag-along rights) for minority shareholders; (5) requirements for transactions by insiders; (6) conflict resolution; and (7) requirements for periodic information disclosure.

Issuers in this market should have common, simplified regulations for listing, issuance, and trading, given their higher corporate governance standards. Ideally, over time these simplified common regulations and higher standards should be gradually extended to all issuers in a more fully integrated PA capital market.

2. *A MILA Passport for Administrators of Mutual and Investment Funds*

Mutual and investment funds are among the most important actors in well-developed capital markets. They are relatively important in the Mexican and Chilean stock exchanges, but still modest players in the Colombian and Peruvian stock exchanges. All countries make individual efforts to attract global players in this industry toward their local markets, for this implies a significant push for demand of local securities and offers local investors higher diversification options. Additionally, this would boost competition, and hence efficiency, in these markets. Mexico has been more successful in pursuing this objective than the other three PA countries, but it is clear that all fund managers could find very attractive the possibility of operating,

[16] Calculated as a share of traded volumes shown in section 3, figure 9.

distributing, and trading their products simultaneously in the four markets under common rules and requirements, by registering only once and, even more, by achieving automatic registration if they proceed from "recognized" jurisdictions, with high standards of regulation and supervision.

Harmonization of regulations should include:[17] (1) Eligibility criteria, including types of funds, minimum capital requirements, corporate governance, valuation benchmarks, and risk management practices, adopting the higher current standard in the region (this would imply no need for a local subsidiary or sponsor in each market and no additional capital requirements to operate in other jurisdictions within MILA); (2) authorization for private placements and public offerings; (3) information disclosure requirements; (4) standard settlement rules and a single custody functionality (see below); and (5) conflict resolution (the possibility of using arbitration through local arbitration chambers).

An important complement would be adopting a common regulation to facilitate the development of commercial paper in the four markets, as this is usually an important item in global mutual fund portfolios.

3. *Remote Access for Brokers and Investors to the Four MILA Markets*

Similar to the concept of a MILA passport for fund administrators, brokers, and intermediaries should have the possibility of operating directly in the other markets (so-called remote membership), which thus would eliminate the current requirement for a local sponsor. This would significantly reduce the transaction costs of operating in the PA markets and eliminate the remaining credit risks of operating through correspondent brokers. Furthermore, brokers should be encouraged to facilitate direct access by their clients to their trading screens, thus facilitating investors' inquiries, orders, and claims and significantly reducing their transaction costs.

Remote access is a type of bourse membership, used in many jurisdictions, and it seems a natural next step for MILA. This would require that each country's regulator accept other countries' brokers and intermediaries as remote members in their own markets. It would also require cost-efficient clearing and settlement arrangements for remote members (e.g., permitting current clearing members to clear transactions in the local market on behalf of the remote member), so that risks are mitigated and the integrity of cross-border transactions is preserved.

Currently, a local investor that is interested in buying securities from another PA market must channel his or her inquiries or orders (for secondary

[17] See Larraín (2015) and IMF (2016a).

market transactions) through his or her local broker, which in turn redirects the inquiry or order through a correspondent broker in the partner country. The same happens with claims. This process is highly inefficient, and it is probably the main culprit (together with taxation issues; see below) for the low level of transactions through MILA.

Ideally, investors should have access through e-trading to inquiries, orders, and claims in any of the four markets. For this to happen, there should be mutual recognition of brokers; and any authorized broker in a MILA market should be able to have remote access to the other markets, as explained above. Brokers in Chile and Mexico have begun to establish subsidiaries in other MILA countries, but this is clearly an inefficient way to build an integrated market. Brokers and intermediaries based in recognized high-standard markets outside the PA should also have direct access to the four markets without the current requirement of having a local sponsor.

4. *Harmonization of Issuance, Clearing, Settlement, and Operational Procedures*

In order to reduce the transaction costs of operating in the four PA markets, and the remaining credit risk associated with payments through local brokers, it is necessary to have a common framework for clearing and settlement. This would reduce costs, facilitate access, and provide a common ground for risk management associated with the settlement of cross-border transactions. Harmonizing settlement periods, linking the Central Counterparties or settlement infrastructures, allowing interoperability of settlement and custody agents, and eliminating the current required reliance on a correspondent broker would all significantly reduce costs and streamline the post-trade operational procedures.

In addition, other harmonization efforts would be desirable, such as adopting common regulation for IPOs and new bond issues. The region could make a concerted effort to have a single IPO process, listing requirements, prospectus, and information disclosure obligations for issuers. Similarly, the PA could issue a 144A-type procedure for bond issues in the integrated marketplace that all investors (both local and foreign) know and recognize, which would help standardize issues and significantly reduce the current review times by institutional investors for a new issue.

These are areas that will require continued efforts, because the current procedures and market structure are very different in each country.

5. *Granting Local Status to Pacific Alliance Pension Funds (and, Later on, to Insurance Companies)*

Given the prominent importance of pension funds in the PA—and other Latin American countries—it would be extremely important to stimulate their holdings of securities issued in the four markets. Ideally, PA member countries should grant full pension portability within the region (Chile and Peru already have arrangements in place, and there are current discussions about bilateral agreements among all members) to facilitate labor mobility, a major objective of the PA. Likewise, the long-term objective should be full harmonization of regulations on investment portfolios, covering, among other aspects, limits on foreign securities, risk classification and exchange rate risk coverage, and tax treatment of pensions and pension funds (see below).

However, given that this long-term objective would take time to be agreed upon and implemented, in the short term it would be critical to grant local status to other PA members' pension funds, so that they could freely buy and sell regional securities within common limits, which, given the significant diversification of options that this would entail, could become much less binding. Current limits for variable rate securities are very low in some of the countries. Likewise, there is an excess of categories and limits that hinder diversification and promote herd behavior among pension funds, contributing to frequent asset bubbles.

Initially, one might begin by granting local status while keeping national regulations and limiting the share of other member countries' securities within each category to a given fraction. At the same time, there would be some relaxation of limits for each category in proportion to holdings of other member countries' securities. This would avoid concerns of displacement by local issuers, while at the same time stimulating pension funds to hold securities from other member countries. Over time, these limits would be relaxed and eventually disappear.

This proposal would be consistent with the IMF's recommendation: "Countries of the region should demonstrate their commitment to integration with an understanding that in the future their pension regulators will agree to treat each other's securities as domestic." "A token of this commitment could be the establishment of a special category for the holding of bonds issued in the region that would not count against foreign asset limit" (IMF 2016a).

A further requirement would be the harmonization of tax treatment for pension funds and their administrations, as discussed below.

A similar process should take place later on with insurance companies, an industry that is currently quite underdeveloped in the region, but that eventually should become larger than pension funds as a holder of corporate debt, as is the case in more developed countries.

A complementary action for this process should be an aggressive drive to facilitate the development of infrastructure bonds in each of the four countries. As we noted above, pension funds (and eventually insurance companies) are the most appropriate domestic holders of such bonds, but the high degree of concentration of pension funds in each country is currently limiting their capacity to fulfill this role.

Unrestricted access to building regional infrastructure projects, and to holding and trading domestic currency infrastructure bonds by regional and global pension funds and insurance companies, could provide a major boost to the development of regional infrastructure, and hence to intraregional trade and economic growth, and contribute to the development and integration of the PA's capital markets. This would also be highly beneficial for regional pension funds and insurance companies, as it would allow them to optimize portfolio diversification, given that infrastructure projects are long-term investments that could match the long-term duration of their pension liabilities.

The multilateral development banks (e.g., the Banco de Desarrollo de América Latina, International Finance Corporation, and Inter-American Development Bank) and local development banks (e.g., Financiera de Desarrollo Nacional of Colombia and Compañía Española de Financiación del Desarrollo in Peru) can help developing these markets by granting liquidity and partial credit guarantees to concessionaries, and in this way helping to achieve higher infrastructure bond ratings, as normally required by pension funds and insurance companies' regulators.

6. *Tax Harmonization*

Differences in tax treatments appear to have been a major factor in limiting operations through MILA. To begin with, it seems necessary to complete the web of bilateral double taxation agreements among member countries to avoid the double taxation of profits realized in the extended market.

In addition, some minimum harmonization of norms is required. For example, it is important to maintain current norms that all funds are not treated as income tax subjects, but profits are taxed only when distributed to beneficiaries. This demands the identification of final beneficiaries, which

currently is legally required only in two PA countries—Colombia and Peru—although there is an agreement to supply this information to the partner countries when requested.

Granting local treatment for pension funds of other member countries, as suggested above, would avoid the current imposition of withholding requirements by some member countries. Otherwise, this problem would need to be solved through tax harmonization agreements.

Furthermore, some degree of harmonization of the tax treatment of capital gains obtained in the trading of securities would be desirable, as there are currently significant differences. Colombia and Peru treat MILA investments in the same way as local equity investments, while Chile and Mexico maintain a discriminating treatment among them.

7. The Longer Term: Full Harmonization and a Single Stock Exchange

In the longer term, the objective should be full harmonization of capital markets regulation and, probably, a single stock exchange, given the significant economies of scale that characterize these markets. If the Board and Technical Secretariat described above achieve their initial purposes, they would probably be able to build the trust and the momentum required for engaging on such a significantly more ambitious object.

Such a process should be based on a general agreement to adopt higher standards and "material" harmonization, mutual recognition, and the delegation of authority to the country of origin (e.g., harmonization of objectives and principles, leaving their adaptation to local institutions and conditions to their own regulators, as has happened in Europe). Supervision would also be delegated to the country of origin, though in the framework of strong cooperation among supervisors, including ample exchanges of information and joint reviews. Topics on which full harmonization would be especially important include requirements for issuers, characteristics of main products and issuing and trading procedures; custody services, clearance, and settlement; investor protection, including classification by type of investors and information disclosure requirements; transparency; the regulation of brokers and fund administrators; and policies to promote competition.

Furthermore, at least Colombia, Chile, and Peru will probably eventually realize that their local capital markets do not provide the required minimum scale for high efficiency, liquidity, and diversification, and that the simple routing of orders is an insufficient way to achieve the

desired degree of market integration. The Colombian stock exchanges of Bogotá, Medellín, and Cali already went through the process of realizing the insufficiency of their size and proceeded to integrate into a single Colombian Securities Exchange (i.e., the BVC). Although the process of agreement on and implementation of this decision was cumbersome, required important investments, and took several years, today there is no doubt that this was an inevitable move.

Of course, integrating three national stock exchanges into a single one would be a significantly more difficult undertaking, as it would require not only physical integration, and thus major investments and operational and revenue agreements among the stock exchanges, but also the full regulatory harmonization of capital markets, in the sense discussed above.

Integration of these three stock exchanges into a single one would provide a major push to MILA, for their combined size would be similar to that of the Mexican stock exchange. This would provide a significantly higher incentive for the Mexican authorities to advance in regulatory harmonization within MILA and to facilitate agreements, due a better balance of interests among two equal-sized MILA members.

The Need for Political Leadership and a Technical Secretariat

As mentioned above, further advances in the integration of capital markets in the PA is urgently requiring a shift in leadership. Initial developments in MILA were the result of private sector initiatives, but this process has reached a limit, in the absence of a major push from governmental authorities, regulators, and supervisors. It is thus imperative that the PA member countries' presidents and ministers of finance now take the lead in agreeing on a broad and ambitious vision for regional financial integration and give regulators and supervisors a clear and forceful mandate to achieve regulatory harmonization and full cooperation in supervision. Otherwise, MILA will stall and languish. In this context, it is encouraging that the last two PA presidential meetings, in Paracas and Puerto Varas, agreed on some important next steps for the process of capital markets integration.

However, a forceful political decision to truly integrate capital markets is a necessary but not a sufficient condition for achieving these objectives. Indeed, it is unlikely that the existing cooperation channels among policymakers, regulators, and supervisors would be enough to achieve a rapid pace of advance in the regulatory and tax harmonization

agenda sketched above, given its broad scope and high degree of technical complexity.

It has been suggested by previous studies that the PA requires a technical secretariat to help it advance in its different areas of cooperation and integration (IMF 2016a). It must be recognized, however, that there is resistance to this proposal, given previous negative experiences with such broad secretariats, in particular in the case of the Andean Community. And even if an agreement is achieved on establishing a general PA technical secretariat, it would be difficult to have in one single body the required expertise in fields as different as trade, labor mobility, and financial integration, to mention only the most important ones.

Thus, a more viable proposition may be to start with a less ambitious but more specialized secretariat for financial integration purposes, as suggested by Larraín (2015). Such a Technical Secretariat for Financial Integration would have a small number of well-remunerated, high-level experts who would respond to the PA ministers of finance and financial markets regulators and supervisors, and would rely on financial and technical support from the regional development banks. It should also draw on the technical capacity of PA financial regulators and supervisors.

This secretariat would have these main functions:

- Build a detailed road map for the PA's financial integration.
- Monitor and disseminate advances toward financial integration.
- Conduct studies, supported by international experts, in the areas requested by the Board.
- Present specific proposals for approval and decisionmaking by PA ministers of finance and financial regulators and supervisors, in order to advance in harmonization of market and tax regulations, according to the agenda sketched above, and the priorities previously agreed upon by the PA's presidents and ministers of finance.

Such an arrangement would have several advantages, as it would:

- Provide the required high-level political support for the process of financial integration, and facilitate policy agreements, given the active participation and guidance of ministers of finance.
- Ensure the quality and timely elaboration of required studies and proposals for decisions.

- Overcome the natural tendency of local regulators to think that each of them has developed “the best” regulatory framework and, thus, that regional harmonization should be based on their own local standards.

A final consideration: There are, of course, other potential avenues of enlargement and integration for Latin America’s regional stock exchanges. Brazil’s BM&FBOVESPA, the largest and most dynamic stock exchange in Latin America, has already demonstrated its interest in the PA’s capital markets by investing in the Mexican, Chilean, and Colombian stock exchanges. It is likely that once Brazil overcomes its current political and economic problems, its government authorities will reassess their previous approach toward regional and global integration, which has left Brazil trapped in a stagnant World Trade Organization and an unbalanced and also stagnant Mercosur. As a consequence, the Brazilian authorities might engage more actively in the future, either directly or through Mercosur, in diverse types of agreements with the PA and other trading and economic cooperation blocs. Financial integration is likely to be an area in which progress between the two major regional blocs—Mercosur and the PA—might be easier to achieve, in comparison with trade, labor mobility, and other areas of possible cooperation.

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Annexes

Annex 1: Market Capitalization by Origin (USD millions)

Annex 2: Market Capitalization by Economic Sector, End of 2014 (percent)

Annex 3: Traded Value of Shares by Origin (USD millions)

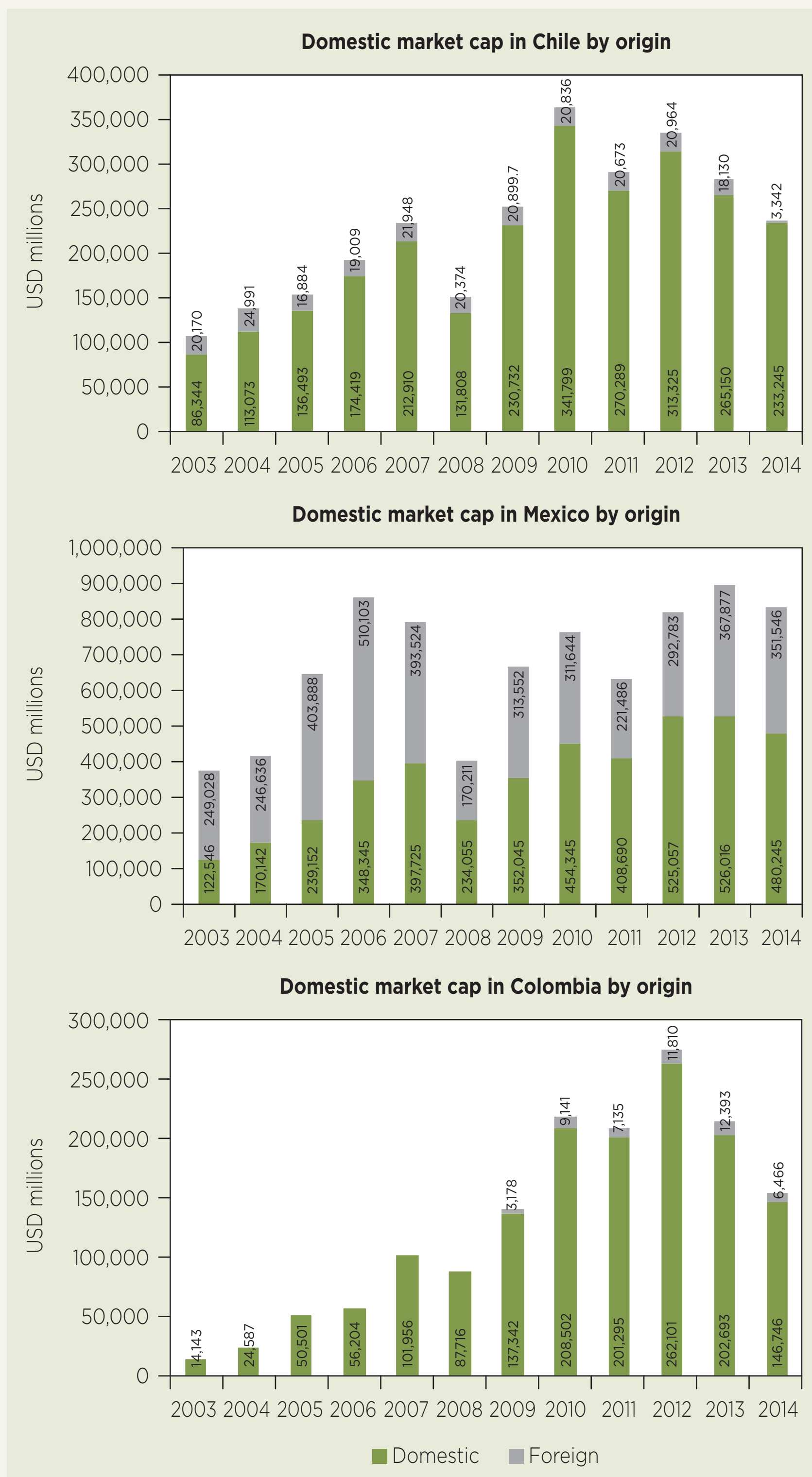
Annex 4: Traded Value of Bonds by Origin (USD millions)

Annex 5: Portfolio Composition of Pension Funds (USD millions)

Annex 6: Portfolio Composition of Insurance Companies (USD millions)

Annex 7: Portfolio Composition of Mutual Funds (USD millions)

ANNEX 1/ Market Capitalization by Origin (USD millions)



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ANNEX 1/ Market Capitalization by Origin (USD millions)

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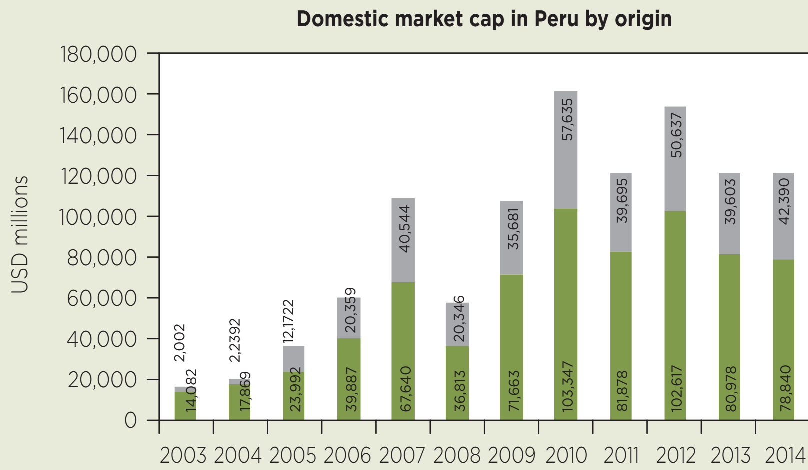
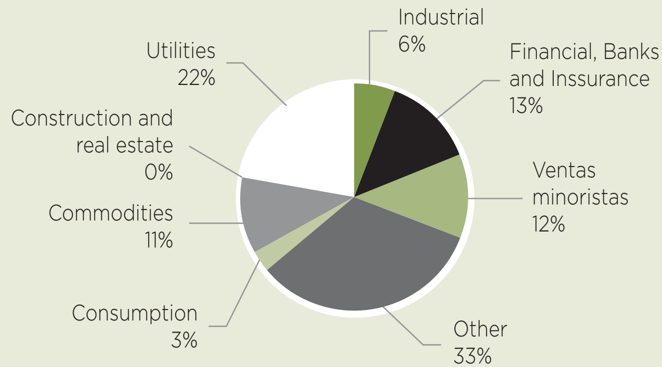


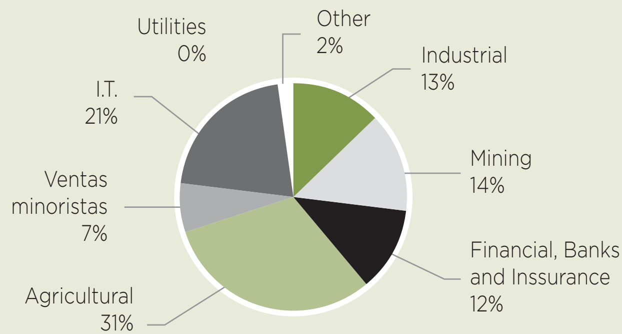
Source: Iberoamerican Federation of Exchanges.

ANNEX 2/ Market Capitalization by Economic Sector, End of 2014 (percent)

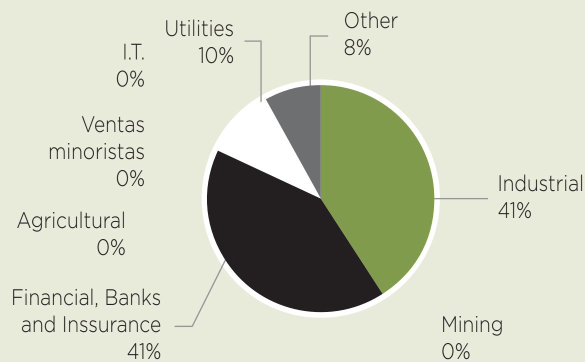
Market cap in Chile by economic sector



Market cap in Mexico by economic sector



Market cap in Colombia by economic sector



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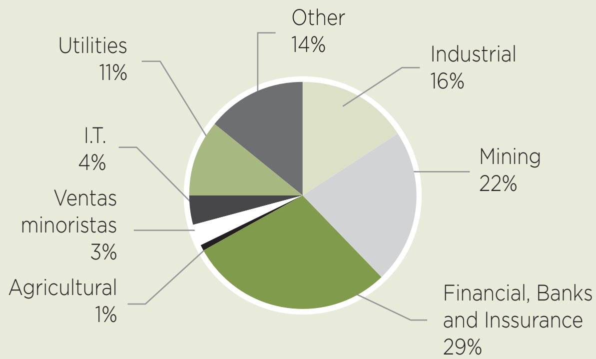
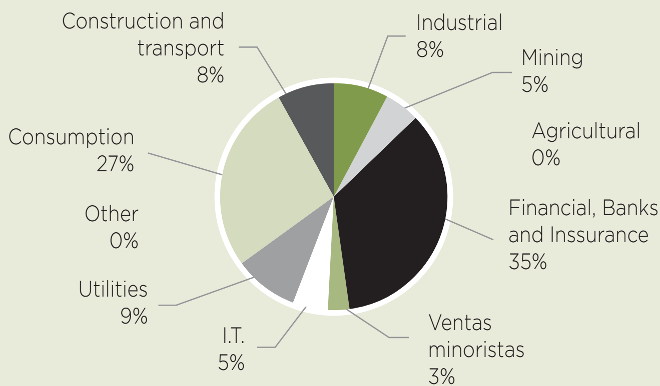
ANNEX 2/ Market Capitalization by Economic Sector, End of 2014 (percent)

(continued)

Market cap in Peru by economic sector

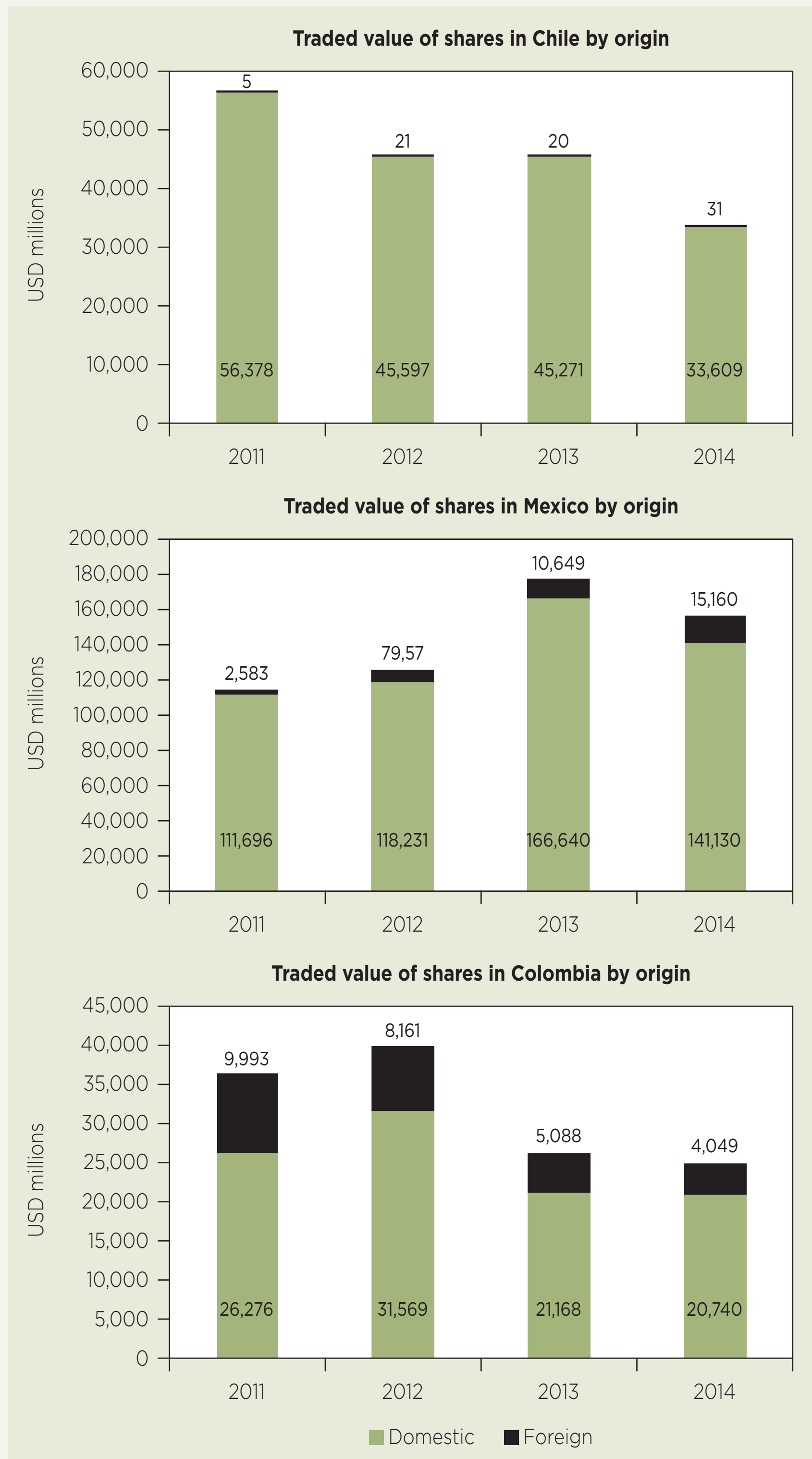


Market cap in Brazil by economic sector



Source: Iberoamerican Federation of Exchanges.

ANNEX 3/ Traded Value of Shares by Origin (USD millions)



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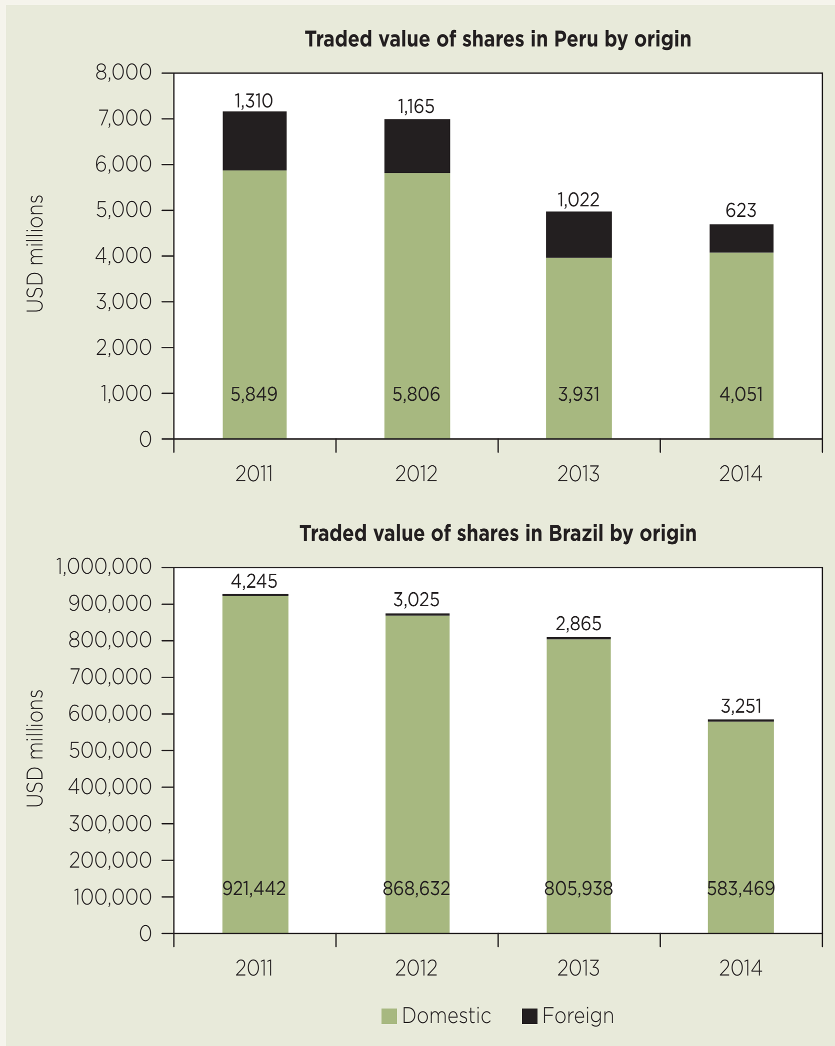
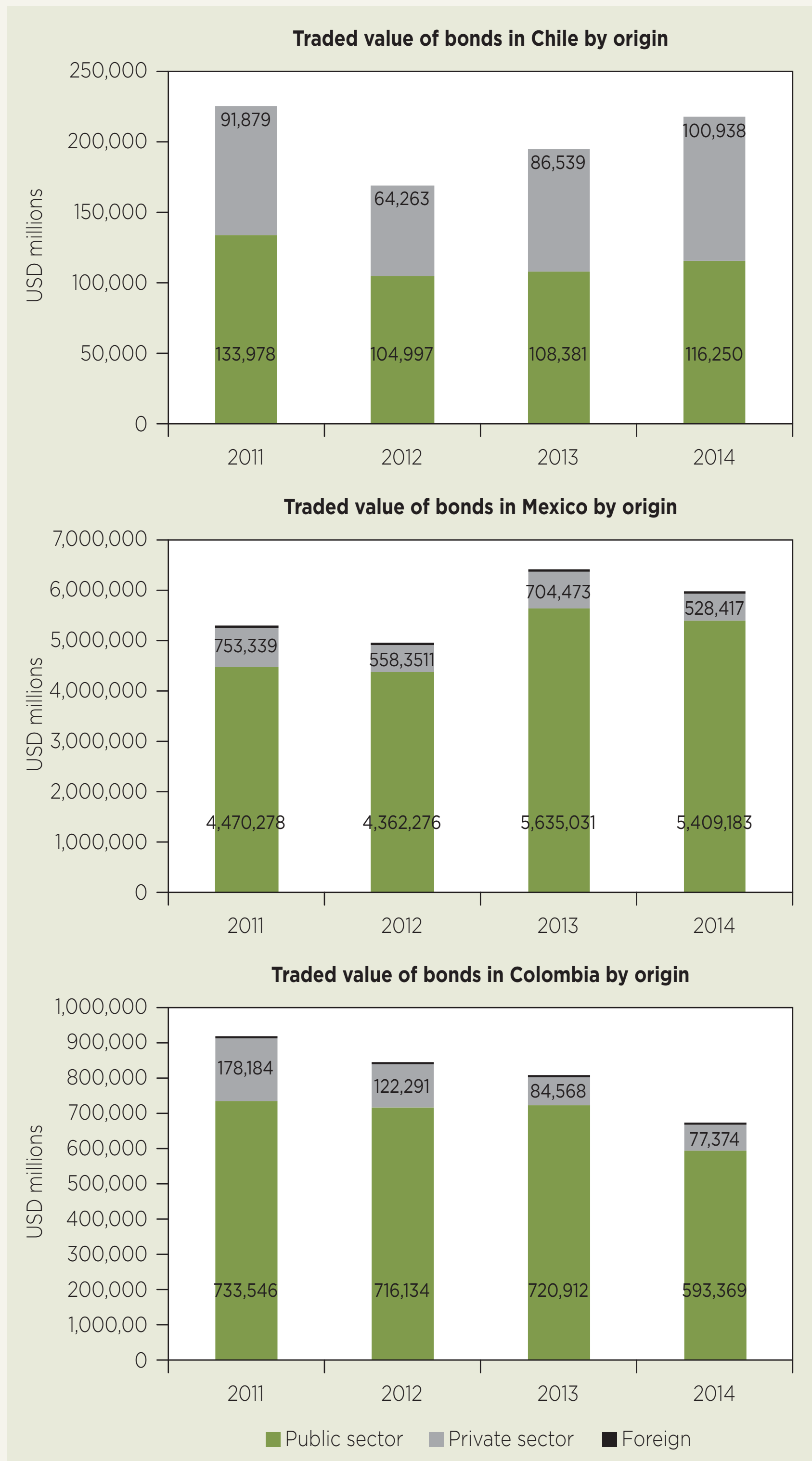


ANNEX 3/ Traded Value of Shares by Origin (USD millions)

(continued)

Source: Iberoamerican Federation of Exchanges.

ANNEX 4/ Traded Value of Bonds by Origin (USD millions)



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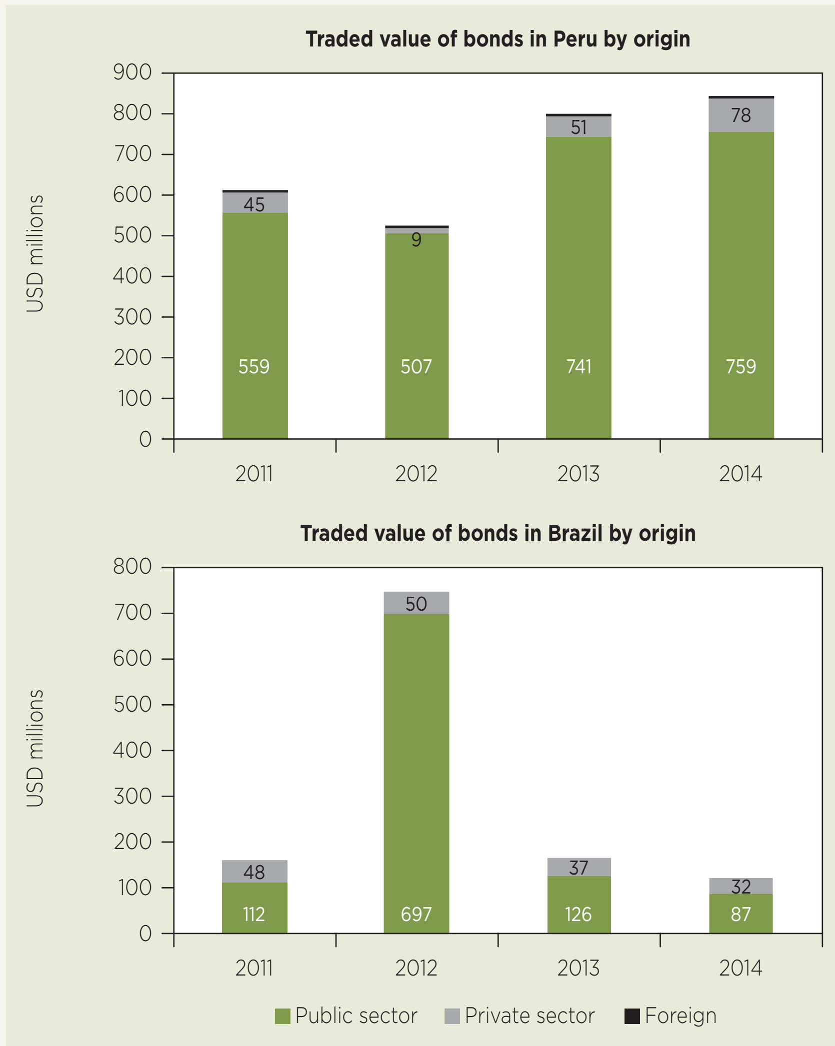
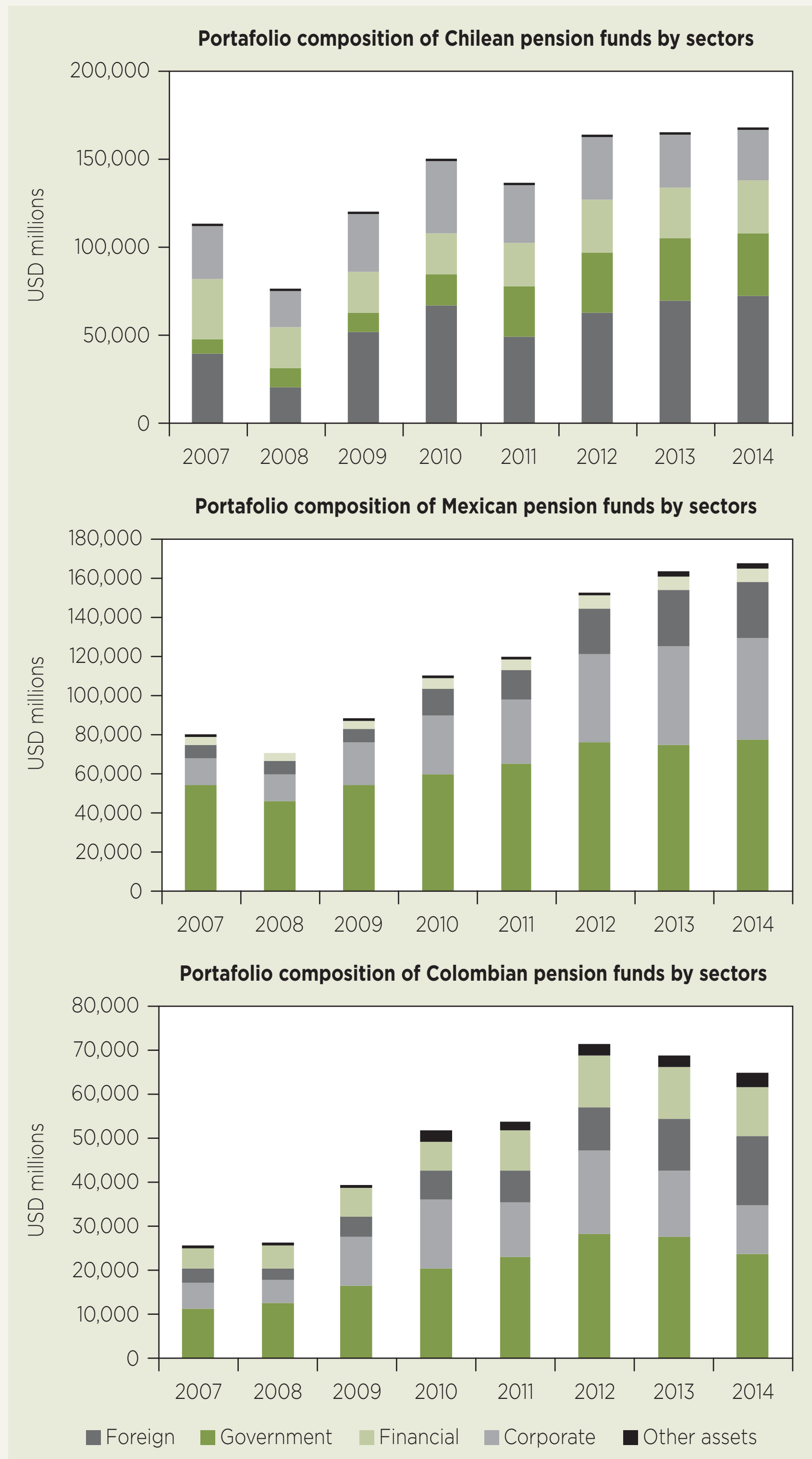
ANNEX 4/ Traded Value of Bonds by Origin (USD millions)

(continued)



Source: Iberoamerican Federation of Exchanges.

ANNEX 5/ Portfolio Composition of Pension Funds (USD millions)



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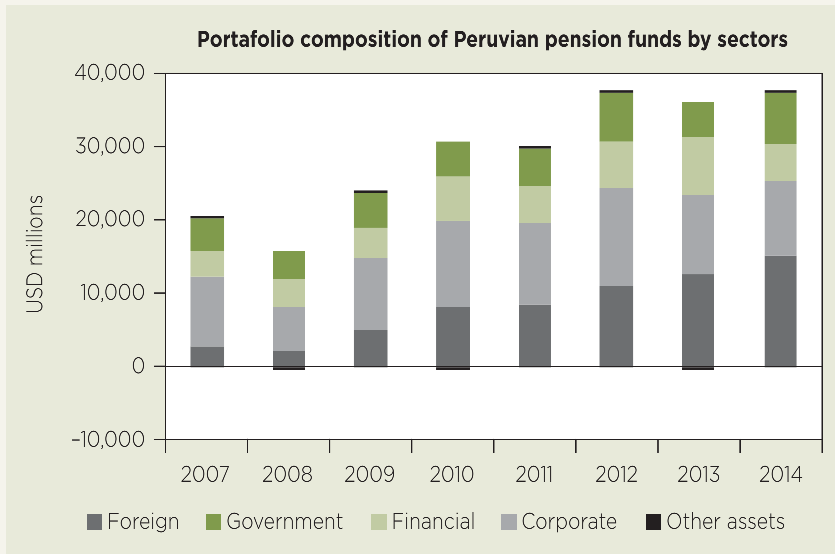
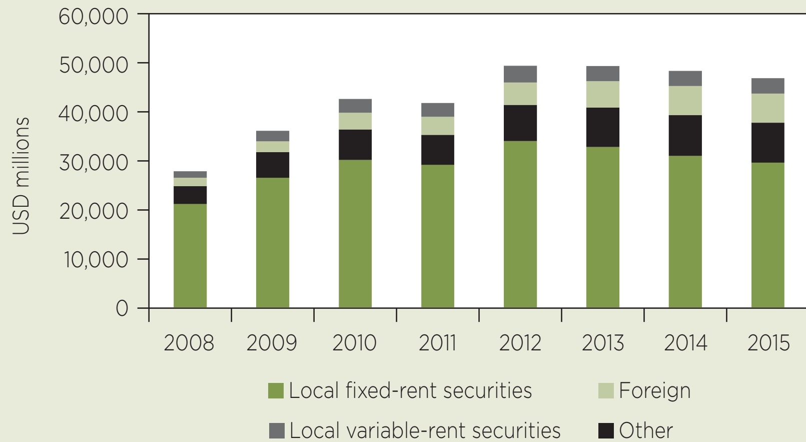
ANNEX 5/ Portfolio Composition of Pension Funds (USD millions)

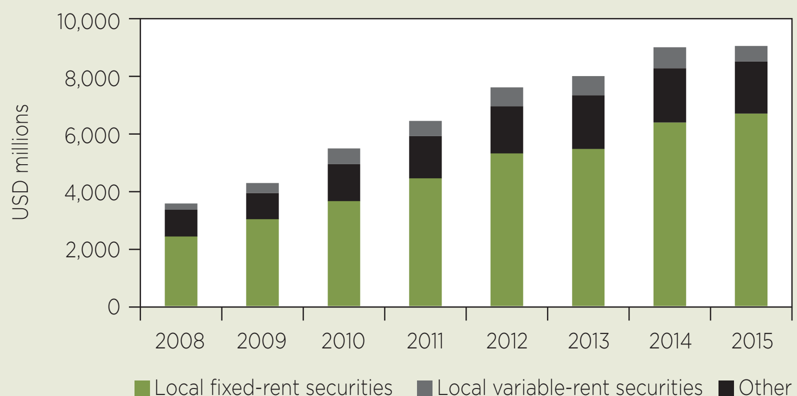
(continued)



Source: Local authorities, Asofondos.

ANNEX 6/ Portfolio Composition of Insurance Companies (USD millions)





Source: Local authorities.

ANNEX 7/ Portfolio Composition of Mutual Funds (USD millions)

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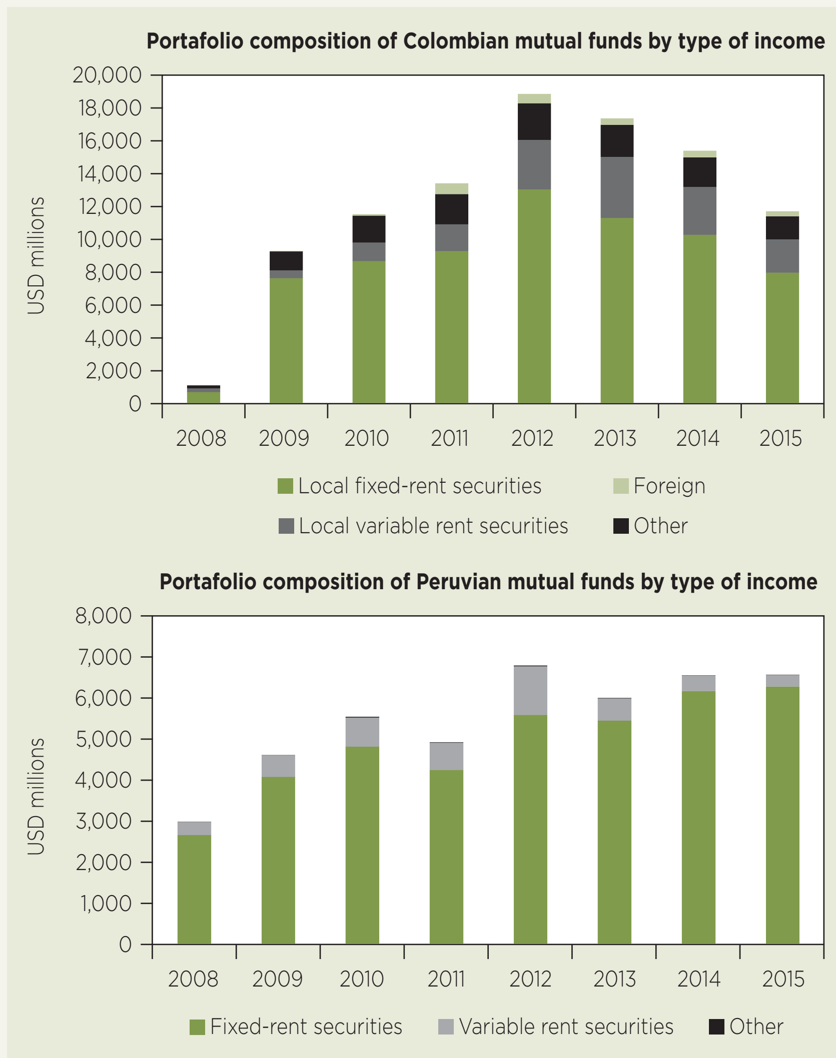
ANNEX 7/ Portfolio Composition of Mutual Funds (USD millions)

(continued)



Source: Local authorities.

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