

Policy Discussion Briefs

# Making the Most of the Economic Recovery

## The Role of Financial Inclusion and Trade Integration



Ninth Meeting of Finance Ministers of the Americas and the Caribbean

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**NINTH MEETING OF FINANCE MINISTERS  
OF THE AMERICAS AND THE CARIBBEAN**

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THE ROLE OF FINANCIAL INCLUSION AND TRADE INTEGRATION

**WASHINGTON DC, OCTOBER 11, 2017**

The following policy discussion briefs were prepared as the basis for discussion during the Ninth Meeting of Finance Ministers of the Americas and the Caribbean held in Washington DC, on October 11, 2017, and chaired by Mr. Luis Andrés Caputo, Minister of Finance of Argentina.

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The opinions expressed in these policy discussion briefs are those of the authors and do not necessarily represent the views of the Inter-American Development Bank, the International Monetary Fund, the World Bank Group, the United Nations Economic Commission for Latin America and the Caribbean, the CAF - Development Bank of Latin America, or their member countries.

# **Making the Most of the Economic Recovery**

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## **Making the Most of the Economic Recovery**

### The Role of Financial Inclusion and Trade Integration

The Meeting of Finance Ministers of the Americas and the Caribbean – also known by its acronym RFM – is an annual dialogue whose objective is to discuss issues of strategic importance and with the potential to promote economic integration and regional cooperation.

RFM meetings are attended by Finance Ministers from 34 countries of the Americas and the Caribbean, as well as the Heads of the International Monetary Fund (IMF), the World Bank Group (WBG), and the Inter-American Development Bank (IDB). Regional institutions such as the United Nations Economic Commission for Latin America and the Caribbean (ECLAC), the Development Bank of Latin America (CAF), the Central American Bank for Economic Integration (CABEI) and the Caribbean Development Bank (CDB) contribute to the discussion of Ministers.

During the Ninth RFM Meeting, the Ministers will discuss three issues related to policy options aimed at promoting inclusive financial systems and deeper regional integration, with a view to supporting economic growth prospects. The following Policy Discussion Briefs provide background information on these issues, selected as a priority by the official delegations.

The first deals with financial inclusion, placing particular attention on the specific problems faced by small and medium-sized enterprises. The corresponding briefs assess the main obstacles preventing access to finance, discuss various initiatives set to close the financial gap, and identify institutional arrangements and policies that enable innovation in terms of products and processes. One example of innovation is leveraging the appearance of new service providers, known as Fintech firms.

Another issue examined is that of *de-risking*, referring to the process of withdrawal or reduction of correspondent banking relations by global banks in recent years. In the aggregate, this process may lead to negative externalities for financial stability, inclusion, growth and development. This is seen as a justification for concerted measures by public and private sector players.

The third issue covered in the briefs is that of regional trade integration. Specifically, a pragmatic policy proposal is brought forward, with the objective of filling the gaps in the coverage of regional trade preferences, unifying the numerous rules of origin in a coherent system of fully extended cumulation, as well as improving trade logistics and facilitation, all leading to a region-wide free trade agreement.





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## World Bank Group

### Six Outstanding Questions on SME Finance\*

#### Do SMEs Face a Financing Gap?

Although small and medium enterprises (SMEs) provide employment to a large share of the labor force in developed and developing countries, they receive limited external funding relative to large firms, thus facing a financing gap. This problem is not specific to Latin America and the Caribbean (LAC) or other developing countries. For example, SMEs in developed countries also suffer from a similar shortfall in financing. According to the World Bank Enterprise Survey, SMEs are less likely to have a formal bank loan or other lines of credit compared to large firms. In LAC countries, whereas 66 percent of large firms resort to credit, only 56 and 38 percent of medium and small firms, respectively, do so. The International Finance Corporation (IFC) estimates that, in the developing world, the “credit gap” to formal SMEs reached around 900 and 1,100 billion U.S. dollars in 2011, respectively.<sup>1</sup> These values represented between 26 and 32 percent, respectively, of total credit to formal SMEs (Stein et al., 2013). Difficulties in obtaining finance affect the ability of SMEs to invest and grow and of new firms to start operating, hindering overall growth in economic activity and employment.

#### A Supply or Demand Problem?

Both credit supply and demand factors explain the low observed use of banking services by SMEs. A supply-side problem is present when SMEs have profitable investment projects but cannot get sufficient external funds to finance them. Market frictions, such as information asymmetries or weak creditor protection, could make it more difficult for financial intermediaries to assess the creditworthiness of SMEs, monitor their actions, and enforce repayment. This type of imperfections can limit lending to firms, including those with profitable investment opportunities. A demand-side problem exists when SMEs are not creditworthy. In this case, unless lending is subsidized, credit will not be available to them, as it would imply losses for the creditors.

Although demand problems are present, the vast evidence points toward the prevalence of supply-side constraints that limit lending. In high-income countries, the proportion of SMEs self-excluded from the loan market (i.e., SMEs that need a loan but refrain from applying for credit) is 20 percent, in middle-income countries 28 percent, and in low-income countries 44 percent. Whereas some SMEs are self-excluded because they lack “bankable” investment projects, other firms perceive that their credit

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\*The authors would like to thank Daniel Lederman for comments.

<sup>1</sup> The credit gap is defined as the amount of credit that would be needed to satisfy the demand of unserved and underserved formal SMEs. Unserved SMEs are those that do not have a loan but are in need of one. Underserved SMEs are those that have a loan but still find access to finance a binding operating constraint.

application will not succeed. Complex application procedures and lack of collateral are often cited as reasons for why SMEs exclude themselves from applying for loans (World Bank, 2013).

### **What Are the Obstacles to Financing SMEs?**

Several roadblocks stand in the way of SME finance and a sufficient credit supply. Bank lending to SMEs can be limited by their “opaqueness.” Compared to large firms, SMEs tend to have less publicly available information and weaker corporate governance frameworks. Thus, banks usually struggle to assess the creditworthiness of these firms, which enhances adverse selection and moral hazard problems.

Opaqueness also requires banks to rely more on relationship lending when dealing with SMEs; lending depends more on “soft information” gathered by loan officers through personalized contacts. In turn, relationship lending can discourage lending by large and foreign banks, which maintain more impersonal relations with clients, although new technologies are reducing the need for relationship lending and facilitating arm’s length lending to SMEs (de la Torre et al., 2010).

In addition, SME lending relies heavily on contract enforcement institutions. Lenders tend to substitute the lack of information on SMEs with collateral. But collateral lending requires an appropriate framework including a clear definition of assets that can be collateralized, protection of creditor rights, and speedy judicial procedures. Weak property rights frameworks reduce finance to SMEs disproportionately more than to large firms (Beck et al., 2008).

Macro-micro issues play a role, too. In particular, the macroeconomic environment affects SME finance. When governments run significant fiscal deficits, bank lending could be diverted from the private to the public sector because the latter may become profitable or less risky. This could reduce the credit available to SMEs.

Financial regulations that require banks to keep detailed information on clients and loan originations could also limit lending to smaller firms for which lending relies more on informal relations. For example, anti-money laundering regulations that mandate banks to have detailed documentation on their customers might exclude smaller and informal SMEs from the loan market.

The policy challenge is, thus, to identify policies that can help overcome these barriers.

### **Which Initiatives Look Promising?**

In light of the financing problem that SMEs face, governments have tried several initiatives to close the gap. Some of the promising measures focus on providing tools for private banks to lend to SMEs. These initiatives depart from direct state intervention in the allocation of credit and focus instead on improving the institutional environment and completing financial markets. They range from establishing programs and platforms to addressing information problems and contract enforcement mechanisms.

### *Public Credit Guarantees*

Public credit guarantees have become a popular tool used by governments to channel credit toward SMEs. A survey of credit guarantee schemes around the world shows that over 30 percent of these schemes have some form of state ownership (Beck et al., 2010). Governments often get involved in these schemes in two different ways: supporting private guarantee schemes (with direct funding, counter-guarantees, tax incentives) or directly administering their own schemes. In LAC, public credit guarantees have a strong presence: around 97 percent of credit guarantee schemes receive public funding. The predominant type of government involvement is through direct management of a scheme (Pombo et al., 2013).

A pioneer case in the region has been FOGAPE (Fondo de Garantía para Pequeños Empresarios, Small Enterprise Guarantee Fund) in Chile. FOGAPE is entirely funded and run by the state through BancoEstado, a large state-owned bank. Although established in 1980, it significantly expanded its outreach since 1999. This scheme has been able to provide credit guarantees to microenterprises and small firms in a large scale, while sustaining good performance and financial stability. As of 2014, loans to micro and small firms with a FOGAPE guarantee represented over 10 percent of all commercial loans to this segment in Chile (de la Torre et al., 2017).

Overall, given the challenges of enhancing access to credit for SMES, it is worth experimenting with guarantees. There is evidence that public credit guarantees can increase loans and enhance financing conditions to targeted firms. Furthermore, in some cases firms that received guaranteed loans enhanced their performance. However, these mechanisms should be designed carefully because otherwise they can lead to lower creditworthiness, higher defaults, and banks simply shifting from unguaranteed to guaranteed lending (Gozzi and Schmukler, 2015).

### *Online Platforms for Supply-Chain Finance*

The development of online platforms to conduct supply-chain finance is another policy area worth considering. Online platforms allow SMEs to post account receivables, typically from large, well-known buyers they serve. Interested financial institutions then submit offers to buy them at a discount. SMEs accept the most convenient offer and automatically receive payment on their bank account. Thus, online platforms foster supply-chain finance by reducing transaction costs and fostering competition. Furthermore, because buyers enter information on the receivable into the system, SMEs cannot submit bogus or duplicate receivables, which reduces fraud. Credit risk is also reduced because financial institutions face the risk of the buyers (usually creditworthy firms) instead of the riskier SMEs.

Governments have developed successful online platforms. The case of NAFIN (Nacional Financiera), a development bank in Mexico, is a case in point. Since 2001, NAFIN operates its own online platform for supply-chain finance but does not provide lending directly. As of 2015, the program encompassed about 12,000 suppliers, over 600 buyers, and about 40 private financing institutions. Due to its success, NAFIN has entered into agreements with other Latin American development banks to develop reverse factoring systems in Central America, Colombia, and Ecuador (de la Torre et al., 2017).

Nowadays, these automated systems are also being offered by fintech companies as well as new ventures set up by traditional banks, in both developed and developing countries (The Economist, 2017).

### *Movable Collateral*

Several countries have pursued reforms of their secured transactions systems with the goal of promoting the use of movable assets as collateral (Alvarez de la Campa, 2013). Movable assets account for most of a firm's assets, particularly for SMEs. However, due to weak contracting institutions, banks are often reluctant to accept these assets as collateral, especially in developing countries.

Creditors in developing countries are typically unwilling to accept movable assets as collateral due to weak legal and regulatory environments. In this context, immovable assets, which are more difficult to hide and are less likely to be subject to ownership disputes, are widely preferred as collateral by banks.

Reforms aimed at fostering the use of movable assets tend to expand finance to SMEs. In particular, improving movable collateral laws and establishing centralized movable collateral registries leads to increases in the amount of credit to SMEs, at lower interest rates.

### *Credit Bureaus and Credit Registries*

Another tool that has also proven to be effective at promoting SME finance are credit information sharing mechanisms. By allowing lenders to share with other lenders relevant information from borrowers, information asymmetries are mitigated. In addition, they increase bank competition because they reduce information monopoly by lenders (OECD, 2012).

Credit information sharing mechanisms can take the form of credit registries and credit bureaus. Credit registries are managed by the public sector (typically bank supervisors or central banks) and collect information from supervised financial institutions. Instead, credit bureaus are private businesses that collect information required by commercial lenders. Among the two, credit bureaus have some advantages because, as they are for-profit organizations, they have incentives to provide wide coverage, collect quality information, and offer value-added services.

The existing evidence shows that information sharing mechanisms are associated with increased access to finance at lower costs. SMEs particularly benefit from these mechanisms. Improving information sharing mechanisms leads to a lower financing gap between large and small firms, and an expansion of credit to small firms that are credit constrained.

### **Which Initiatives Have Failed?**

Other initiatives have been implemented trying to circumvent private banks, which remain reluctant to lend to SMEs. Unfortunately, solutions to sidestep banks are not easy to reach, partly because of poor assessment of the problem or inherent failures in the tools used. Still, governments are trying to get around the problems of access by experimenting with different versions of this kind of initiatives.

### *Traditional Public Banks*

One relatively simple way for governments to channel credit to SMEs has been through traditional public banks, including development banks. Governments typically instruct public banks to favor SMEs (for example, by subsidizing interest rates) or simply to allocate a certain share of funds to them.

But this solution has faced many problems. To start, it takes for granted that the financing gap originates from the supply side. If the reason that explains the financing gap stems from the demand side, artificially increasing the supply of funds would result in a misallocation of credit.

A supply-side problem might justify having public banks intervene. When the banking system is not competitive, public banks could exert pressure on private banks by lending profitably to segments that are underserved. However, even when problems of SME finance arise from the supply side, public banks have failed to produce the expected results. As a result of lack of disciplining devices, soft budget constraints, and difficulties in measuring their performance, public banks have often lent to unprofitable companies, have been prone to political influence and corruption, and have faced incentives similar to those in the private sphere.

One way to ameliorate problems with public banks has been to conduct institutional reforms. Reformed public banks have an adequate incentive structure and hard budget constraints that impose discipline. In addition, initiatives are limited to “market friendly” interventions that work with the private sector rather than displacing it. Public banks complement the private sector when possible and collaborate with private participants to identify and fund bankable SMEs. Furthermore, rather than increasing the use of financial services per se, interventions are highly selective, targeting the underlying causes of problems of access. They are only conducted when benefits outweigh costs. In line with this new view, a new wave of market-friendly public banks has emerged in the LAC region, trying to solve market imperfections and completing markets (de la Torre et al., 2017). Whereas the old model of public banks often seems destined to failure, the new model looks more promising.

### *Capital Markets*

As another alternative to circumvent traditional banks, governments have fostered the development of capital markets. However, capital markets have not proven to be an alternative for SMEs yet. Although many capital markets are large and have developed significantly, they typically serve large companies, as listing and capital raising costs are high and investors seek to invest in liquid and less risky companies. Alternative financing providers, such as venture capital and private equity, are available only in some countries and to some sectors. Even when present, they tend to be much smaller than capital markets and banks (de la Torre et al., 2011). Thus, SMEs need to rely on banks, which provide around 88 percent of total financing to SMEs (Stein et al., 2013).

As a possible solution to this problem, governments in some countries have established secondary exchanges to cater to the specific needs of SMEs. These exchanges offer listing and regulatory requirements tailored to smaller firms with lower fees, lower profitability requirements, and smaller

issuances, among others. However, the efforts have not been fruitful so far. The case of China is worth analyzing given its undergoing efforts to establish these markets.

Despite the initial enthusiasm to promote these markets worldwide, many SME capital markets seem to be reaching a small number of firms (Harwood and Konidaris, 2015). The underdevelopment of these markets could be due to a lack of financial literacy of SMEs that discourages them from turning to capital markets for funds. Other SMEs might feel that they have to pay a high premium to raise capital in these markets only to be subject to their short-termism and volatility. Another difficulty resides in attracting institutional investors, which are the main participants in capital markets but favor large, liquid companies, whose prices are not affected by their actions and which can be disposed of on short notice.

### **What Should Governments Do Next?**

The initiatives discussed above show a sample of the different tools that countries in LAC have at their disposal to try to unlock SME finance.

Designing effective policy interventions requires having accurate and extensive information on the state of SME finance and the nature of the problem in each country. Better information enables governments to identify cases when SMEs are not being adequately served by the financial sector. Information also helps to determine the extent to which the lack of financing to SMEs is caused by problems of supply or demand, which kind of intervention might be more appropriate, and the impact of these interventions. More information is also helping traditional financial firms as well as the fintech sector reach out to SMEs. Governments might want to engage in these efforts by fostering the collection and use of information on the financing needs of SMEs and supporting alternative financing mechanisms.

Policy initiatives aimed at enhancing access to credit for SMEs would benefit from experimentation as well as systematic and rigorous impact evaluations of the ongoing efforts. The challenge has been well identified across the world, but solutions have yet to be properly vetted and continuously monitored.

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## International Monetary Fund

# The Withdrawal of Correspondent Banking Relationships A Case for Policy Action\*

Following the global financial crisis, global banks have been withdrawing correspondent banking relationships (CBRs)—a process often referred to as “de-risking”.<sup>1</sup> In recent years, several countries have reported a reduction in CBRs by global banks. Pressure on CBRs has been associated with restricted access to financial services by certain categories of customers, business lines, jurisdictions or regions. Survey evidence indicates that smaller emerging and developing economies in the Caribbean, Africa, Europe and Central Asia and countries under sanctions may be the most affected.

### Country Experience

Discussion with authorities and surveys indicate pressure on CBRs in some parts of the world.<sup>2</sup> Surveys by the World Bank (World Bank 2015a, b), the IMF with the Union of Arab Banks (UAB) (IMF/UAB, 2015), and the Association of Banking Supervisors of the Americas (ASBA, 2015) indicate that smaller jurisdictions in the Caribbean, Africa, Europe and Central Asia were most affected. Several country authorities in the Caribbean have reported particular pressures on their CBRs. In Asia and the Pacific, Pacific islands appear to have been most affected, with the decline in CBRs potentially undermining progress on financial inclusion. In Africa, CBR withdrawal occurred for example in Liberia, while problems with banknote supply surfaced in Angola. In Botswana concern about compliance with Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) regulations has led some correspondent banks to close their accounts at the central bank, limiting the range of counterparties available for foreign exchange transactions and investment operations. In the Middle East and Northern Africa, countries under economic and trade sanctions are most affected by the withdrawal of CBRs (IMF/UAB, 2015).

In the Western Hemisphere, the effects are most prominent in the Caribbean, although pressure on CBRs is also seen in some larger economies in Latin America (including Mexico). In particular, major global banks have recently terminated CBRs with many banks in the Caribbean, or are considering to discontinue them. At least sixteen banks in the region across five countries had lost all or some of their CBRs as of May 2016. The loss of CBRs has had a varying impact across Caribbean countries depending on the size of the affected

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\*For a fuller explanation, see Erbenova, Michaela, et. al. “The Withdrawal of Correspondent Banking Relationships: A Case for Policy Action,” IMF Staff Discussion Note, Number 16/06, June 2016, and “Recent Trends in Correspondent Banking Relationships—Further Considerations,” International Monetary Fund, March 16, 2017.

<sup>1</sup> The term “de-risking” could cover a wide range of behaviors, including a set of reactive actions adopted by banks effectively avoiding the business and reputational risks altogether as well as any form of withdrawal of financial services. The indiscriminate use of the term “de-risking” to describe different types of events has been at times misleading and has confused the dialogue on this issue.

<sup>2</sup> These surveys are generally perception-based and response rates vary. As with any survey-based evidence, the usual caveats of a self-selection, non-response and cognitive response biases apply.

banks and the level of foreign presence in affected countries' banking systems. The full extent of the impact is yet to be quantified, but the unmeasured effect has been loss in business confidence and in the ease of some basic transactions.

The main CBR providers in the Caribbean are located in the U.S., Canada, and to a lesser extent Europe and the Caribbean. Several institutions in Barbados, The Bahamas, the Eastern Caribbean Currency Union (ECCU), Guyana, Haiti, Jamaica, and Trinidad and Tobago have had CBRs terminated. Many of them have reportedly been able to find replacement CBRs or rely on their remaining CBRs. Reasons given for terminating CBRs included risks associated with the presence of offshore sectors in some of these countries or jurisdictions, the respondent banks' customer base including higher-risk categories of customers (e.g., Money or Value Transfer Services, cash intensive firms and specialized professionals, and politically exposed persons), a change in over-all risk appetite of the correspondent bank and perceived lack of profitability of certain correspondent banking services. In response to pressure on CBRs, some respondent banks have tried to mitigate the risk of losing access to CBRs by closing local accounts with their higher-risk customers.

In Belize, several banks lost their CBRs. Only two of the nine domestic and international banks (representing 27 percent of the banking system's assets at the end of March 2016) have managed to maintain CBRs with full banking services. Other banks found alternative relationships with non-bank providers of payment services or through nesting arrangements. The Central Bank of Belize also lost two CBRs. While the overall size of deposits and lending was not affected, international banks' deposits decreased significantly, partly compensated by an increase in deposits in domestic banks. There has also been some displacement of customers toward the two banks that still have CBRs with full banking services.

Financial institutions in The Bahamas have experienced additional scrutiny of their CBRs, although only in a few cases this has resulted in temporary disruptions of correspondent banking services. Five financial institutions (representing about 19 percent of the assets of the banking system) have recently lost one or more CBRs. The Money or Value Transfer Services sector has also been affected, as well as different business lines, including credit card payments, cash management, investment services, clearing and settlement, international wire transfers and remittances. Although the impact has been limited so far, further pressure on CBRs could have an adverse impact on the financial sector and increase costs of outgoing remittances in the Caribbean. Indeed, The Bahamas is a source of remittances to other countries (e.g., Haiti, where the impact of this spillover would be immediate, as about 75 percent of remittances from The Bahamas to Haiti are paid and received in the same day).

### **Motives for Withdrawal of CBRs**

While the factors leading to the withdrawal of CBRs are multiple and interrelated, these are ultimately individual business decisions. These drivers operate concurrently, with their relative significance varying case-by-case. Banks' cost-benefit analysis has been shaped by the re-evaluation of business models post-GFC (Global Financial Crisis), including changes in the regulatory and enforcement landscape. The new macroeconomic environment, more stringent prudential requirements, and higher compliance costs are

putting pressure on banks' profitability and weighing on decisions to withdraw CBRs. Other evolving regulatory requirements, notably with respect to economic and trade sanctions, AML/CFT and tax transparency, and the current enforcement landscape also weigh on global banks' cost/benefit analysis and shape their reputational risk and cost perceptions. In addition, lack of clarity about the regulatory expectations, banks' concerns about their ability to manage risks and cross-border legal impediments to the implementation of regulatory requirements may result in a bank's decision to withdraw from a CBR.

### **Potential Consequences of Withdrawal of CBRs**

Continued pressure on CBRs could potentially disrupt financial services and cross-border flows, although macroeconomic consequences have not been identified so far at a global level. The impact of the withdrawal of CBRs on certain jurisdictions can become systemic in nature if unaddressed. It could disrupt financial services, including trade finance and remittances, and lead to financial exclusion for certain categories of customers, particularly Money or Value Transfer Services and Non-Profit Organizations, who serve vulnerable segments of the population. More generally, the risk of a jurisdiction completely losing access to the global financial system would warrant policy actions. To mitigate this risk, in line with the Financial Stability Board (FSB) action plan unveiled in 2015 and endorsed by the G20 Summit, there is a need to further understand the scope, scale and implications of these trends, and address the drivers that are adding pressure on CBRs leading to the exclusion of certain categories of customers (FSB, 2015).

While pressure on CBRs has reached a critical level in a few jurisdictions, so far the economic or financial stability impact has been limited, partly reflecting the ability of financial institutions in affected countries to find alternative arrangements. In many cases where CBRs have been lost, financial institutions have been able to find alternative arrangements including by relying on their remaining CBRs, finding replacement CBRs or using other means of transferring funds across borders. However, the ability of financial institutions to find replacement CBRs has varied. Authorities have reported that maintaining existing CBRs has come at a price, including: (i) newly imposed minimum activity thresholds below which the account is closed, (ii) higher costs (often associated with due diligence) passed on to the consumer when establishing a new CBR, and (iii) pressure on the respondent banks to limit their exposure to certain categories of customers in order to maintain a CBR (e.g., small banks have reported severing ties with Money or Value Transfer Services to maintain CBRs) (World Bank, 2015a).

The withdrawal of CBRs appears to have affected certain categories of customers and business lines. According to the results of the surveys undertaken by the IMF/UAB and ASBA, Money or Value Transfer Services, small and medium exporters, and small and medium domestic banks have been the most affected categories of customers. In addition, international wire transfers, clearing and settlement services and trade finance appear to have been particularly affected (World Bank 2015b). In the case of Latin America, the reduction of CBRs is believed to have inhibited further financial integration, raised the cost of finance for small and medium enterprises and, in some cases, led to firms losing access to credit from U.S. exporters (IMF, 2016). Moreover, in countries where Non-Profit Organizations have a sizeable role in the economy and rely on financial services to receive funding and conduct their operations (e.g., Somalia, West Bank and Gaza), withdrawal of CBRs could affect growth, poverty reduction and security (Warden, 2015a, b, and Center for Global Development, 2015). Importantly, an increase in the

concentration of correspondent banks and consequent reduction of CBRs could also push activities to the informal sector, leading to transparency concerns (Center for Global Development, 2015).

### **Possible Way Forward**

While the developments associated with CBRs post-crisis are a result of individual decisions of global banks, they may in aggregate lead to a negative externality for financial stability, inclusion, growth and development goals. Against the backdrop of low profitability and rising costs associated with weak macroeconomic conditions, strengthened regulatory standards and enhanced enforcement, it may be rational for an individual bank to cut some CBRs or to increase the price charged for this service based on a cost-benefit analysis. However, simultaneous actions by many banks to withdraw from CBRs would leave only a few global banks providing correspondent banking services in concentrated markets, which could have systemic impact on some affected countries resulting from being disconnected from the global financial system.

Overcoming the coordination and collective action problems associated with the negative externalities that can be created by a continued withdrawal of CBRs justifies concerted measures by public and private sector players. Several initiatives are being considered to help mitigate potential macroeconomic and financial stability impact of the CBR withdrawal. These include the need to: (i) clarify regulatory expectations and address directly legal conflicts and impediments; (ii) strengthen regulation and supervision in line with international standards, including through capacity development; (iii) promote industry initiatives to mitigate compliance costs; and (iv) develop contingency plans to address a risk of complete loss of CBRs in certain jurisdictions. The 2015 FSB action plan is a key element of the coordinated response by international community (FSB, 2015).

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## Economic Commission for Latin America and the Caribbean

### Challenges of Financial Inclusion in Latin America and the Caribbean

Financial inclusion encompasses all public and private, supply- and demand-side initiatives to provide products and services appropriate to the needs of households and small and medium-sized enterprises (SMEs) that are traditionally excluded from the formal financial sector. In addition to boosting levels of financial access and banking penetration, financial inclusion also relates to policies to enhance the use of the financial system by the SMEs and households that already participate in formal financial channels.

Accordingly, financial inclusion should be conceived as a policy of economic insertion. This means using the financial system as an instrument for expanding the potential for savings and consumption, while at the same time taking fuller advantage of business talent and investment opportunities. Financial inclusiveness thus allows the financial system to respond to the disparate financing needs of households at different stages of the human life cycle, and of businesses at different stages of productive and technological advancement.

An analysis of financial inclusion in Latin America and the Caribbean reveals that the region's households and SMEs have low and uneven access to the formal financial system, and that only a limited number of instruments and mechanisms exist for improving the financial integration of SMEs already participating in the system.

Latin America and the Caribbean is one of the regions of the world with the lowest levels of household financial inclusion. On average, fewer than half (45.8%) of the region's adults over the age of 15 have access to the financial system. This figure is below the global average (61%) and well below the average posted in developed regions such as North America and Western Europe (approximately 93.3% in both cases) and in most developing regions, including East Asia and the Pacific (71.6%), Eastern Europe and Central Asia (58.2%), and the Middle East and North Africa (52.8%). Levels of financial access in Latin America and the Caribbean are not only comparatively low, but also highly unequal. For the region as a whole, the proportion of adults with access to the formal system was 1.5 times greater in the top 60% than in the bottom 40% of the income distribution. The only region with a wider gap between the two income strata was Sub-Saharan Africa, with a ratio of 1.9.

In the productive sector, SMEs have low levels of access to the formal financial system, while a gulf exists between small and large enterprises. The available data show that on average in Latin America and the Caribbean, just over 45% of small businesses are able to access credit provided by formal financial institutions. Moreover, SMEs mainly use the financial system for deposits and as a payment method, rather than to obtain credit products. On average, in Latin America 93.57% of SMEs used current accounts, while only 36.88% used lines of credit and 23.42% term loans. This unbalanced use of the financial system restricts SMEs' capacity for expansion and future growth.

The financial inclusion gap may be explained by two sets of factors that limit the access of households and SMEs to financing. These include, on the one hand, demand and supply side factors that directly concern SMEs, and on the other the characteristics of the financial system in Latin America and the Caribbean, including the lack of incentives for channeling sources of financing to SMEs.

The difficulties that directly concern SMEs stem from their small size, limited resources and narrow production base – factors which restrict access to credit. Owing to these characteristics, their production costs, risk levels and financing costs are higher than those of larger enterprises, as reflected in the steep collateral or guarantee requirements demanded of SMEs to access external sources of financing. Latin America and the Caribbean is one of the regions with the highest collateral requirements for small businesses seeking loans, with guarantees on average amounting to 234.6% of the requested loan amount. This figure exceeds the global average of 209.8%.

A second explanation of the financial inclusion gap in Latin America and the Caribbean may be found in the characteristics of the region's financial system. This system is shallow and underdeveloped, highly concentrated, short-termist and lacking in financial instruments.

The high cost of accessing external financing and the characteristics of the financial system mean that most SMEs finance themselves from internal resources or informal sources. Difficulties in accessing financing from the banking system may also discourage investment, a phenomenon that has been documented in several analyses on investment and its financing—regarding both working capital and fixed capital—in different regions of the world.

A new perspective on financial innovation is needed, with a view to channelling resources towards the productive sector and the achievement of development goals. Financial innovation should be conceptualized as a public good in a broader sense that differs from the traditional definition based on non-rivalry and non-excludability.

In that sense, public goods are something that markets do not provide, either due to asymmetries, uncertainty or simply a lack of knowledge. Public goods and services tend not to be produced in response to demand, even where, considering their significant positive externalities, they should be widely available.

Within this framework, financial innovation policy may also take the form of actions undertaken to channel financing to different actors, investments and production requirements, including innovation in products, processes and institutions. Each type of innovation should promote the inclusion of households and businesses, develop appropriate instruments for risk management by various economic agents in a range of sectors, and provide financing for new development goals and priorities.

Development banks play an important role in fostering innovation for financing, both directly and through coordination with other banks. While there is a complementarity between regional, subregional and national development banks that stems from shared goals and instruments, there is also scope for coordination with the private banking sector, in which potential synergies could lead to mutually beneficial innovations. This is a key aspect on which financial innovation should focus.



However, in Latin America and the Caribbean the pursuit of financial innovation faces significant challenges, since an array of instruments needs to be developed to address the production heterogeneity that is the region's hallmark. These new instruments must also respond to existing needs, such as ensuring the inclusion of SMEs, closing the infrastructure gap, devising financial instruments to foster international trade, and strengthening complementarity between public and private financial intermediaries.

Conceptualizing financial inclusion as a public good implies assigning development banks a role as drivers of productive financing. Development banks may also complement commercial banks, which at present do not have enough incentives to extend their services to SME financing. Indeed, development banks have proven to be capable of expanding their financing instruments and mechanisms in view of the requirements, characteristics and risks inherent to different production activities.

In order to promote financial inclusion development banks have turned to innovate in the form of products, processes and institutionality. Innovation in the form of products includes instruments on the one hand to facilitate the access to the financial system and reduce risk, such as the *Cartao BNDES* in the case of Brazil which has increased the level of access to the financial system of SMEs and has the potential to reduce financing costs. Another example is the use of technological platforms to improve financial inclusion, such as the case of the Productive Chains program of *Nacional Financiera* in Mexico.

Innovation in the form of processes includes the broadening of the financial network, as is the case of non-banking correspondents in Colombia. Greater flexibility in the method of evaluating the capacity of payment of individuals and companies also falls into this category. This comprises substituting the evaluation of risk based on financial statements with evaluations based on direct, personal and continuous relationships between banks and SMEs.

Innovation by public banks also extends to the institutional dimension. This implies on one side generating greater complementarity between development and commercial banks. Innovation in the institutional framework also implies finding the right balance between innovation and regulation.



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## CAF – Development Bank of Latin America

### Technological Change and Financial Inclusion: The Contribution of Fintech

There is broad consensus concerning the important role of micro, small and medium enterprises (MSMEs) in Latin America's economies. They represent a substantial portion of the productive units (over 90%) and of employment (over 60%). It is also known that as a sector they remain neglected or underserved by the financial system, as a result of large information asymmetries, the prevalence of informal business practices, market heterogeneity, and little capacity for innovation and, in many cases, the presence of regulatory restrictions.

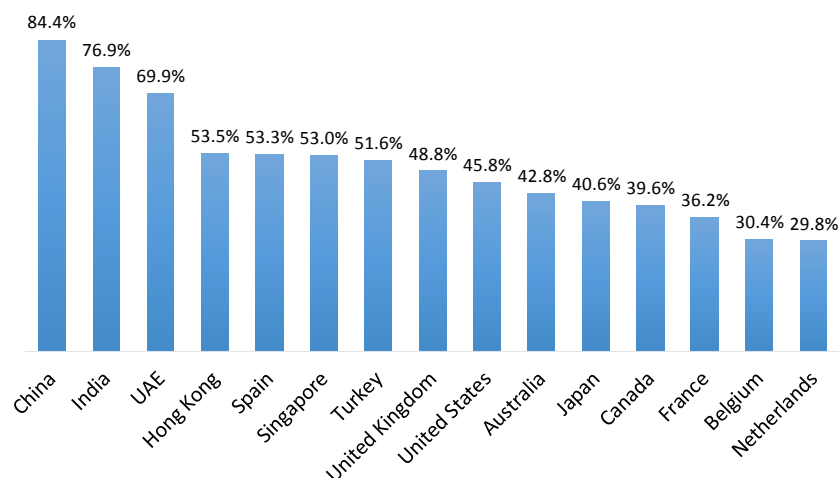
In addition to MSMEs, the financing gap includes low-income people, people from rural or remote areas, the informal productive sector and other sectors that, while currently served by the financial system, are looking for alternative services and financial products with better costs and processing time to improve their competitiveness.

It is also recognized that new technologies and digitalization have a growing impact in all sectors of the economy. In the financial sector virtual transactions are becoming increasingly common. Traditional financial institutions have been making intensive use of information technology (IT) in their internal operations, gradually automating most of their processes.

Since the 2008-2009 crisis, this process has been accelerating with the appearance of new players in the financial intermediation industry that are rapidly attracting the aforementioned segments of business and families that are not well served by traditional financial institutions. There is a rapid increase in new non-financial companies with a solid track record in the technology and telecommunications segment, in a market that was previously dominated by banks. This universe of new financial service providers is known as "Fintech."

Fintech firms have characteristics that allow them to fill gaps in the market of financial intermediation and forms of payment, as they offer solutions to the system's traditional bottlenecks and problems. One example is the substitution of collateral which is required of creditors and which leaves large segments of the population without access to credit, through credit assessment and guarantee mechanisms based on information algorithms that identify behavior (Big Data). Another example are digital applications that help MSMEs manage their finances without incurring large consulting costs. In this manner, these companies become a powerful mechanism for financial inclusion in the broadest sense. Figure 1 shows how Fintech firms have become much more attractive in countries where banking service coverage is lower, whereas in those economies where the financial sector is highly developed and have high rates of banking, they have not had as much success.

**Figure 1. Customers using at least one non-traditional financial services company in 2016**  
(Percentage)



Source: Capgemini, LinkedIn and Efma (2016)

Fintech firms also present significant challenges for the future of the traditional banking sector and for governments. In the first case, Fintech firms are expected to take over a significant portion of the market currently held by banks, specifically in segments or products where they have the competitive advantage due to very favorable cost structures. In the second case, the challenges are related to devising regulations aiming at consumer protection and monitoring of financial prudent practices, as this will become more difficult in virtual digital environments.

### Fintech Services

Fintech has a presence in all the links of a traditional financial operator's value chain: in those that deal directly with client services (front office), those that serve intermediary or support functions on specialized products (back office), and those that facilitate processes between these two (middle office).

The following is a brief description of some relevant Fintech services:

- Digital finance and management tools for MSMEs and personal finance.
- Payment and transfer services in e-commerce.
- Loan platforms that emphasize person-to-person loans and that connect investors with borrowers without the mediation of a financial institution.
- Crowdsourcing platforms for companies to obtain capital from investors in exchange for debt instruments or equity.
- Institutional investment tools for financial operators to optimize the profitability of their investment portfolios with sophisticated risk prediction and measurement tools.
- Banks without physical infrastructure (i.e. no bank branches or ATMs).

- Banking infrastructure services that offer solutions for managing databases, data analysis and predictive models.
- Security, authentication and fraud prevention through big data analysis and other algorithmic methods.
- Platforms for the financing of products, services, social causes and creative projects through donations.
- Digital currency.

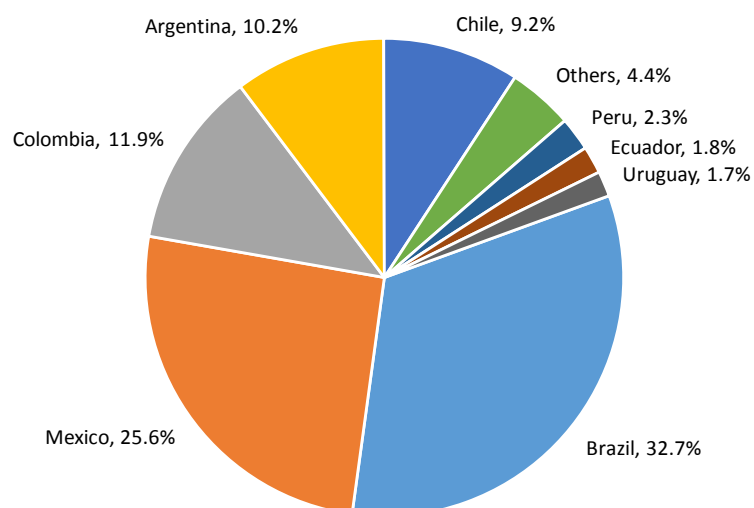
For MSMEs, the most common Fintech firms are financing platforms, virtual markets for e-commerce and digital invoice discounting services.

### Fintech Firms in Latin America

As discussed earlier, Fintech providers represent a valuable opportunity to raise the levels of financial inclusion in Latin America. Indeed, the percentage of the population that still does not have access to formal financial services is approximately 50% (CAF, 2011; IDB and Finnovista, 2017). And this figure does not include those that have access to financial services but who are looking for alternatives that are more adapted to their particular behavior, or who face restrictions and high costs in financing.

Latin America offers a propitious environment for Fintech firms to expand their business given the gap in access to financial services. Nonetheless, the region receives less than 1% of global Fintech investments (Wyman, 2016).

**Figure 2. Fintech ventures by country of origin**  
(Percentage of a total of 703 companies)



Source: IDB and Finnovista (2017).

Figure 2 shows that Brazil and Mexico have the greatest presence of Fintech companies in the region, followed by Colombia, Argentina and Chile. With the exception of Chile, these are the only countries in the region with populations above 40 million.

Factors such as speed in network traffic, the existence of a more developed banking infrastructure than in Asia and Africa and regulatory aspects may explain why growth in Latin America has not been as rapid as in other emerging economies.

### **Challenges for Fintech Expansion: Information, Regulation and Consumer Protection**

It has already been mentioned that a fundamental challenge facing the traditional financial system is the adaptation or incorporation of the new technological trends and business models characteristic of the Fintech sector. Although many Fintech companies have a close connection with the traditional banking system, it is likely that in the future this system will incorporate different formats and business models into its operation, in particular those that develop new financial products for customers. In terms of Fintech inputs and channels, this adaptation is already happening.

This new scenario will also require an adaptation of financial intermediation regulation. In countries such as the United Kingdom, Australia and Singapore regulations have already been created for the sector, with goals of facilitating and promoting the growth of Fintech initiatives or in some cases, controlling and restricting its expansion (Rojas, 2016). In Latin America, there are many challenges related to regulation of the Fintech sector. One of them is achieving effective coordination among the different actors in public policies and the associated regulation. The efforts thus far have progressed at different speeds in each country and the regulatory framework in many cases is fragmented (a different regulation for each subsector). While in countries with larger financial systems (Argentina, Brazil, Chile and Colombia) this has happened relatively quickly, those countries with less consolidated financial structures still face challenges in this area.

In many Latin American countries, the emergence of associations of companies in this sector has helped in the creation of regulatory frameworks. The interaction among different types of actors has been driven by associations that have sprung up around the need to facilitate and promote the Fintech business. For their part, governments have found an opportunity for action in their role protecting consumers and investors. Current associations include ABFintech in Brazil, Asociación Fintech México (Mexican Fintech Association), Colombia Fintech, Cámara Argentina de Fintech (the Argentine Fintech Chamber), and the Asociación de Empresas de Innovación Financiera en Chile (the Association of Financial Innovation Companies in Chile).

Regulators seek to prevent fraud, money laundering and financing of terrorism activities. But the objectives should also include flexibility so that these companies continue to innovate and help in the ultimate goal of financial development and deepening. A non-exhaustive list of the state of regulatory frameworks is presented in the following table:

Country	Status	Segments	Regulator
Argentina	Proposal in progress	<ul style="list-style-type: none"> <li>• Mobile wallet</li> <li>• Capturing crowdfunding resources, via the Law of Entrepreneurs</li> </ul>	Central Bank National; Securities Commission
Brazil	In progress	<ul style="list-style-type: none"> <li>• Payment transactions</li> <li>• Financial services</li> <li>• Cryptocurrency</li> </ul>	Central Bank
Colombia	Consultation	<ul style="list-style-type: none"> <li>• Capturing crowdfunding resources</li> </ul>	Ministry of Finance and Public Credit
Mexico	Proposal	<ul style="list-style-type: none"> <li>• Comprehensive regulation (costs, claims, risks, continuity of services)</li> </ul>	Secretariat of Finance and Public Credit

Source: Prepared by the authors.

## Final remarks

The combination of technological changes and the Internet, along with the existence of large segments of the population and companies neglected or underserved by the traditional financial sector triggered the appearance and high growth of the Fintech sector and its alternative business models for financial intermediation. Currently, the sector presents a great opportunity to rapidly scale up financial inclusion levels and improve access to financial services in the region's economies. However, in view of the operating characteristics of Fintech companies, particularly of those that provide services aimed at end consumers and investors, there is a need to introduce novel regulation that would allow the goal of financial inclusion to be achieved, while also defending the interests of consumers and the soundness and stability of the financial system overall.

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## Inter-American Development Bank

### The Importance of Women's Financial Inclusion

Inclusive growth requires women not to be at a disadvantage in their ability to pursue economic opportunities, participate in the labor force, and contribute to the economy. Women's financial inclusion plays a crucial role in this regard because, by providing women better and more efficient ways to access, use, manage, and control resources, economic opportunities and development outcomes can be improved substantially.<sup>1</sup> It is in this context that enhancing women's financial inclusion plays a crucial role as a policy objective to improve women's economic empowerment, but also economic insertion and inclusive growth.

Women need a wide range of adequate financial services, not only access to a bank account, but also credit, savings, cost-effective payment mechanisms, insurance, among others. There is ample evidence, for instance, that shows that access to adequate savings products is a promising way to improve women's economic empowerment and productivity as it gives them more control and privacy to manage their resources, allowing them to invest in their family and businesses and to better address emergencies without resorting to selling accumulated assets.<sup>2</sup> Similarly, access to digital financial services, especially payments, is also important for women since they tend to have time and mobility constraints due to household-related obligations. In other words, if women can save time and money through reduced transaction costs, they will not only be able to dedicate more time to their business, careers, and families, but they will also shift to more formal financial services, from informal mechanisms that today may appear more convenient but are less efficient, costlier and riskier.

#### Women's financial inclusion and gender gaps in Latin America and the Caribbean

Despite efforts to increase financial inclusion during the last years, it is estimated that 43% of women in the world still don't have a bank account, a proportion that reaches 76% for low-income women. In Latin America and the Caribbean (LAC), 52% of women do not have a bank account, a proportion that is high when compared to the average for middle-income countries (47%) and, particularly, OECD countries (6%).<sup>3</sup>

Moreover, women are less included in the formal financial sector than men. In terms of account ownership, the gender gap in LAC is estimated at 5.5 percentage points ("pps"), and while it decreased from 9.3 pps in 2011, this regional progress hides important differences across LAC countries, where gender gaps oscillate between 13 pps in Peru to 2 pps in Jamaica, while in other countries such as

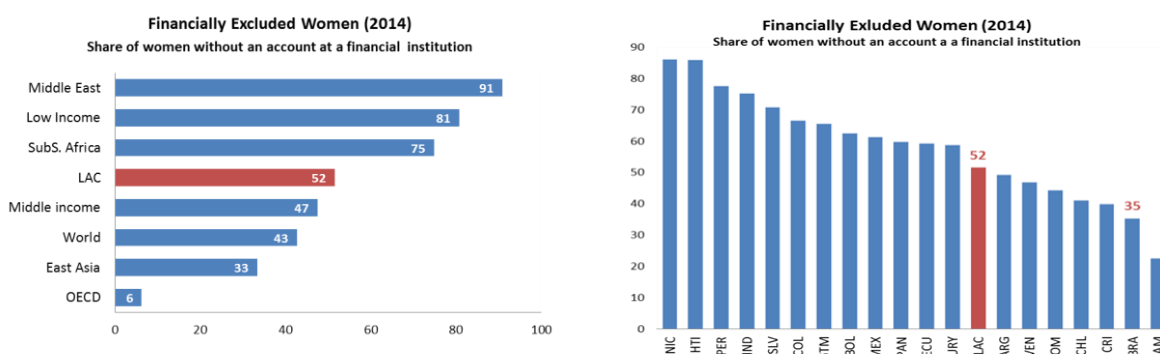
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<sup>1</sup> Ashraf, Karlan, & Yin (2009); Kast and Pomeranz (2014); Schaner (2014); and Aker et al. (2011)

<sup>2</sup> Knowles (2013); Dupas and Robinson (2009 and 2013); Jakiela and Ozier (2012); Gamberoni, Heath, and Nix (2013); and Buvinic and Furst-Nichols (2014).

<sup>3</sup> Demirguc-Kunt A. et al. (2015); Global Findex, (2014)

Argentina and the Dominican Republic the gender gap is nonexistent or inverted (i.e. the share of women with an account is larger than for men).



Source : Demirguc-Kunt A. et al. (2015)

But as mentioned, women need much more than a bank account. In this regard, LAC also shows low levels of access and use of other instruments such as formal credit and savings. Indeed, available data shows that only a very small proportion of women in LAC are using formal saving products, one of the most important instruments given the aforementioned evidence that adequate savings products can improve women's economic empowerment. Only 11% of women declared saving at a financial institution, even though 37% declared saving money, showing the predominance of informal mechanisms in LAC. These numbers are in addition low compared to the average for middle-income countries (54% saved money, 26% formally) and the OECD average (69% saved money, 50% formally). LAC also shows low levels of women's use of formal credit. Only 10% of women in LAC declare borrowing at a financial institution. However, as opposed to other indicators, LAC is in line with the world average (9.6%) and slightly above middle-income countries (8%), although still below the OECD (16%).

It is important to note that this problematic, moreover, also affects women-owned or women-led Small and Medium Enterprises (SMEs). Different studies have shown that SMEs led by women not only face greater challenges in accessing financial services but also tend to face higher interest rates or collateral requirements. While specific empirical evidence for LAC is not abundant, recent studies show that women-led businesses in LAC are more likely to be financially constrained than other comparable firms, and surveys show that firms in LAC with 1+ women owners are more underserved across all firm sizes, and have a significantly smaller loan size, adjusted for the revenue level, than firms with no female owners.<sup>4</sup> Similarly, the Women's Entrepreneurial Venture Scope<sup>5</sup> found that in LAC the weakest category, among the five used in the overall index, was precisely "access to finance", meaning that among all the factors in women's entrepreneurial success in LAC, obtaining financing is the most difficult step for starting

<sup>4</sup> Piras et al. (2013); IFC-McKinsey (2011).

<sup>5</sup> The Women's Entrepreneurial Venture Scope is an index and study by the Economist Intelligence Unit, commissioned by the Multilateral Investment Fund of the IDB Group.

or growing a SME. The impact of this gender gap is not trivial as it has been estimated that closing the credit gap for women-owned SMEs could boost productivity and income per capita growth.<sup>6</sup>

### Barriers or constrains affecting women’s financial inclusion

Women face demand and supply-side barriers for the access to and use of financial services. Although these barriers operate differently depending on each context, there are a set of overall constraints that have been identified in the literature, as summarized in the Table below.

Demand	Supply
Time and mobility constraints (Primarily due to household-related obligations)	Legal and regulatory restrictions Especially in terms of: women’s property rights and land ownership, impediments for innovation in delivery mechanisms, products and processes
Cultural and social norms (primarily through undermining incentives for women to demand financial services)	Financial infrastructure weaknesses (For instance, credit bureaus with limited information related to women or collateral frameworks that do not allow moveable assets)
Limited access to information and networks	Gender biases in financial institutions practices (For example, asking for male guarantors)
Low levels of financial literacy or financial capability	Financial products, services and delivery mechanisms not adapted to women’s needs

Importantly, one of the factors to understand the problem of access to credit, especially for women-owned or women-led SMES relates to the availability and size of collateral. Women often have shorter credit histories or less collateral, which may result in higher interest rates and more collateral/guarantees required. The Women’s Entrepreneurial Venture Scope found that for all the countries (except Brazil) the value of collateral women need to obtain a loan is greater than the size of the loan, and in cases such as Paraguay and Costa Rica this value can reach 369% and 267% of the value of the loan, respectively. In addition, legal and regulatory restrictions in terms of women’s property rights and land ownership can have a direct impact in the women’s ability to account for collateral and thus in accessing credit.<sup>7</sup> Nonetheless, an analysis using the Women, Business and the Law database and other sources suggest that while the data show that the legal framework in LAC has a relatively low number of explicit restrictions against women, social practices and cultural factors explain disparities that are found in terms of ownership and use of property as well as in the way it is divided between men and women.<sup>8</sup>

<sup>6</sup> World Bank (2012); Goldman Sachs Global Markets Institute (2014).

<sup>7</sup> Demirguc-Kunt et al (2013) ; IFC-McKinsey (2011).

<sup>8</sup> Pailhe (2014).

## Public sector interventions and areas of work

Policymakers can undertake different measures to improve women's financial inclusion, for instance: (i) modifications to the legal, regulatory and institutional framework to ensure women's equal treatment under the law, especially in terms of property rights and land ownership, and (ii) strengthening financial infrastructure such as credit reporting systems and secured transactions frameworks, as women have less credit history or immovable assets. Nonetheless, there are three main areas that are usually less discussed but that can provide important gains in the short and medium term:

1. Tackle substantial data gaps and include women in National Financial Inclusion Strategies. Understanding both demand and supply constraints affecting women is crucial to address women's financial exclusion and the gender gap. Nonetheless, there is a systematic lack of gender disaggregated data at the public and private sector level and from both the demand-side (data collected from users through household or other special demand surveys) and the supply side (data from financial service providers). This lack of data prevents an adequate or complete diagnosis of the constraints affecting women, while it also limits the design of policies and reforms, the evaluation of public interventions (what works and what doesn't) and the measure of success (or failure). Importantly, this lack of information also prevents the development of financial products and processes especially suitable for women, which further undermines inclusion efforts. Finally, it is important to note that without a gender focus and action plan, a National Financial Inclusion Strategy could actually decrease women's inclusion, or achieve a lower level of progress relative to men.
2. Promote and support innovation in product experimentation and design. Many of the financial products currently offered do not offer an adequate value proposition to unserved and underserved women, whose demand is quite sensitive to fees and lack of proximity, among others. Without this focus, the likelihood of adoption and commercial sustainability falls and true financial inclusion is not achieved. Moreover, product design can be fundamental in shaping financial behaviors that are important for empowerment. For example, a substantial collection of literature shows that small "nudges" may have a significant impact on forward-looking financial and nonfinancial behaviors in settings as diverse as defined-contribution pension accounts, insurance products, and commitment savings products.
3. Address lack of infrastructure in key areas and promote a digital ecosystem. Inclusive digital financial services require an extensive ecosystem, including cash-in/cash-out points that allow people to transit between the digital and cash worlds. However, providing this ecosystem in some areas, notably rural areas, tends to be expensive and unprofitable in the early stages. This often results in a lack of provision by the private sector. The experience thus far suggests that strengthening the ecosystem in these areas require public incentives, such as subsidies or challenge funds to attract private investment. This is crucial for rural women in the context of increasing efforts to digitize government to people (G2P) payments.

## Conclusions

Financial inclusion is now widely recognized as a key public policy objective. Nonetheless, and despite increased efforts to promote it, women's financial inclusion remains low and gender gaps are not narrowing fast enough. New approaches and more intensive efforts are needed to tackle this situation and close the gender gap in financial services. This, in turn, requires additional and sustained funding, the data and intelligence to sustain and design interventions, and greater political support and commitment at the global and national level.

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## Inter-American Development Bank

### Resetting the Trade Integration Agenda

The contraction in global trade that lasted over two years ended towards the end of 2016, allowing Latin America and the Caribbean (LAC) exports to pick up in 2017. The return to export growth after the longest trade recession in the region's recent history begs the question of which could be the next drivers of LAC's export performance in an increasingly uncertain trade environment.

LAC has a long history of pursuing regional integration. In the 1990s, with the so-called new regionalism, integration efforts were renewed as part of an outward-oriented new strategy. Open integrated markets are expected to deliver growth opportunities, as firms and individuals reap the benefits of greater economies of scale and specialization. These in turn should raise productivity, promote trade diversification and facilitate a better insertion into the global economy.

After twenty years of implementation, and in a much-changed global economy, a few key policy questions need to be asked.<sup>1</sup> How did the region perform in global markets? What has been the specific impact of preferential trade policies? What are the gaps in the current trade architecture? What could be the main pillars of a new effective strategy? This policy note addresses these issues with the purpose of identifying policy options that can pragmatically set the region on a new integration course, to stimulate productivity and generate economic growth.

#### Export Performance in the Long Run

It is common to refer to LAC trade performance since the turn of the millennium as a *boom*, which in turn distracted policymakers from the objective of pursuing an ambitious and consistent trade promotion strategy. But, on the heels of the end of the commodity super cycle, it is now evident that the export expansion was mostly due to an increase in prices, while growth of real flows followed a more modest and linear path, at a rate slightly lower than that of world trade.

As a result, the participation of LAC in global markets measured in constant prices has been practically stagnant over the last two decades. In 2015 the region's exports represented 5.4% of total world imports, a share slightly below the 5.7% of 1995. Indeed, excluding Mexico, whose participation in world trade increased substantially, the global market share of the rest of LAC fell sharply from 4.0% to 2.9%, equivalent to a 27% reduction.<sup>2</sup>

A decomposition of these trends at the sectoral level reveals that the greatest source of dynamism in world trade has been in industrial manufactures. While the region has increased its market share in this class, gains have been almost entirely due to the performance of Mexico and, to a lesser degree, Central

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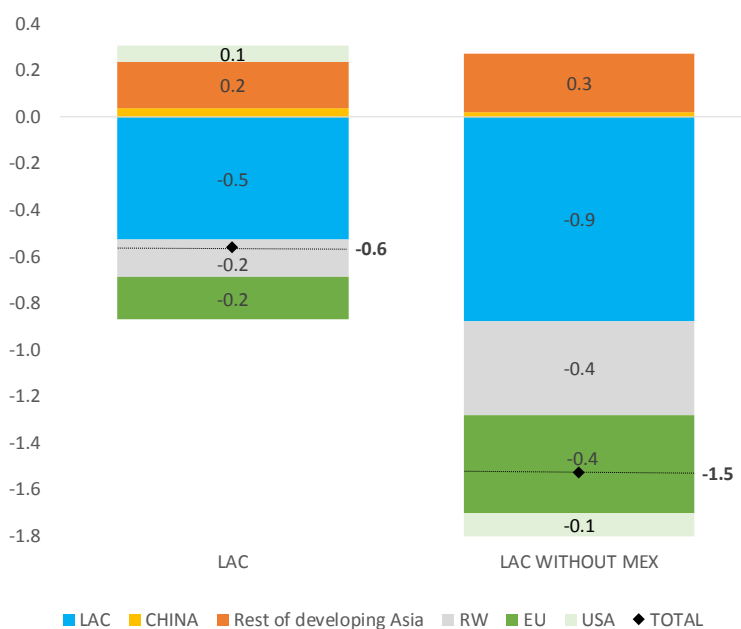
<sup>1</sup> This brief draws heavily on recent IDB publications, including: Giordano (2016), Powell (2017) and Mesquita Moreira (forthcoming).

<sup>2</sup> See Giordano (2016) for a complete assessment of the trade performance of the region valued at constant prices.

America. In fact, with few exceptions, LAC countries reinforced their specialization in commodities and their derivatives, and within this group of products, in goods of lesser value added. This mismatch between the evolution of global demand and the region’s export supply contributes to explaining the weak long-run trade performance of most countries.

One simple way to separate the demand and supply-side drivers of the growth of LAC exports in global markets is to break down the variations of market shares in compositional and performance effects. The former is exogeneous and related to the geographical and sectoral composition of the global demand for the region’s export basket, whereas the latter is driven by supply-side determinants of the export performance and can be interpreted as a proxy for countries’ competitiveness, which can be influenced by policy. Figure 1 focuses on the latter in the period 2010-2015.<sup>3</sup> It reveals that the lack of capacity to compete in the intra-regional market has been a major factor explaining the low performance component of LAC overall export growth, particularly if Mexico is excluded. For example, in the latter case, the lack of capacity of the countries of LAC to compete in the intra-regional market was equivalent to an average yearly loss of 0.9 percentage points in total export growth.

**Figure 1. LAC Export Performance Effect, by Selected Destination**  
(Equivalent contribution to annual average growth, percentage points, 2010-2015)



Source: IDB Integration and Trade Sector calculations.

<sup>3</sup> See Giordano (forthcoming) for a complete description of the results and the methodological approach. The performance effect measures the export growth gap due to supply-side factors not related to demand-side determinants, such as the growth of world trade or the geographical and sectoral structure of the demand for LAC exports.



This evidence points to a compelling policy conclusion. The outcome of preferential trade policies pursued in LAC under the new regionalism did not meet expectations. LAC economies did not witness gains in market shares nor a substantial transformation of the pattern of insertion into the global economy, even after controlling for the ebb and flow of the commodity super cycle. This raises the urgency of reframing the integration agenda to promote diversification and global competitiveness.

### **Trade Impact of Preferential Trade Policies**

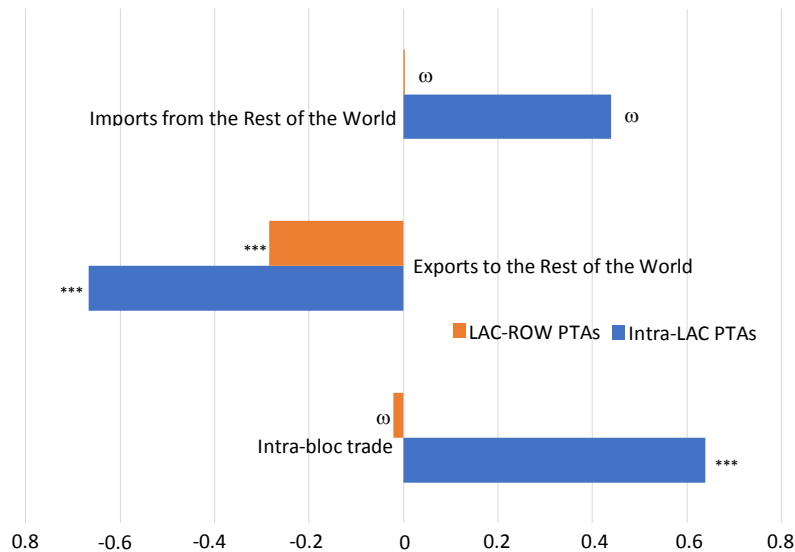
As theory suggests, the relatively small size and fragmentation of LAC preferential trade agreements (PTAs) and the similarity of the members' comparative advantages do not work in their favor. The key question that emerges is therefore how to precisely trace back the trade effects of PTAs to their policy design and implementation. An econometric investigation carried out with two state-of-the-art gravity models, the standard workhorse of empirical trade analysis, provides several relevant policy insights.<sup>4</sup>

Figure 2 groups LAC PTAs along two geographical dimensions – intra-regional (IR) among LAC members only, and extra-regional (XR) among LAC and non-LAC members. From it we can observe that: i) IR PTAs did indeed contribute to intra-regional trade growth (+64% compared to trade with non-members); ii) IR PTA's trade diversion, i.e. the inefficient substitution of imports from more competitive outsiders, may not have been as prevalent as skeptics feared (imports from third parties increased, though the effect is not statistically significant); however, iii) IR PTAs failed to serve as a platform to boost exports in third markets (-67% compared to exports to members); and, by contrast, iv) XR PTAs exhibit mostly statistically non-insignificant impacts, except for the negative impact on extra-bloc exports.

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<sup>4</sup> See Mesquita Moreira (forthcoming) for a complete description of the results and the methodological approach.

**Figure 2. LAC PTAs Impact on Intra and Extra-Bloc Trade**  
(Gravity model coefficient estimations)



Source: IDB Integration and Trade Sector calculations.

Note: Results of a gravity model estimated by Poisson Maximum Likelihood (PPML) with pair, exporter-year, and importer-year fixed effects.  $\omega$  stands for results that are not statistically significant, \*\*\* for those significant at 1%, \*\* at 5% and \* at 10%.

A complementary modeling strategy aimed at highlighting the impact of specific policy design features of LAC PTAs relies on the separation of direct and indirect effects on trade at the sectoral level. The direct effect captures the impact of the preference margin, i.e. the difference between the applied preferential tariff rate and the most favored nation (MFN) rate applied to non-members, whereas the indirect effect reflects other policy provisions (non-tariff barriers, investment, trade facilitation, etc.) or intangibles such as the reduction of policy uncertainty. The reported results focus only on the impact on LAC members' trade of the five main integration blocs: Andean Community, CACM, CARICOM, NAFTA and MERCOSUR.

This granular approach, unprecedented for LAC, allows to refine some of the conclusions stemming from the previous, more aggregate, analysis. First, while the main LAC PTAs continue to exhibit a positive impact on intra-bloc trade, the results point to much smaller effects, in the range of 8 to 10%. Second, they reaffirm the lack of substantial trade diversion and, except for the CACM, a limited capacity to boost exports to third markets. Last, and more important, even though the direct effect of tariff elimination is not the only source of benefits, it still accounts for more than half of the effects in most cases.

To sum up, the analytical evidence shows that the region has not been able to capture increasing shares of global trade, to upgrade the pattern of insertion into the global economy, and that the PTAs have not helped much in that regard.

## Gaps in the Regional Trade Architecture

Recasting these analytical results in a policy perspective, there are at least three main gaps to be filled to build a trade integration architecture that is effective in promoting intra-regional trade and in sustaining competitiveness in global markets.

The first is the product coverage gap of the 33 intra-LAC PTAs in force, which set preferences for some 85% of the current value of intra-regional trade. Although most PTAs will have reached their full-liberalization potential by 2020, tariffs on a number of products will not be completely eliminated. These exclusions cover only a small fraction of trade, but involve major export products for some countries. In the Andean and Central American sub-regions they are concentrated in agricultural and labor-intensive goods, whereas in MERCOSUR they mainly involve machinery and equipment.

The second is the relationship gap, referring to the geographical coverage of bilateral or sub-regional PTA relationships. Just under 20% of intra-regional trade in value, corresponding to a total of 183 bilateral links, remains excluded from preferential treatment. The bulk of trade not covered by PTAs is between the countries of MERCOSUR and Mexico, and between the CARICOM countries and Latin America. The first consists of a few high-value trade flows, while the second is the sum of many lower-valued trade relations.

The third is the regulations gap. A key challenge is addressing the 47 rules of origin built-in in the existing PTAs. While these provisions are essential to determine the eligibility for preferential access, they also restrict firms' input choices and impose significant compliance and enforcement costs, particularly in the context of multiple PTAs. The unification of the rules of origin regimes in a system of *fully extended* or *diagonal* cumulation would be a first significant first step towards a truly integrated regional market.<sup>5</sup> It may also provide incentives for the harmonization of other regulations related to trade in goods, services and investment, and other deeper integration commitments.

## A Pragmatic Policy Proposal

Against this backdrop, four concrete actions can be outlined to pragmatically upgrade the current trade architecture underpinning regional integration in LAC:

1. Allow extended cumulation of the rules of origin among LAC trade agreements to enable exporters from member countries to source inputs from the most competitive suppliers within the existing agreements, and contribute to reducing trade diversion of inputs importable from outside the region.
2. Negotiate new trade agreements among regional countries and trade blocs that currently do not have PTAs to fill missing links and unlock trade gains, particularly if this includes the larger LAC economies such as Mexico and Brazil.
3. Improve trade logistics and facilitation to address head-on the region's historical negligence of the non-traditional trade costs, arising from poor logistics and costly customs procedures.

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<sup>5</sup> See Mesquita Moreira (forthcoming) or for a more complete discussion of the proposal.

4. Consolidate existing and newly negotiated preferences and rules of origin into a regionwide LAC free trade agreement, while maintaining the consistency with current extra-regional PTAs.

As further detailed in past and forthcoming IDB work<sup>6</sup>, this plan is feasible without contemplating new institutions, over-arching structures, or all-encompassing objectives. Moreover, the first three actions could be taken independently of each other, in the sequence that countries desire. Countries can choose the speed and depth of their involvement. However, if a sufficient critical mass of countries joined-in, the others would likely wish to follow and avoid being left behind. In this sense, these actions are self-reinforcing and incentive compatible.

## Conclusion

Despite a long history of attempts at regional integration, LAC has not been able to command increasing shares of global trade. Time is ripe for a new, pragmatic, approach to progress towards a truly unified regional market.

The large yet incomplete current network of trade agreements is a powerful platform to undertake an overhaul of regional integration. The ultimate goal would be to build a region-wide free trade agreement, constituting a market of about US\$ 5 trillion or approximately 7% of global GDP, with a sufficient critical mass to allow efficient firms to grow and develop value chains, and enabling the region to compete on a global scale.

This brief argues that this overall policy goal can be achieved gradually in a series of pragmatic steps, that would entail relatively modest economic and political costs, while having the potential to boost scale, efficiency, productivity, exports and, thereby, economic growth.

## References

- Giordano, P. (2016) "Downshifting: Latin America and the Caribbean in the New Normal of Global Trade," *Trade and Integration Monitor*, Washington, DC: Inter-American Development Bank
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<sup>6</sup> See Powell (2017) and Mesquita Moreira (forthcoming).