Financial Globalization: Opportunities and Challenges for Peru

By

JULIO CESAR SIPAN VELASQUEZ
(Peru)

“This paper was submitted in partial fulfillment of the requirements for the Masters of Business Administration (MBA) degree at the Maastricht School of Management (MSM), Maastricht, the Netherlands, August 2002.”

Maastricht School of Management
P.O. Box 1203
6201 BE Maastricht
The Netherlands

August 2002
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACKNOWLEDGMENTS</td>
<td>IV</td>
</tr>
<tr>
<td>LIST OF ABBREVIATIONS</td>
<td>V</td>
</tr>
<tr>
<td>1. INTRODUCTION</td>
<td>1</td>
</tr>
<tr>
<td>1.1 Introduction</td>
<td></td>
</tr>
<tr>
<td>1.2 Problem Definition</td>
<td></td>
</tr>
<tr>
<td>1.3 Research Objectives</td>
<td></td>
</tr>
<tr>
<td>1.4 Limitations of the Study</td>
<td></td>
</tr>
<tr>
<td>1.5 Research Methodology and Design</td>
<td></td>
</tr>
<tr>
<td>1.6 Organization of the Report</td>
<td></td>
</tr>
<tr>
<td>2. GLOBALIZATION AND FINANCIAL GLOBALIZATION</td>
<td>4</td>
</tr>
<tr>
<td>2.1 Globalization</td>
<td></td>
</tr>
<tr>
<td>2.2 Historical Perspective of Financial Globalization</td>
<td></td>
</tr>
<tr>
<td>2.3 Financial Globalization</td>
<td></td>
</tr>
<tr>
<td>2.4 Forces Driving Globalization of Finance</td>
<td></td>
</tr>
<tr>
<td>2.4.1 Advances in Information and Computer Technology</td>
<td></td>
</tr>
<tr>
<td>2.4.2 The Globalization of National Economies</td>
<td></td>
</tr>
<tr>
<td>2.4.3 The Liberalization of National financial and Capital Markets</td>
<td></td>
</tr>
<tr>
<td>2.4.4 Competing among the Providers of Intermediary Services</td>
<td></td>
</tr>
<tr>
<td>2.5 Changes in Capital Markets</td>
<td></td>
</tr>
<tr>
<td>2.6 New Developments and Main Agents in Financial Globalization</td>
<td></td>
</tr>
<tr>
<td>2.6.1 New Nature of Capital Flows</td>
<td></td>
</tr>
<tr>
<td>2.6.2 Intermediation of Financial Services</td>
<td></td>
</tr>
<tr>
<td>2.6.3 Main Agents of Financial Globalization</td>
<td></td>
</tr>
<tr>
<td>2.6.3.1 Governments</td>
<td></td>
</tr>
<tr>
<td>2.6.3.2 Borrowers and Investors</td>
<td></td>
</tr>
<tr>
<td>2.6.3.3 Financial Institutions</td>
<td></td>
</tr>
<tr>
<td>3. PERUVIAN ECONOMY</td>
<td>16</td>
</tr>
<tr>
<td>3.1 Economic Situation</td>
<td></td>
</tr>
<tr>
<td>3.1.1 The Economic Program</td>
<td></td>
</tr>
</tbody>
</table>

Julio Sipan Velasquez
27/07/2002
3.1.1.1 Macro-Economic Policy
3.1.1.2 Program with the IMF: Structural Reforms

3.2 Political Factors
3.2.1 Heritage from the past and Democratic Transition
3.2.2 Internal Political and Security Situation
3.2.3 Regional and International Context

3.3 Financial Situation
3.4 Legal Framework
3.5 International Approach of Peru

4. OPPORTUNITIES AND CHALLENGES OF FINANCIAL GLOBALIZATION FOR PERU

4.1 Globalization and Crises
4.2 Evidence on Crises
4.3 Globalization and Contagion
   4.3.1 Contagion due to Fundamentals
   4.3.2 Contagion due to Herding Behavior
4.4 Evidence on Contagion
4.5 Financial Globalization and Financial Sector Development
4.6 New and more Capital is available
4.7 Improvement in the Financial Infrastructure
4.8 Evidence on Globalization and Financial Sector Development
   4.8.1 Aggregate Evidence on Stock Market Liberalization
   4.8.2 Firm-level Evidence
   4.8.3 Bank-entry Evidence
4.9 Net Effects on Globalization

5. THE ROLE OF PERUVIAN GOVERNMENT AND POLICY OPTIONS FOR DEALING WITH FINANCIAL GLOBALIZATION

5.1 Three views on the role of government
   5.1.1 Minimal government intervention
   5.1.2 Restrictions on cross-country capital movement
   5.1.3 Risk Management
5.2 Fewer Policy Options
5.3 Three examples of Policies affected by Financial Globalization
   5.3.1 Capital Controls
5.3.2 Managing Risk
5.3.3 Monetary and Exchange rate Policy

6. LESSONS OF COUNTRIES THAT HAVE OPENED THEIR MARKETS TO FINANCIAL GLOBALIZATION

6.1 The Chilean Case
6.2 The Mexican Case
   6.2.1 Benefits for Mexico
   6.2.2 Globalization Concerns Misguided
   6.2.3 A Positive Direction

7. CONCLUSIONS AND RECOMMENDATIONS

7.1 Conclusions
7.2 Recommendations

REFERENCES

APPENDIX
ACKNOWLEDGEMENTS

First at all, I thank God for being the light of my life and for sustaining it to-date with all the opportunities and challenges.

I particularly acknowledge and thank to the Department For International Development (DFID) from the British Government for having me given the opportunity of studying a MBA at the Maastricht School of Management.

Also I would like to thank my supervisor Dr. W. R. F. Cunningham for his guidance and insights to make this research paper, to the lecturers and staff of MSM for the guidance and support, and also to my colleagues for their valuable recommendations.

Finally, I am very grateful to my parents Eusebia, Gladys, Marcos and Miguel for having given their support in finishing this stage of my life.
ABBREVIATIONS

ADRs  American Depositary Receipts
AFPs  Pension Funds Associations
BVL  Lima Stock Exchange
BBVA  Bilbao Vizcaya Argentaria Bank
BCRP  Central Reserve Bank of Peru
BSCH  Santander Central Hispano Bank
FDI  Foreign Direct Investment
GDP  Gross Domestic Product
IMF  International Monetary Fund
IPAB  Institute for Protecting the Banking Savings
NAFTA  North American Free Trade Agreement
NBER  National Bureau of Economic Research
PROMPEX  Commission for Promoting the Exports
SBS  Banking and Insurance Companies Supervisory Agency
US  United States
WTO  World Trade Organization
CHAPTER 1
INTRODUCTION

1.1 Introduction

This paper examines the opportunities and challenges that financial globalization entails for Peru. The literature defines financial globalization as the country's local financial system with international financial markets and institutions. This integration typically requires that governments liberalize the domestic financial sector and the capital account. Integration takes place when liberalized economies experience an increase in cross-country capital movement, including action participation of local borrowers and lenders in international markets and a widespread of international financial intermediaries. Although developed countries are the most active participants in the financial globalization process, Peru as a middle-income country has also started to participate. This paper focuses on integration of Peru with the international financial system.

1.2 Problem Definition

Financial globalization can come with crises and contagion, but financial globalization can also lead to large benefits, particularly to the development of a financial system. The net effect of financial globalization is likely positive, with risks being more prevalent right after countries liberalize. In the long run, large potential gains are expected.

Thus the problem for the following research is to determine the opportunities and challenges that financial globalization entails for Peru and determine the policy options that the government of Peru could take to deal with this paradigm.

1.3 Research Objectives

The research paper objectives are as follows:
- Determine the opportunities that financial globalization entails for Peru
- Determine the challenges that financial globalization entails for Peru
- Determine the policy options that the government of Peru could take to deal with financial globalization
1.4 Limitations of the Study

This paper is only focused on financial globalization that is one part of the entire concept of Globalization. Also, in writing this paper the author is faced with some limitations such as lack of sufficient and up-to-date data for carrying out the analysis due to being far away from the home country and the time constraint in writing the paper. Due to these limitations, the paper cannot cover, in detail, all aspects concerning the topic.

1.5 Research Methodology and Design

The information required for developing the framework is being collected from secondary resources. The study is being undertaken through the review of available data and information regarding the topic. The paper is also based on knowledge from MBA program in MSM, literature and professional journals from both MSM library and Peru, and information from Internet. It is hoped that the information drawn from these sources will enable the author to draw conclusions on the above objectives.

1.6 Organization of the Report

Chapter 1, gives an introduction to the research paper, it describes the problem definition, research objectives, methodology and design, and the relevance and limitations of the study.

Chapter 2, in order to reach the paper objectives, this chapter covers a theoretical framework conceptualizing the Globalization, financial globalization, describing the forces driving globalization of Finance, analyzing the changes in capital markets, mentioning new types of capital flows, the internationalization of financial services and pointing out the main agents that take part in the process of financial globalization.

Chapter 3, describes the Peruvian environment for financial globalization. It takes into account the economic, political, legal and above all the financial environment as well as the international approach of the country.
Financial Globalization: Opportunities and Challenges for Peru

Chapter 4, describes the opportunities and challenges of financial globalization for Peru, considering factors as crisis and contagion, its positive inter-relation with the financial sector development and the net effects of financial globalization.

Chapter 5, describes the policy options that the government of Peru could take for dealing with financial globalization, taking into consideration three views of the role of the government and fewer policy instruments.

Chapter 6, analyzes some cases where developing countries have opened their markets to financial globalization.

Chapter 7, draws conclusions and makes recommendations.
CHAPTER 2
GLOBALIZATION AND FINANCIAL GLOBALIZATION

Globalization is the phenomenon that the degree of global human interaction increases to such an extent that both its primary effects and the reactions it provokes give rise to numerous new developments. Globalization is caused by three prime movers: technological globalization, political globalization and economic globalization. The three prime movers initiated a process in which geographic distance becomes less a factor in the establishment and sustenance of border crossing, long distance economic, political and socio-cultural relations and which we call globalization. People become aware of this fact. Networks of relations and dependencies therefore become potentially border crossing and worldwide. This potential internationalization of relations and dependencies causes democratic, environmental, security and social deficits and rebound effects, like a change in attitudes and administrative shortcomings. Globalization is not only negative. It also includes people in the world community and gives rise to new systems of global governance and a global civil society.

2.1. Globalization

Globalization is characterized by increases in flows of trade, capital and information, as well as mobility of individuals, across borders. It is not a new phenomenon; globalization has progressed throughout the recorded history (IMF, 2002).

It denotes the process through which sovereign national states are crisis-crossed and undetermined by transnational actors with varying prospects of power, orientations, identities and networks (Beck, 2000).

Globalization means that borders become markedly less relevant to everyday behavior in the various dimensions of economics, information, ecology, technology, cross-cultural conflict and society (Obstfeld, 1998)

What is that makes Globalization Irreversible?
Eight reasons may be given under the following headings:
1. The geographical expansion and ever greater density of international trade, as well as the globalization networking of financial markets and the growing power of transnational corporations.

2. The ongoing revolution of information and communications technology.

3. The universal demands for human rights.

4. The stream of images from the global culture industries.

5. The emergence of a post national, polycentric world politics, in which transnational actors (corporations, non-governmental organizations, United Nations) are growing in power and number alongside governments.

6. The question of world poverty.

7. The issue of global environmental destruction.

8. Transnational conflicts in one and the same place

2.2. Historical Perspective of Financial Globalization

During the past two decades, financial markets around the entire world have become increasingly interconnected. Financial globalization has brought considerable benefits to national economies and to investors and savers, but it has changed the structure of markets, creating new risks and challenges for market participants and policymakers. From a historical perspective, financial globalization is not a new phenomenon, but today’s depth and breath are unprecedented. Capital flows have existed for a long time. In fact, according to some measures, the extent of capital mobility and capital flows a hundred years ago is comparable to today’s. At that time, however, only few countries and sectors participated in financial globalization. Capital flows tended to follow migration and were generally directed towards supporting trade flows. For the most part, capital flows took the form of bonds and they were of a long-term nature. International investment was dominated by a small number of freestanding companies, and financial intermediation was concentrated on a few family groups. The international system was dominated by the gold standard, according to which gold backed national currencies. The start of the First World War represented the first blow to this wave of financial globalization, which was followed by a period of instability and crises ultimately leading to the Great Depression and the Second World War. After these events, the international system was dominated by the Bretton Woods system of fixed but adjustable exchange rates, limited capital mobility, and autonomous monetary policies.
As Mundell (1999) argues, the 1970s witnessed the beginning of a new era in the international financial system. As a result of the oil shock and the break up of the Bretton Woods system, a new wave of globalization began. The oil shock provided international banks with fresh funds to invest in developing countries. These funds were used mainly to finance public debt in the form of syndicated loans. With the change in the Bretton Wood system of fixed exchange rates, countries were able to open up to greater capital mobility while keeping the autonomy of their monetary policies. The capital inflows of the 1970s and early 1980s to developing countries lead to the debt crises, started in Mexico in 1982. To solve the debt crisis of the 1980s, Brady Bonds were created with the subsequent development of bond markets for emerging economies. Deregulation, privatization, and advances in technology made foreign direct investment (FDI) and equity investments in emerging markets more attractive to firms and individuals in developed countries. The 1990s witnessed an investment boom in FDI and portfolio flows to emerging markets. Portfolio flows were severely affected by the advent of the 1997-98 Asian crisis. Following the crises of the 1990s, economists have argued that countries will move towards corner solutions of free floating or firm fixing in a world of free capital movement, according to the impossible trinity. 1

2.3. Financial Globalization

Three decades ago, a manufacturer building a new factory would probably have been restricted to borrowing from a domestic bank. Today it has many more options to choose from. It can shop around the world for a loan with a lower interest rate and borrow in foreign currency if foreign currency loans offer more attractive terms than domestic-currency loans; it can issue stocks or bonds in either domestic or international capital markets; and it can choose from a variety of financial products designed to help it hedge against possible risks. It can even sell equity to a foreign country.

---

1 The impossible trinity is a principle of international economics that affirms that a country can only choose two out of the following three following policies: fixed exchange rates, autonomous monetary policy, and free capital mobility.
2.4. Forces Driving Globalization of Finance

2.4.1. Advances in information and computer technologies
These have made it easier for market participants and country authorities to collect and process the information they need to measure, monitor, and manage financial risk; to price and trade the complex new financial instruments that have been developed in recent years; and to manage large books of transactions spread across international financial centers in Asia, Europe, and the Western Hemisphere.

2.4.2. The globalization of national economies
It has advanced significantly as real economic activity—production, consumption, and physical investment—has been dispersed over different countries or regions. Today, the components of a television set may be manufactured in a country and assembled in another, and the final product sold to consumers around the world. New multinational companies have been created, each producing and distributing its goods and services through networks that cover the globe, while established multinationals have expanded internationally by merging with or acquiring foreign companies. Many countries have lowered barriers to international trade, and cross-border flows in goods and services have increased significantly. World exports of goods and services, which averaged $2.3 billion a year during 1983-92, have more than tripled, to an estimated $7.6 billion in 2001 (IMF, 2002). These changes have stimulated demand for cross-border finance and, in tandem with financial liberalization, promoted the creation of an internationally mobile pool of capital and liquidity.

2.4.3. The liberalization of national financial and capital markets
Coupled with the rapid improvements in information technology and the globalization of national economies, has catalyzed financial innovation and stimulated the growth of cross-border capital movements. The globalization of financial intermediation is partly a response to the demand for mechanisms to intermediate cross-border flows a partly a response to declining barriers to trade in financial services and liberalized rules governing the entry of foreign financial institutions into domestic capital markets. Global gross capital flows in 2000 amounted to $7.5 trillion, a fourfold
increase over 1990. The growth in cross-border capital movements also resulted in large net capital flows, rising from $500 billion in 1990 to nearly $1.2 trillion in 2000 (IMF, 2001).

2.4.4. Competing among the providers of intermediary services

It has increased because of technological advances and financial liberalization. The regulatory authorities in many countries have altered rules governing financial intermediation to allow a broader range of institutions to provide financial services and new classes of nonbank financial institutions, including institutional investors, have emerged. Investment banks, securities firms, asset managers, mutual funds, insurance companies, specialty and trade finance companies, hedge funds, and even telecommunications, software and food companies are starting to provide services similar to those traditionally provided by banks.

2.5. Changes in Capital Markets

These forces have, in turn, led to dramatic changes in the structure of national and international capital markets. First, banking systems in the major countries have gone through a process of disintermediation—that is, a greater share of financial intermediation is now taking place through tradable securities (rather than bank loans and deposits). Both financial and nonfinancial entities, as well as savers and investors, have played key roles in, and benefited from, this transformation. Banks have increasingly moved financial risks (especially credit risks) off their balance sheets and into securities markets—for example, by pooling and converting assets into tradable securities and entering into interest rate swaps and other derivatives transactions—in response both to regulatory incentives such as capital requirements and to internal incentives to improve risk-adjusted returns on capital for shareholders and to be more competitive. Corporations and governments have also come to rely more heavily on national and international capital markets to finance their activities. A growing and more diverse group of investors are willing to own an array of credit and other financial risks, thanks to improvement in information technology that have made these risks easier to monitor, analyze, and manage.

Secondly, cross-border financial activity has increased. Investors, including the institutional investors that manage a growing share of global financial wealth, are trying to enhance their risk adjusted returns by diversifying their portfolios internationally and are seeking out the best...
Financial Globalization: Opportunities and Challenges for Peru

investment opportunities from a wider range of industries, countries and currencies. At the wholesale level, national financial markets have become increasingly integrated into a single global financial system. The major financial centers now serve borrowers and investors around the world, and sovereign borrowers at various stages of economic and financial development can access capital markets to finance their activities and fund cross-borders mergers and acquisitions, while financial intermediaries can raise funds and manage risks more flexibly by accessing markets and pools of capital in the major international financial centers.

Third, the nonbank financial institutions are competing—sometimes aggressively—with banks for household savings and corporate finance mandates in national and international markets, driving down the prices of international instruments. They are acquiring a rising share of saving, as household bypass bank deposits to hold their funds in higher-return instruments—such as mutual funds—issued by institutions that are better able to diversify risks, reduce tax burdens, and take advantage of economies of scale, and have grown dramatically in size as well as in sophistication.

Fourth, banks have expanded beyond their traditional deposit-taking and balance-sheet-lending businesses, as countries have relaxed regulatory barriers to allow commercial banks to enter investment banking, asset management and even insurance, enabling them to diversify their revenue sources and business risks. The deepening and broadening of capital markets has created another new source of business for banks—the underwriting or corporate bond and equity issues—as well as a new source of financing, as banks increasingly turn to capital markets to raise funds for their investment activities and rely on over-the-counter (OTC) derivative markets—decentralized markets (as opposed to organized exchanges) where derivatives such as currency and interest rate swaps are privately traded, usually between two parties—to manage risks and facilitate intermediation.

2.6. New Developments and main Agents in Financial Globalization

The new nature of capital flows and the increasing use of international financial intermediaries constitute two of the most important developments in financial globalization. The last thirty years witnessed many changes in financial globalization. New technological advances and the liberalization of the domestic financial sector and the capital account have led to new
developments. The main agents driving financial globalization are governments, private investors and borrowers, and financial institutions.

2.6.1. New Nature of Capital Flows

Net capital flows to emerging economies have increased sharply since the 1970s. Capital flows went from less than 28 billion U.S. dollars in 1970s to about 306 billion U.S. dollars in 1997 in real terms, when they peaked. The composition of capital flows to developing countries changed significantly during this period. The importance of official flows more than halved, while private capital flows became the major source of capital for a large number of emerging economies. The composition of private capital flows also changed markedly. FDI grew continuously throughout the 1990s. Mergers and acquisitions (M&As) were the most important source of this increase, especially the ones resulting from the privatization of public companies. Net portfolio flows grew from 0.01 billion U.S. dollars in 1970 to 103 billion in 1996 in real terms. New international mutual funds and pension funds helped to channel the equity flows to developing countries. The importance of syndicated bank loans and other private flows decreased progressively in relative terms throughout this period, especially after the 1980s debt crises.

The top panel of Appendix 1 shows that the increase of private capital flows to developing countries is also important when considering flows in real terms (accounting for inflation). In particular, the figure shows the large increase of foreign direct investment, whereas official flows stagnated or declined.

Even though net private capital flows to developing countries increased in recent years, private capital does not flow to all countries equally. Some countries tend to receive large amounts of inflows, while other countries receive little foreign capital. The bottom panel of Appendix 1 shows that flows to developing countries increased. But among these countries, the top 12 countries with the highest flows are receiving the vast majority of the net inflows. Also, the top 12 countries are the ones that experienced the most rapid growth in private capital flows during the 1990s. As a consequence, the share of flows dedicated to low-income and middle-income countries (outside the top 12) has decreased over time. This is important because if countries

---

2 Lipsey (1999) argues that FDI has become the most dependable source of foreign investment for developing countries.
Financial Globalization: Opportunities and Challenges for Peru

benefit from foreign capital, only a small group of countries are the ones benefiting the most. The unequal distribution of capital flows is consistent with the fact that income among developing countries is diverging although the causality is difficult to determine.

2.6.2. Internationalization of Financial Services

The internationalization of financial services means the use of international financial intermediaries by local borrowers and investors. This internationalization is achieved through two main channels. The first channel is an increased presence of international financial intermediaries, mainly foreign banks, in local markets. The second channel involves the use of international financial intermediaries by local borrowers and investors; these international financial intermediaries are located outside the country. One example of the latter channel is the trading of local shares in major world stock exchanges, mostly in the form of depositary receipts.

Appendixes 2, 3, and 4 provide examples of the internationalization of financial services in developing countries. Appendix 2 shows the increased presence of foreign banks in three regions: East Asia, Eastern Europe, and Latin America. The figure illustrates the rapid increase in foreign-bank ownership over the 1990s for a number of selected emerging economies. The figure shows that the assets and the proportion of assets held by foreign banks increased in the three regions between 1994 and 1999. In Eastern Europe, the proportion of assets held by foreign banks passed 50 percent in 1999.

Appendix 3, illustrates the increasing importance of international issuance of bonds for developing countries. The figure shows that bond issuance increased substantially in 1993 and 1996, years of high capital inflows, while it decreased in 1998, when the East Asian crisis spread to other regions.

Appendix 4 displays the increased participation of companies from developing and developed countries in the U.S. equity markets using depositary receipts. The top panel shows the capital raised by foreign companies in the U.S., while the bottom panel shows the value traded in depositary receipts. Appendix 4 shows that companies from developing countries have been actively participating in the U.S. equity markets since the early 1990s. Appendix 4 shows that the top six middle-income countries with the highest participation capture most of the activity among middle-income countries. As argued above in the case of capital flows, this might be creating a
Financial Globalization: Opportunities and Challenges for Peru

divergence among developing countries. If capital raised in international capital markets brings benefits to recipient countries, for example because the cost of capital is lower or because a longer maturity structure can be achieved, a group of middle-income countries has been benefiting more than other developing nations.

2.6.3. Main Agents of Financial Globalization

There are four main agents of financial globalization: governments, borrowers, investors, and financial institutions. Each of them is helping countries become more financially integrated.

2.6.3.1. Governments

Governments are one of the main agents of financial globalization. Governments allow globalization by liberalizing restrictions on the domestic financial sector and the capital account of the balance of payments. In the past, governments used to regulate the domestic financial sector by restricting the allocation of credit through controls on prices and quantities. Governments also imposed several constraints on cross-country capital movements. The list of instruments used to restrict the capital account is rather extensive. The restrictions on the capital account include restrictions on foreign exchange transactions, derivative transactions, lending and borrowing activities by banks and corporations, and the participation of foreign investors in the local financial system. Even though the domestic financial sector and the capital account were heavily regulated for a long time, and Schmukler (2000) shows how the restrictions have been raised over time.

Appendix 5 presents the evolution of restrictions on financial markets and on the capital account. The figure illustrates the gradual rising of restrictions in developed and emerging countries during the last 30 years. The figure shows that developed countries have always used more liberal policies than developing countries. Although there has been a gradual lifting of restrictions over time, there were periods of reversals, in which restrictions were re-imposed. The most substantial reversals took place in the result of the 1982 debt crisis and in the middle 1990s in Latin America, and in the repercussion of the Asian crisis in Asia.

The literature identifies six main reasons to explain the new wave of liberalization and deregulation by governments of different countries. First, governments found capital controls
Financial Globalization: Opportunities and Challenges for Peru

increasingly costly and difficult to maintain effectively. Second, Errunza (1999) and the World Bank (2001) argue that policymakers have become increasingly aware that government-led financial systems and non-market approaches have failed. Third, recent crises have reinforced the importance of foreign capital to finance government budgets and smooth public consumption and investment. Also, foreign capital has helped governments capitalize banks with problems, conduct corporate re-structuring, and manage crises. Fourth, opening up the privatization of public companies to foreign investors has helped increase their receipts. Fifth, although governments can also tax revenue from foreign capital, they might find this harder to do than with other factors of production due to its free nature. Sixth, governments have become increasingly convinced of the benefits of a more efficient and robust domestic financial system for growth and stability of the economy and for the diversification of the public and private sectors' investor base.

2.6.3.2. Borrowers and Investors

Borrowers and investors, including households and firms, have also become main agents of financial globalization. By borrowing abroad, firms and individuals can relax their financial constrains to smooth consumption and investment. Firms can expand their financing alternatives by raising funds directly through bonds and equity issues in international markets and thereby reducing the cost of capital, expanding their investor base, and increasing liquidity. As argued by Feldstein (2000), borrowing countries not only benefit from new capital but also, in the case of FDI, they benefit from new technology, know-how, management, and employee training. More financing alternatives help foreign investors overcome direct and indirect investment barriers. International investors, as argued in Werner (1998), have taken advantage of financial globalization to achieve cross-country risk diversification. If developing countries are to grow faster than developed economies, lenders can expect to obtain higher returns from their investment. As a consequence of the liberalization of financial markets, both institutions and individuals in developed countries can now easily invest in emerging markets through buying shares of international mutual funds (including global, regional, and country funds) as shown in Kaminsky (2001). They can also purchase depositary receipts, cross-listed shares of international companies, and international corporate and sovereign bonds in international capital markets.
Financial institutions, through the internationalization of financial services, are also a major driving force of financial globalization. As discussed by the International Monetary Fund (2000), changes at the global level and changes in both developed and developing countries explain the role of financial institutions as a force of globalization. At a global level, the gains in information technology have diminished the importance of geography, what is allowing international corporations to service several markets from one location. As discussed in Crockett (2000), the gains in information technology have had three main effects on the financial services industry.

(i) It promoted a more intensive use of international financial institutions.

(ii) It led to a major consolidation and restructuring of the world financial services industry.

(iii) It gave rise to global banks and international conglomerates that provide a mix of financial products and services in a broad range of markets and countries, making less clear the distinctions between financial institutions and the activities and markets in which they engage.

Demographic changes and the increase sophistication of small investors around the world have intensified competition for savings among banks, mutual funds, insurance companies, and pension funds. Households have avoided bank deposits and securities firms to hold their funds with institutions better able to diversify risks, reduce tax burdens, and take advantage of economies of scale.

In developed countries, increased competition has lead banks and other non-bank financial firms to look for expanding their market shares into new businesses and markets, attracting customers from other countries, what allows them to diversify risk. This increased competition has taken place mainly in developed countries and was brought about by decreasing costs due to deregulation and technical improvements. Deregulation has meant that banks could enter business that had been off limits (like securities, insurance, and asset management). Non-bank financial institutions have been slowly competing with traditional banks, facilitating the securitization of finance, offering financial services traditionally exclusively provided by banks, adopting new
Financial Globalization: Opportunities and Challenges for Peru

financial risk calculation methods, and penetrating traditional banking activities in credit markets, such as syndication of loans and bridge loans via new structured financial instruments.

In developing countries, the liberalization of the regulatory systems has opened the door for international firms to participate in local markets. The privatization of public financial institutions provided foreign banks an opportunity to enter local financial markets. Macroeconomic stabilization, better business environment, and stronger fundamentals in emerging markets ensured a more attractive climate for foreign investment.
CHAPTER 3
PERUVIAN ENVIRONMENT FOR FINANCIAL GLOBALIZATION

Peru is located in the central-western part of South America. It has a surface area of 1,285,216 km² and is divided into three large natural regions: the coast, the mountains, and the jungle. Peru is a multicultural, multilingual, and multiethnic country. The Constitution of 1993 established the department as the main political-administrative unit (the country has 24 departments subdivided into 192 provinces, which, in turn, comprise 1,812 districts, plus one “constitutional province”). State policy is influenced by two main trends: the promotion of economic liberalization and the effort to respond to basic social needs, many of which are unmet. According to the 1993 census, 53.9% of households had at least one unmet basic need. In response, the Government has decided to reform the functions of the State and reorient public spending in order to achieve greater efficiency in the use of resources and ensure that expenditures do not exceed tax revenues. This process implies limiting public functions to those areas that can not be taken over by the private sector for reasons relating to national security, social equity, and market regulation. There are two basic objectives of State reform: (1) to free up financial resources by deregulating the market, privatizing State-run companies, and creating an institutional framework that is favorable to free enterprise; and (2) to restructure the general and specific functions of the State and to find the most effective and efficient use of proceeds. The State reform process is taking place in a context of fiscal and monetary austerity coupled with efforts to pay off foreign debts. Within the context of the restructuring of general and specific State functions, modernization of the financial sector is a medium term goal and forms the basis for the Government’s economic policy.

To analyze the opportunities and challenges of financial globalization for Peru, it is necessary to find out what is the situation of the factors that influence the market. These factors are the economic, political, financial, and legal environment in Peru as well as its international approach.

3.1. Economic Situation

Last September 11, the world lived through one of the darkest pages of its history, with the criminal terrorist attacks on the cities of New York and Washington in the United States. This sole event, in the third quarter of year 2001, threatens to deeply affect the way the world
economic and political systems establish relations from now on. It is clear that what happened in the United States will by all means affect the performance of Peruvian economy. Also, it became evident that the American economy was entering a much more serious recession than earlier anticipated and that it would require intervention from the US Federal Reserve to slow down the fall of the country's product. A cooling of the world's leading economy will be reflected in the rest of the world's economic blocks, it will have a negative impact on world trade and therefore on the prices of raw materials. It will also restrain the flow of capital to higher risk areas and could also bring other factors previously not considered into relations between developed and developing countries, such as the fact that the United States has included the issue of terrorism as a key part of its foreign policy.

This new world economic and political situation means, in few words, that Peru can anticipate a longer duration of the low prices of some minerals, that obtaining new investments will be much more difficult -especially long-term investments- and that it will have to work much harder to obtain better conditions for placing export products. The latter is particularly reflected in the North American market since the Andean Trade Preferences Act has not been renewed yet. Although there have been some important advances in this issue, like the visit of President Bush in March and the apparent renewal of the Act by the US Senate during the next weeks.

This new phase in the world economy coincided with the first months of Peru's new Government, which administration's officers -particularly of those in charge of the country's economic policies such as the minister of Economy and Finances, Pedro Pablo Kuczynski, the president of the Cabinet, Roberto Dañino, and the other ministers of the productive sectors- was to place the highest priority on maintaining a macroeconomic balance (fiscal and monetary) and particular emphasis on seeking long-term national and foreign investment.

It is in fact the issue of attracting investment on which a large number of analysts coincide that the new administration will have to focus its greatest efforts. It will require the focused attention of the country's business and political leaders in order to ensure that important projects can be developed, either through privatization sales or concessions, through the specific attraction of direct foreign investment that is decreasing (Appendix 6), or by any other mechanism that will bring capitals to the country. This is an issue that will become more complicated now after the September attacks, since developing countries will be competing ever harder for an ever much smaller piece of the world's investment capitals.
In the national environment, beginning from 2001's second semester, there have been some signals of a recovery during year 2002, but without too much optimism. The mine Antamina has contributed to GDP's recovery and also improved national exports. This mining mega-project is the main attraction for year 2002, because it explains the growth of Peruvian GDP and traditional exports.\(^3\)

Government has projected a real GDP growth of 3.5%-4% for year 2002. Although, according to analysts of Credit Suisse First Boston, Deutsche Bank, Dresdner Bank Lateinamerika, Dresdner Kleinwort Wasserstein, Goldman Sachs, ING Barings, JP Morgan and Santander Central Hispano, a 3.3% average growth is expected for Peru during 2002, while next year's production should rise 3.9% (Appendix 7a). These figures place Peru in an important position among the projected growth frame of the region for the next two years. The GDP rise will be perceived during the second semester of the year, period where international economy recovery will take place. Additionally, if Mivivienda Program is implemented and construction sector grows, GDP could be stimulated.\(^4\)

Inflation has been under control during the last decade, so the Government has established an inflation goal of 2.5% for year 2002. This goal should be obtained without problems, considering that during last months inflation has been negative. According to international analysts, the estimated average inflation for Peru during year 2002 is lower than the Government's projection (2.4%).

Inflation during year 2001 was 3.61% (4.45% corresponding to transable goods and 3.04% to the non-transable). During January, the Central Bank decided to adjust the monetary growth to the inflation goal, establishing for year 2002 a 2.5% inflation, with a 1.5% floor. Inflation during January 2002 was -0.52%, while during February reached -0.04% (annual prices variation of -1.1%). Deflation reported during February can be explained by the reduction of groceries prices (-0.66%), especially sugar (-3%), grapes (-22%) and beef meat (-0.7%); and by lower prices of fuels (-0.33%), (Appendix 7b).

Average interbank exchange rate during February was S/. 3,478; 0.5% higher than previous month, but lower than the levels of the previous year (Appendix 8). This behavior was influenced

\(^3\) Central Reserve Bank of Peru, Memoria Anual.
\(^4\) Comision Para la Promocion de Exportaciones (PROMPEX), The Peruvian Economy.
by banks actions to face the growth of forward operations. In real terms, during February a 1.7% appreciation (compared with January) was reported. This is explained because the 0.5% nominal depreciation was lower than the difference between the estimated external inflation (-2.2%) and internal inflation (-0.04%).

Despite of certain exchange volatility due to Argentina's crisis or internal events, there are no signals of pressure in the exchange market. The relative exchange stability is one of the factors that have allowed the Central Bank to concentrate in rising inflation.

The GDP during year 2001 grew 0.2% -despite a negative growth was expected- based on a production recovery in the last semester, compared with the first half of the year, where it was negative. During the last month of year 2001 GDP grew 4.1%, while during January and February (2002) production growth continued, but at lower rates (3.94% y 3.34%, respectively).

Behavior of Peruvian economy during the last months seems to indicate a recovery, although the situation is not clear with this information, because it was compared with very low growth rates during year 2001. However, there is some evidence of a slight recovery of Peruvian economy. Among this evidence we can find, besides last months positive growth rates, facts such as that almost every sector, except the ones related with agriculture and fisheries, grew during last year's months; a growth of the domestic demand; rise of cement consumption; acceleration of consumer goods imports and a rise in tax collection.

In the case of the fiscal deficit, there is a coincidence between the Government's goal and international analysts estimates (2.2%). This projected figure is higher than the one settled with the IMF (1.9%), because to reach this goal implies the accomplishment of all assumptions, which hardly will be done, especially tax collection. Although, the sole intention of the Government to establish that fiscal deficit is good, because it implies fiscal discipline (Appendix 9).

Also, Government has implemented expansive monetary and fiscal polices. Public expenditure during December 2001 rose 9.3%; meanwhile the Central Bank reported a higher monetary issue.

As a conclusion we can say that there is evidence of a slight recovery, however, to confirm this situation we should wait the next months and observe if the trend continues.
Due to the negative inflation rates reported during last months, added to a lower country risk and lower international interest rates, the Central Bank assumed a more expansive monetary policy. This situation made the internal interest rates to continue its downward trend.

Corporative interest rate during February was 3.9%, while the same rate in foreign currency was 2.9%. March 5th average interbank interest rate was 2.5% (2.6% during February), while corporative interest rate decreased to 3.8%. Interbank interest rate in foreign currency was 2.2% on March 5th (during February was 1.9%), while corporative interest rate fell to 2.8%, compared with the previous month (Appendix 10).

According to the BCRP officers with such low levels, the tendency will be to stabilize, until international interest rates begin to increase again, which is foreseen to occur during the year.

At the beginning of March, the spread between Peruvian Brady bonds and the Treasury Bonds, considered as a country risk approximation, was 4.5%, lower than the reported in February (4.8%), (BCRP, 2002).

In the case of the Peruvian 10 years bond, the spread compared with the US Treasury bond diminished from 4.7% in February to 4.5% during March. According to Fitch Inc, Moody's Investors Service and Standard & Poors, Peru obtains a country risk rating of 6 (BB- or Ba3), above Brazil, Argentina, Venezuela and Ecuador. However, Peru is still below Chile's level, the country with the lowest country risk rating in the region (Appendix 11).

3.1.1. The Economic Program

3.1.1.1. Macro-economic Policy

Fiscal Policy
- The deficit of the Consolidated Public Sector will be reduced to 1.9% of the GDP in 2002 and to 1.4% in 2003.
- In 2002, if incomes from privatizations exceed US$ 700 millions projected, the goal of the fiscal deficit will be extended to 2.2% of the GDP to allow more expenses in infrastructure.
- The tax incomes of the General Government will grow from 12.1% of the GDP in 2001 to 12.6% of the GDP in 2003.
Financial Globalization: Opportunities and Challenges for Peru

Monetary Policy

- The monetary policy will be consistent with the goals of economic growth, inflation and balance of payments of the program.
- Banco Central (BCRP) will keep the system of floating exchange rate, which has been essential for the Peruvian economy to come into line with the fluctuations of the exchange terms and other external shocks. Besides, it will continue intervening in the exchange market, to limit the volatility of the exchange rate, keeping the practice of not intervening in the forward market of foreign currency.  

3.1.1.2. Program with the IMF: Structural Reforms

The structural reform will include reforms to the tax system, privatizations and concessions, strengthening of the bank supervision, re-scheduling of the law of fiscal soundness and transparency. It will also help for local governments so that they may achieve financial self sufficiency, gradual reform of public and private systems of pensions, initial adjustments to the commercial system for possible entering of Peru in the area of free trade of the West hemisphere, as well as increase the efficiency of the public sector and promote the activity of the private sector.

3.2. Political Factors

3.2.1. Heritage from the past and democratic transition

Peru can be defined as an ethnically mixed country, which throughout its history has experienced deep political and social conflicts, thus creating a situation of chronic instability and preventing the emergence of a genuine national identity. Peruvian society covers major ethnic and cultural diversities, which makes it one of the most heterogeneous societies on the American continent.

The country experienced serious civilian troubles during the 1980s and the beginning of the 1990s as a result of political violence led by terrorist movements Sendero Luminoso and Movimiento Revolucionario Tupac Amaru. It also suffered from the destruction of its economy as the biggest hyperinflation in its history occurred at the end of Alan García’s term (1985-1990).

---

3 Central Reserve Bank of Peru. Memoria Anual.

Julio Sipan Velasquez 27/07/2002
During the 1990s the country was governed by Alberto Fujimori, who managed to defeat terrorism and to re-integrate the country into the international economy by implementing an in-depth process of stabilization and structural reform. However, this policy had also a very negative cost in terms of social indicators (increase of underemployment and inequalities) and institutional stability (de-institutionalization, increase of state-led corruption, authoritarianism).

Ex-President Fujimori was forced to resign in November 2000 following the discovery of an extensive corruption network in the upper spheres of the State. A government chaired by Valentín Paniagua, which endeavored to restore democratic institutions, to re-integrate the country in the international democratic community, and to prepare open and free elections, then administered the democratic transition. Alejandro Toledo, one of the leaders in the fight against the authoritarian regime of Alberto Fujimori, was elected in June 2001 as the new President. The current political situation is complicated in Peru. Toledo has not an automatic majority in Congress (his party - Perú Posible - has 45 out of the 120 seats). Therefore, he needs to spend more time and energy in parliamentary management than his predecessors to avoid constitutional congestion.

3.2.2. Internal political and security situation

After a long period of violence, the internal political situation of Peru has become reasonably stable. However, there is the political danger for Toledo that protests may spread in the margins of the party system. Having been largely ignored under Fujimori, workers organizations are eager to reassert themselves, testing Toledo's commitment to respect democratic institutions and procedures. Discontent is likely to increase if he fails to honor election campaign promises, especially with regard to job creation.

Some structural factors of political instability must be added, like the latent racism that dominates all relations throughout the country and, besides that many people are not familiar with party politics, respect of fundamental rights and ideological debate. As regards internal security, the policies of the Toledo Government are directed towards the continuation of the fight against terrorism in a fairer and more transparent way. It must be stressed that the application of the antiterrorist laws, including the emergency areas, considerably improved the situation over the
last two years, so much so that they no longer seem necessary today. Other issues are drug trafficking as well as ordinary and organized crime, which remain alarming and call for an active policy on the part of the government.

3.2.3. Regional and international context

As in all the countries bordering Colombia, numerous fears have emerged regarding the effects of Plan Colombia, owing to the expected overflow of drug traffickers and coca leaf farmers across the long border between the two countries. Fears are also centered on the consequences for the region of the increase of North-American military aid to Colombia in the fight against drugs, and the harmful ecological effects. The “Andean Regional Initiative” currently under discussion accentuated this concern. As a part of his policy to reform the military and also as a way to avoid future conflicts in the region as a result of this difficult scenario, president Toledo has proposed a reduction in military spending in Peru and the rest of the Andean region. This proposal has been reiterated during the Ibero-American Summit on Lima the 23 and 24 November 2001.

International relations have changed significantly since Fujimori. The Toledo government is much more committed than its predecessor to work actively towards regional economic integration. Another level of Toledo’s international policy is the recognition of Peru as a full-developed democracy in the hemisphere. Important initiatives were taken in order to reintegrate the country into the international Community. These initiatives include the signature of the Rome statute of the international penal Court (IAPSC), the signature of the OAS Convention on forced disappearances, the recognition of the contentious competence of the Inter-American Court of Human Rights, and the signature of the Convention for the elimination of all forms of discrimination against women.

3.3. Financial Situation

The strong participants in the financial system in Peru are: the banking system; the Lima Stock Exchange (BVL); the regulatory institutions Banking and Insurance Companies Supervisory Agency (SBS), and the National Supervisory Commission for Companies and Securities (CONASEV); the Pension Fund Associations (AFPs) and the informal exchange market of U.S. dollars. From these participants the ones that intervene more in the derivatives market are the
banking system, the regulatory institutions and the BVL with the companies that use these financial instruments in Peru.

The context of the financial environment in Peru has been influenced by the sharp swings in the international environment. The drying up of some business in the emerging markets of Asia because of the financial crisis in those places, followed by the Russian, Brazilian crisis. The latter strongly affected the Peruvian financial situation because the Latin American region was classified as a risky destination for investments, due to the contagious effect therefore the investment flows flew to safer markets.

At the beginning of 2000 the Financial System reduced dramatically the short-term loans because of the Russian crisis and a liquidity crisis followed raising the interest rates due to the banks difficulty to obtain funds from abroad. The liquidity crisis caused a bad debt crisis, where a significant number of companies have weaken financial management and were not able to obtain credits to finance their working capital. Now that the trust has been recuperated in the region, the situation is stabilized and the number of short-term loans are slowly growing while the interest rate has been decreasing. Thus the local banks are in a better position now to resume lending.

The banking system has been experiencing mergers and acquisitions of local banks with foreign ones to obtain a stronger position in the market. These mergers started happening more frequently during the liquidity and bad debt crises where the small banks, trying to gain more market share, neglected their risk measures to approve credits, resulting in a necessity for fresh capital. The banking system reached a dangerous edge when the second most important bank of the system reached an unmanageable liquidity ratio. In this case the government ran in supporting the local bank to avoid a banking crisis and finally it got merged with a foreign bank. The deterioration of the banks’ indicators has expressed the adoption of rules to strengthen the banks’ equity, especially through the reinvestment of profits, mergers and increase of capital (Appendix 12).

Currently the banking system is formed by foreign capital in more than 50%. This recent situation reinforces the financial system because the foreign banks participating in the Peruvian market are solid banks with sufficient resources.

Another participant of the Peruvian financial system are the Pension Funds Associations (AFPs), which are in charge of collecting, retaining and investing the pension funds of the labor.

Julio Sipan Velasquez 24 27/07/2002
Therefore these companies count with enormous amount of cash to inject into the exchange market trades. These funds are expected to increase 30.2 percent this year, reaching US$2,300 millions in accumulated funds. Investments on stocks are the primary instruments of these kinds of organizations. Currently the investment of AFPs in mortgage drafts is 1 percent of the total investments, while in Chile, where this system is more developed, they represent 30 percent. Mortgage drafts have a potential to increase in its market but it depends on the development of the real state credit market.

3.4. Legal Framework

The legal framework in Peru, together with the booming economy, gives financial transactions the necessary environment to make them viable and attractive. As a general rule, no authorization, consent, permit or other similar requisite is required for the companies to proceed with financial and hedging transactions or security contracts from any government authority, except banks and insurance companies that have to fulfill some requisites.

In accordance with the international trends, during the last years the Peruvian financial system has been developing the treasure business, reflecting an increase in the derivative operations (forwards and currency swaps) and in debt and capital instruments (bonds, stocks and mortgage drafts).

The globalization process, technological innovations and strong foreign investment in the Peruvian financial system exposed it to market risks, therefore was necessary to establish a regulatory frame. This regulation was issued on May 1998. Its goal is to promote a risk management culture. Its objectives are to maintain the direction of financial innovations and new business areas, measure the effect of making operation exposed to market risks, and give support to the enterprises to diversify their business operating competitively and efficiently.

The regulation states that the board of directors or the equivalent organism in a company is responsible of establishing the policies and procedures to identify and manage the market risks and fulfill them. The regulation promotes the supervision made by internal and external auditors to prevent the companies to fall into acquiring excessive risks.
The SBS has determined a prudential limit for the global position in foreign currency; this should reach only 100 percent of the effective equity. This position includes the purchase and sell of futures, forwards, swaps and future currencies.

3.5. International Approach of Peru

As a result of the existing investment opportunities and the confidence and security climate offered within Peru, this is the opinion of many investors of the international community. That opinion is supported by the significant foreign investment flows channeled to Peru during the last years in the context of the privatization process, and the plethora of important investments directed towards setting up new companies and in other cases to strengthen the already existing ones.

The solid and stable economic position earned by Peru in the last years, as result of the economic stabilization and structural reform process applied in the early ‘90s, was a determining factor for the creation of an appropriate climate for investment. Another factor was the implementation and execution of an adequate legal framework that strengthens the respect, guarantee and protection of investments and also includes a legal stability regime for the investor and his investments in the country. This regime is executed through the subscription of agreements directly with the State. In the external field, this legal framework is complemented with the access to bilateral and multilateral protection mechanisms, as well as to effective mechanisms with regard to dispute settlements.

The climate for the establishment of foreign investments has also been encouraged by the results of national pacification, in the domestic field; and, in the external field, by the recent Peace Agreement concluded with Ecuador. The recent peace reached between the both our countries will have a positive effect in the development of the corresponding border area and in the integration process with Andean countries, which will contribute to foster commerce and investment.

Notwithstanding, Peru was not excluded from the effects of the international financial crisis, though it was less vulnerable than other Latin American countries. According to some international entities, risk-rating agencies and investment banks the decision to keep the current macroeconomic policy will enable Peru to recover faster and reach dynamic growth again.

Julio Sipan Velasquez 26 27/07/2002
As we close the present decade, the actions taken by Peru as to openness and modernization of its economy enable the country to be considered as a trustworthy place for foreign investment. Facing the new millennium, Peru offers foreign investors: a stable economy that has largely liberalized its investment regime, clear rules, a skilled labor force and national entrepreneurs willing to share the challenge of developing within a market governed by modern competition policies, based on consumer protection laws and fulfillment of the WTO agreements.

Likewise, a pro-active attitude exists towards the participation within integration mechanisms that make it possible to access expanded markets. Thus, the investor established in Peru not only enjoys the benefits a highly deregulated economy, but also the country’s capacity to reach a larger amount of potential consumers.

Peru is a member of the free trade area accorded amongst the Andean Community nations, which include Bolivia, Colombia, Ecuador and Venezuela and means a market of 106 million consumers. Additionally, Peru has concluded an agreement with Chile for a progressive establishment of a free trade zone. In a few years, we expect the Andean Community and MERCOSUR to agree on South American free trade zone.

With regard to the US market, the Andean Trade Preference Act (ATPA) benefits 6300 products, which enter this competitive market with zero tariffs. As to the European Union, the General System of Preferences for the Andean countries sets zero tariffs for fishing, agricultural and textile products for which Peru provides competitive advantages due to its natural resources. Finally, our country has become a member of the Asia Pacific Economic Cooperation (APEC) forum, which comprises 50% of the world’s trade, which makes us a natural link between the emerging economies of Asia and Latin America.

The economic indicators, the financial ones and those related to the level of the economic activity, show the soundness of the Peruvian economy. The international perception of our economy, in terms of the indicators of country risk, is very favorable. There are clear signs that the economic recovery is beginning, which has extended to the non-primary sector.
CHAPTER 4

OPPORTUNITIES AND CHALLENGES OF FINANCIAL GLOBALIZATION FOR PERU

The recent stream of financial crises and contagion after countries liberalized their financial systems and became integrated with world financial markets, might lead some to suggest that globalization generates financial volatility and crises. Despite the fact that financial globalization can be related to crises and contagion, financial globalization can lead to the development of the financial system in Peru.

4.1. Globalization and Crises

Even though domestic factors tend to be key determinants of crises, there are different channels through which financial globalization can be related to crises. First, when one country like Peru liberalizes its financial system it becomes subject to market discipline exercised by both foreign and domestic investors. When an economy is closed, only domestic investors monitor the economy and react to unsound fundamentals. In open economies, the joint force of domestic and foreign investors might urge Peru to achieve, in the long run, sound fundamentals.

Secondly, globalization can also lead to crises if there are imperfections in international financial markets. As a consequence, open countries like Peru are more prone to crises regardless of their fundamentals. The imperfections in financial markets can generate bubbles, irrational behavior, herding behavior, speculative attacks, and crashes among other things. Imperfections in international capital markets can lead to crises even in countries with sound fundamentals and can also deteriorate fundamentals. For example, if investors in Peru believe that the exchange rate is unsustainable they might speculate against the currency (Sol), what can lead to a self-fulfilling balance of payments crisis regardless of market fundamentals. This is illustrated in the literature following Obstfeld (1998). Imperfections can as well deteriorate fundamentals. For example, moral hazard can lead to over borrowing syndromes when Peruvian economy is liberalized and there are implicit government guarantees, increasing the likelihood of crises, as argued in McKinnon (1997).
Financial Globalization: Opportunities and Challenges for Peru

Thirdly, globalization can lead to crises in Peru due to the importance of external factors, even in countries with sound fundamentals and even in the absence of imperfections in international capital markets. If Peru becomes dependent on foreign capital, sudden shifts in foreign capital flows can create financing difficulties and economic downturns. These shifts do not necessarily depend on country fundamentals. Calvo (1996) argues that external factors are important determinants of capital flows to developing countries. In particular, they find that world interest rates were a significant determinant of capital inflows into Asia and Latin America during the 1990s. Economic cyclical movements in developed countries, a global drive towards diversification of investments in major financial centers, and regional effects tend to be other important global factors. Rose (1996) highlights the role that foreign interest rates play in determining the likelihood of financial crises in developing countries.

4.2. Evidence on Crises

Though crises can be associated with financial liberalization, the evidence suggests that crises are complex; they are not just the consequence of globalization. The evidence indicates that crises have been a recurrent feature of financial markets for a long time, both in periods of economic integration and in periods of economic disintegration. Furthermore, the evidence points out that there are several causes of financial crises, many of which are related to domestic factors. Kindleberger (1996) provides a detailed account of financial crises through history. The particular relation between globalization and crises has inspired many studies like Eichengreen (1996). This author compare today’s wave of globalization with that of a hundred years ago. He concludes that given the level of integration prevalent in the global economy today, it is surprising that financial instability is not worse. Eichengreen claims that this pattern can be attributed to the development of institutional innovations both at a global level, like the International Monetary Fund (IMF) or the Bank of International Settlements (BIS), and at a local level, such as better accounting standards and contract enforcement. Eichengreen, studies the frequency, duration, and output impact of crises during the last 120 years. He compares the crises of the 1980s and 1990s with three distinct historical periods: the gold standard era (1880-1913), the inter-war years (1919-1939), and the Bretton Woods period (1945-1971). He concludes that crises are more frequent today than during the Bretton Woods and the gold standard periods. Today’s frequency of crisis is comparable to the inter-war years. There is little evidence that crises have grown longer or output losses have become larger. Eichengreen concludes that, even if more frequent, crises have not become more severe.
Though globalization can lead to crises, a vast literature on financial crises stresses the importance of domestic factors as key determinant of crises. Rose (1996) argues that domestic factors such as slow growth and a boom in domestic credit increase a country's likelihood of experiencing a financial crisis. Reinhart (2000) argues that crises occur mostly due to domestic factors, as the economy enters a recession following a period of prolonged boom in economic activity fueled by expanded credit, capital inflows, and an overvalued currency. Klingebiel (1997) stress the importance of both macroeconomic and microeconomic factors in determining banking crises. Eichenbaum (2001) argues that not only typical macroeconomic indicators such as actual deficits but also other factors like large prospective deficits (associated with implicit save guarantees to failing banks) can determine crises. He claims that this was the case of the Asian crisis, where governments were actually running small deficits or surpluses.

Although both domestic and foreign investors can generate crises, it is not possible to conclude from the evidence that foreign investors are the main destabilizing group.

Schmukler (2000) argues that domestic investors seem to be the ones that run first when problems arise, as if they had more information. Foreign investors tend to follow domestic investors. Furthermore, other papers fail to find that foreign investors add to volatility. For example, Stulz, (1999) finds no evidence that foreign investors had a destabilizing effect on Korea's stock market between 1996 and 1997. On the other hand, Kim (1999) finds that in Korea foreign investors were more prone to herding behavior than local ones.

4.3. Globalization and Contagion

Besides the crises generated in one country, financial globalization can also lead to financial crises through contagion, namely by shocks that are transmitted across countries. Contagion effects can be generated by fundamental linkages among economies or by factors unrelated to fundamentals, such as herding behavior. Fundamental linkages include both “real” and “financial” linkages.

---

4.3.1. Contagion due to Fundamentals

Real linkages that cause contagion have generally been associated with trade and FDI. When two countries trade with each other or when they compete in third foreign markets in similar products, a devaluation of one country’s exchange rate reduces the international price competitiveness of the other country. To the extent that the two countries are competing for FDI inflows from the industrial nations to maintain an industrial edge, the impact of one country’s currency devaluation on the other is even bigger. Consequently, if one country devalues the currency, then pressure will increase in other closely linked countries to also devalue their currencies so that their relative international price competitiveness is restored.

Financial linkages can also generate contagion. This linkage is created when international investors engage in global diversification of financial portfolios and connect different economies financially. Countries with internationally traded financial assets and liquid markets tend to be subject to contagion. Banks and institutional investors can spread a crisis from one country to another. For example, when international investors decide to shift their portfolios following the eruption of a crisis in one country, they need to sell assets from third countries to evade their positions as discussed in Kodres (1998.) This mechanism puts downward pressure in asset values from these countries, thus propagating the initial shock. Because other countries or regions are still unaffected, it is better not to sell the asset whose price has collapsed to raise cash, but other valuable holdings allocated to these unaffected economies. In doing so, other asset prices are depressed, and the initial shock is transmitted to the rest of the world.

4.3.2. Contagion due to Herding Behavior

Contagion can also be due to herding behavior. The magnitude of recent swings in exchange rates and stock prices across countries seem to be beyond those predicted by any fundamental linkages. Shocks were indeed transmitted to economies where fundamental linkages are not present or strong, due to shifts in expectations. Herding leads investors to panic and run away from countries that do not necessarily share fundamental linkages. Is it rational for investors to follow this herding behavior? The literature suggests that, at a private level, it might be rational to follow the herd. Calvo (2000) claims that information is too costly, so each investor might benefit from
looking at the market reaction and mimic what other investors are doing because others may have better information.

The issue of herding behavior is one of multiple equilibrium. If markets regard a country’s state to be good, then large capital inflows can take place. If markets judge the country as being in a bad state, then rapid capital outflows and a crisis can take place. In a world of “multiple” equilibrium, external shocks can quickly force the economy to shift from a “good” to a “bad” equilibrium. When investors suddenly become concerned about emerging markets like Peru for any reason, Wall Street reacts and European markets follow.

When investors observe a crisis in Argentina, they react to it thinking about a potential crisis in Chile and Peru, and a crisis indeed could take place. Both developed and developing countries markets are subject to these panics. Because investors know little about developing countries, investors are probably more prone to herding behavior in these markets. Uninformed investors are the ones that find market changes more informative.

4.4. Evidence on Contagion

The evidence suggests that all the different channels of contagion have played important roles in the transmission of crises. Regarding the trade channel, Eichengreen (1996) argues that trade links are important. Trade links tend to make crises more regional. Once a crisis hits one country, its trading partners become particularly vulnerable to suffer from contagion. The Mexican crisis of 1994-95 affected not only Mexican trading partners but also countries like Hong Kong, Malaysia, and Thailand with little trade links with Mexico.

Financial and non-fundamental links are also very important to understand contagion. Financial institutions, such as banks and mutual funds, can spread crises across countries. The evidence suggests that institutional investors have withdrawn funds from different countries when a crisis hit one of the countries in which they had invested. As a consequence, the fact that some countries are connected through international financial intermediaries makes them sensitive to foreign crises. Reinhard (2000) argues that the contagion of Argentina and Brazil from Mexico in 1994, and that of Indonesia from Thailand in 1997-98 are best explained by financial sector linkages among these countries, in particular banks and international capital markets. Schmukler (2000) highlights the role of mutual funds and point out that in the consequences of the Russian default...
in 1998 Malaysia suffered average mutual funds sales of 30 percent and the Czech Republic of 16 percent. The evidence is also consistent with contagion unrelated to fundamentals, either financial or trade related. Schmukler suggests that herding behavior is present, what can be a major driving force of contagion.

In sum, the evidence suggests that crises can spill over to other countries through different channels. All these channels require that economies are open and integrated with the rest of the world. A country that does not trade internationally or that does not have assets being held by foreign investors has fewer transmission channels and is therefore less exposed to contagion effects.

### 4.5. Financial Globalization and Financial Sector Development

Despite the fact that financial globalization can be related to crises and contagion, financial globalization can lead to the development of the financial system in Peru. A well functioning financial sector provides funds to borrowers (households, firms, and governments) who have productive investment opportunities. As discussed in Mishkin (2001), financial systems do not usually operate as desired because lenders confront problems of asymmetric information; lenders know less about the particular project than the borrower. Asymmetric information can lead to adverse selection and moral hazard. Adverse selection means that low-quality borrowers are the ones more likely to seek out funds in the market. Low-quality borrowers are the ones less concerned about paying back a loan. As argued by Stiglitz (2000), adverse selection might lead to credit rationing, in the sense that lenders are not willing to lend even at high interest rates; lenders realize that low-quality borrowers are the most attracted ones to high rates. Moral hazard means that, after obtaining the funds, borrowers have incentives to take risky positions or to use the funds in certain ways that are not beneficial to lenders. Thus, borrowers can obtain large gains if their bets pay off and default otherwise.

One of the primary potential benefits of financial globalization is the development of the financial sector, enhancing the provision of funds for productive investment opportunities. Financial globalization helps improve the functioning of the financial system through two main channels. First, financial globalization increases the availability of funds. Secondly, financial globalization improves the financial infrastructure, that reduces the problem of asymmetric information. As a
consequence, financial globalization decreases adverse selection and moral hazard, that enhances the availability of credit.

4.6. New and more Capital is available

As described above, both borrowers and investors have incentives to move funds across countries. In a financially integrated world, funds can flow freely from countries with excess funds to countries where the marginal product of capital is high. In this context, both foreign institutions and individuals might provide capital to Peru if they expect this country to grow faster than developed economies. As a consequence, Peru can level consumption and make investments financed by foreign capital. This flow of capital from developed to developing countries is reflected in the large current account deficits typically observed in many developing nations.

The effects of capital flows on financial development take place because new sources of funds and more capital become available. New source of funds means that Peruvian borrowers not only depend on domestic funds, they can also borrow from foreign countries willing to invest in domestic assets. The capital available from new sources means that market discipline is now stronger both at the macroeconomic level and at the financial sector level, as now local and foreign investors enforce market discipline on private and public borrowers. Foreign capital is particularly effective in imposing this kind of discipline given its free nature; foreign capital can more easily shift investment across countries. Domestic capital tends to have more restrictions to invest internationally.

More capital leads to a deepening and increased sophistication of financial markets, including an increase in the sources and uses of financing, and expands the scope of products, instruments, and services available to Peru. As a consequence, borrowers and lenders have more financial opportunities; more assets and liabilities of domestic borrowers and investors become available and transacted. An increased number of instruments and investors allows better risk diversification within and across countries. By issuing to global investors, borrowers can lower their cost of capital, in part because international investors are more diversified and, therefore, ready to pay higher prices for domestic equity and bonds. Foreign direct investment brings not only capital but also new technology, know how, and management and employee training all of which contribute to increase productivity and foster economic growth.
Thanks in part to the availability of more capital, developing economies like Peru have developed their stock and bond markets as well as some of their local financial service industry. Capital markets have developed, in the sense that more domestic equity and bonds are issued and traded, but this does not imply that all domestic financial institutions have become more important. As discussed above, borrowers and investors can just use international financial intermediaries, like stock exchanges and banks, to conduct their financial transactions. In fact, domestic financial institutions can actually contract due to competition with international financial institutions. For example, local banks obtain a lower share of the domestic market. Moreover, many stock markets are decreasing as trading moves from domestic markets to major global stock exchanges. Appendix 13 illustrates how the increasing importance of international markets has not resulted in the development of domestic stock markets. The top panel figure shows the decreasing relative importance of developing countries stock markets. The bottom panel shows the increase in the use of international stock markets, in the form of ADRs, by firms from emerging markets.

4.7. Improvement in the Financial Infrastructure

Financial globalization tends to improve the financial infrastructure. An improved financial sector infrastructure means than borrowers and lenders operate in a more transparent, competitive, and efficient financial system. In this environment, problems of asymmetric information are minimized and credit is maximized. In theory, there are different channels through which financial globalization can lead to improvements in the financial sector infrastructure.

- Firstly, financial globalization can lead to a greater competition in the provision of funds, which can generate efficiency gains.
- Secondly, the adoption of international accounting standards can increase transparency.
- Thirdly, the introduction of international financial intermediaries would push the financial sector towards the international frontier.
- Fourthly, Stulz (1999) argues that financial globalization improves corporate governance; new shareholders and potential bidders can lead to a closer monitoring of management.
- Fifthly, Crockett (2000) argues that the increase in the technical capabilities for engaging in precision financing results in a growing completeness of local and global markets.

- Sixthly, Stiglitz, (2000) argues that the rigorous market discipline imposed by financial globalization has consequences not only on the macro-economy, but also on the business environment and other institutional factors.

Foreign bank entry is another way through which financial globalization improves the financial infrastructure of developing countries. Mishkin (2001) argues that foreign banks enhance financial development for at least three main reasons.

- Firstly, foreign banks have more diversified portfolios as they have access to sources of funds from all over the world, what means that they are exposed to less risk and are less affected by negative shocks to the home country economy.

- Secondly, foreign entry can lead to the adoption of best practices in the banking industry, particularly in risk management but also in management techniques, what leads to a more efficient banking sector.

- Third, if foreign banks dominate the banking sector, governments are less likely to help banks when they have solvency problems. A lower likelihood of bailouts encourages a more prudent behavior by banking institutions, an increased discipline, and a reduction in moral hazard.

4.8. Evidence on Globalization and Financial Sector Development

The evidence supports the claim that globalization has a positive effect on the development of the financial sector. The evidence can be found in different pieces of the literature. There are papers that analyze the aggregate data and papers that use different types of micro data, including firm-level and bank-level information.

4.8.1. Aggregate evidence on Stock Market Liberalization

Werner (1998) presents evidence on the development of equity and bond markets in emerging countries. Market capitalization of emerging stock markets multiplied more than nine-fold from
Financial Globalization: Opportunities and Challenges for Peru


Using aggregate data, some papers study the effects of stock market liberalization on asset prices and investment. Stock market liberalization might affect asset prices and investment through reductions in the cost of capital, as international investors are more diversified and ready to pay higher equity prices. In turn, this reduction in the cost of capital makes some investment projects profitable, as their net present value becomes positive. Focusing on the financial liberalization episodes, which for the most part took place in the late 1980s and early 1990s, Henry (2000) finds evidence consistent with the prediction for that stock market liberalization increases equity prices and investment. Example, Brazil and Philippines are identified by Kim (1999) as countries where liberalization leads to higher returns.

4.8.2. Firm-level evidence

Other papers study firm-level evidence. These papers analyze how the actual participation of firms in international capital markets, mainly through cross listing, affect firms’ equity prices, liquidity, financing structure, and investment. Some papers concentrate on abnormal returns, volatility, cost of capital, and liquidity after companies cross list their stocks in major world stock exchanges. Cross listing may have both liquidity and signaling effects. The liquidity effect takes place because international markets are more efficient and liquid than domestic markets. Overall, this literature finds evidence of abnormal returns and lower cost of capital after cross listings. Moreover, cross listing is associated with higher liquidity and lower volatility due to the fact that the company shares are now held by a wider set of investors.

Several papers present evidence on the effect of cross listing on the cost of capital. Miller (1999) documents a significant decline in the cost of capital for firms using depository receipts and finds positive abnormal returns around the announcement date of a depository receipt program.

Even though the effect of cross listing on the cost of capital is positive, the effect is still small. Stulz (1999) argues that the overall effect is small because markets can anticipate future gains in
Financial Globalization: Opportunities and Challenges for Peru

prices. Stulz also claims that the existing lack of complete integration in world markets can diminish the potential benefits of financial globalization. Regarding the signaling effect, international listing can be interpreted as evidence of management's confidence to meet the minimum listing requirements of the foreign stock exchange, which could improve transparency in the management of the firm.

The firm-level evidence has also looked at the effects of firms' participation in international markets on investment and financing ratios. The evidence suggests that the participation in the international capital markets relaxes financing constraints and improves the firms' financing opportunities. Strickland (1999) shows that financing constraints (the sensitivity of new investment to internal cash flow) are relaxed when firms from emerging capital markets cross list using depository receipts in U.S. equity markets (this is not true for firms from developed markets). Laeven (2000) finds that financial liberalization affects more small firms than large firms, relaxing their financing constraints and domestic firms that participate in international markets obtain better financing opportunities, being able to issue more debt and extend their debt maturity structure.

4.8.3. Bank-entry evidence

Regarding foreign bank entry, Claessens (1998) argues that the competitive pressure created by foreign banks lead to improvements in banking system efficiency in terms of lower operating costs and smaller margins between lending and deposit interest rates. Foreign bank entry tends to strengthen emerging markets' financial systems and lower the probability that a banking crisis will occur. Kinney (2000) studies the case of Argentina and Mexico and conclude that diversity in ownership appears to contribute to greater stability of credit in times of crisis and domestic financial system weakness.

Even though the effects of foreign bank entry seem to be positive the evidence is still scarce. More evidence on the effects of foreign bank entry will make it clearer new light on this relatively new phenomenon. Also, the regional differences are significant, with Latin America receiving a large share of foreign banks. There is as yet only limited evidence as to whether a greater foreign bank presence contributes to a more stable banking system and less volatility in the availability of credit.
4.9. Net Effects of Globalization

The previous sections argued that globalization could bring benefits by developing the domestic financial system in a developing country like Peru. But globalization can also be associated with crises and contagion. As discussed in Obstfeld (1998), this is inescapable in a world of asymmetric information and imperfect contract enforcement. Though many crises are produced by domestic factors and countries have had crises for a long time (even in periods of low financial integration), it is the case that globalization can increase the vulnerability of Peru to crises. In an open economy like Peru, the country is subject to the reaction of both domestic and international markets, which can generate crises. Moreover, the cross-country transmission of crises is characteristic of open economies. Completely closed economies should be isolated from foreign shocks. But when a country like Peru integrated with the global economy, it becomes exposed to contagion effects of different types and, more generally, to foreign shocks.

Any potential increase in volatility tends to occur in the short-run, right after liberalization. When countries first liberalize their financial sector, volatility and crises might arise, particularly in countries like Peru with vulnerable fundamentals. If the domestic financial sector is not prepared to cope with foreign flows and is not properly regulated and supervised, financial liberalization can lead to domestic crises.
CHAPTER 5
THE ROLE OF THE PERUVIAN GOVERNMENT AND POLICY OPTIONS FOR DEALING WITH FINANCIAL GLOBALIZATION

There are different views on how the Peruvian government can maximize the benefits of globalization and minimize its risks. As discussed above, one of the most important benefits of financial globalization is the development of the financial sector. This development tends to lead to deeper and less volatile financial markets. But, on the other hand, globalization can also be associated with some costs. The most important one involves a higher sensitivity to crises and contagion. The gains are likely to materialize in the long run, while the costs will tend to be more prevalent in the short run. In all the aspects of globalization, the action or inaction of the Peruvian government is important.

5.1 Three views on the role of government

In the past the atmosphere might have favored free capitalism, but the fact that globalization has been associated with crises and contagion have led many economists to believe that some degree of government intervention can be beneficial. Most economists would now agree that financial integration with the rest of the world is beneficial. Only few economists would suggest policies that isolate countries. However, the recent experience with crises and contagion has generated large disagreements on how to integrate and on the policy recommendations. There are different views on what Peruvian Government should do regarding financial integration.

5.1.1. Minimal government intervention

A first view argues that government intervention is at the root of recent crises. This view believes that international capital markets are efficient and developed or at least international financial markets are more efficient than financial markets in developing countries. Therefore, countries with underdeveloped financial markets would benefit from full financial liberalization, with minimal government intervention. Certain types of government intervention create distortions that can lead to moral hazard and crises.
5.1.2. Restrictions on cross-country capital movement

A second view claims that cross-country capital flows should be restricted. According to this view, inefficient international financial markets debilitate the argument for unregulated financial integration. Anomalies such as asymmetric information, moral hazard, asset bubbles, speculative attacks, herding behavior, and contagion are present in international financial markets. So economies open to capital flows suffer the consequences of these imperfections. The recent crises showed that international financial markets punished similarly countries with different fundamentals and policies.

In this context, Stiglitz (2000) argues that government intervention to restrict cross-country capital movements can be socially beneficial. Peruvian government can mitigate the cost of volatile capital flows, reducing excessive risk taking and making markets less vulnerable to external shocks, and still pursue integration with international financial markets.

5.1.3. Risk management

A third view concentrates on risk management. This view focuses on strengthening the domestic financial sector and sequencing financial liberalization. This view argues that opening a weak domestic financial sector to large capital movements is potentially risky. If the domestic financial sector does not manage risk properly, does not have sufficient reserves and capital, or does not have the right incentives, large capital inflows and outflows can create severe problems in the domestic financial sector.

Foreign competition can also debilitate local financial intermediaries. Since financial crises can be very costly, this view proposes an adequate regulation and supervision of the domestic financial system without distinguishing between “foreign capital” and “domestic capital.” Additional proposals include the use of counter cyclical fiscal policy, the stability of prices, the active management of reserve requirements, and the implementation of contingent liquidity arrangements. Also, improved prudential regulation and increased market discipline, through more transparency and information, have been recommended as a way to avoid excessive risk taking.
5.2. Fewer policy instruments

One of the main consequences of globalization for policymaking is that the number of instruments at the country level diminishes when the economy is integrated. When the domestic financial system integrates with the rest of the world, it is more difficult for countries to monitor and regulate the transactions outside its borders. For example, local authorities are able to regulate the activities of the local subsidiary of an international bank, but it is more difficult to regulate the parent company and subsidiaries in other countries, which can be linked to the local bank. Also, the ability of capital to move freely in and out of the country makes government intervention less effective. There are more policy options at the domestic level when countries have a low level of financial integration. As countries become more integrated like in the Peruvian case, the need for international financial coordination grows.

5.3. Three examples of policies affected by financial globalization

The rest of the section illustrates, with three examples, how financial globalization influences the policies available to policymakers. These policies have received significant attention in the discussions surrounding crises and financial globalization. The policies discussed below are the ones related to capital controls, risk management, and the choice of monetary and exchange rate regimes.

5.3.1. Capital controls

The proposals on capital controls are designed to reduce the probability or mitigate the effects of sudden shifts in foreign capital. These proposals suggest that international capital flows should be restricted in very particular and judicious ways.

Following the classification in Rose (1996), the main proposals can be divided in different categories. (1) Controls on outflows, which restrict investors to move capital outside the country. (2) Controls on aggregate inflows, which are intended to keep capital from flowing into the country rather than restricting the exit of capital once it is in the country. (3) Controls on short-term inflows, a-la Chile, to avoid the build up of short-term debt. (4) Controls on foreign exchange transactions, or “Tobin tax,” aimed at imposing a small uniform tax on all foreign exchange transactions, regardless of their nature.
Some papers suggest that controls work as expected, while others find or negative effects of controls. The evidence suggests that when controls work, they do so on a temporary basis. As time passes, controls become ineffective; market participants find ways to avoid the controls. A brief review of part of the empirical evidence follows.

Probably the country that has received most of the attention is Chile, given the attractiveness of its scheme, which imposed capital controls on short-term inflows through unremunerated reserve requirements. Chile was also widely studied because it systematically put limits to capital flows in both episodes of international capital inflows to emerging markets (1978-1981) and (1990-1996). The evidence from studies including Hernandez (1999), and Soto (1997) suggests that controls on inflows introduce a block between domestic and foreign returns and allowed Chile's central bank to undertake a more independent monetary policy. This finding only holds when external shocks were small. Controls were not effective in preventing spillovers from very large shocks, such as the ones to the long term, the effects were only limited to the short run. The effectiveness of observed in the midst of the Asian crisis in 1997. Even though controls in Chile appear to have shifted the composition of capital flows the controls was reduced over time, as investors found ways to circumvent them. The evidence also suggests that controls might have had negative financial and growth effects, questioning their efficiency.

The cases of Colombia and Brazil have also attracted some attention. The evidence from the literature is mixed. On the one hand, papers like Edwards (1985) for Colombia and Cardoso (1998) for Brazil find that capital account restrictions had some impact on domestic interest rates. On the other hand, others such as Garcia (1996) finds that controls were ineffective in Brazil. The experience with capital account controls in Asia has also been analyzed in various studies. The evidence for this region is also mixed. Reisen (1993) examines the degree of monetary independence in Korea and Taiwan and find that capital mobility remained roughly constant in the 1980s in the presence of capital controls.

These studies, however, are mostly concerned with the degree of capital mobility in episodes of financial repression and do not compare these estimates with those in periods of financial liberalization. Analyzing the more recent experience in Malaysia, Kaplan (2000) argues that the Malaysian controls were able to segment financial markets and provided room for monetary and financial policies, allowing a speedier recovery from the crisis. They compare the recovery to
what would have been possible via a more traditional response to the crisis. China is another interesting case, which apparently succeeded in remaining isolated from the recent crises, although it could not avoid experiencing recent capital outflows.

5.3.2. Managing risk

As an alternative to capital controls, some economists have proposed focusing on managing risk by regulating and supervising the financial system, without distinguishing between domestic and foreign capital. When economies are partially integrated with the rest of the world, distinguishing between domestic and foreign capital becomes more difficult, that is why capital controls tend to be ineffective. In this case, governments can benefit by focusing on the stability of the overall financial sector to avoid financial crises or to make crises less costly. If there are imperfections in capital markets, it becomes even more important to avoid excessive risk taking. So the discussion shifts towards risk management.

Peruvian government might want to regulate and supervise financial systems to ensure that the financial sector is managing risk well. Peruvian government might want to avoid large asset-liability mismatches, like unhedged foreign exchange borrowings invested in no tradable sectors and short-term assets for long-term investments, which can leave banks vulnerable to exchange depreciations and to interest rate surges. Also, the regulation and supervision should ensure that banks are sufficiently capitalized with appropriate loan classification and adequate loan loss provisions. Transparency for investors and depositors through mandatory public disclosure of audited financial statements will help enforce market discipline. The removal of explicit or implicit government guarantees and sharing risk with investors will decrease the potential for moral hazard.

The policies towards the financial sector should also be accompanied by the right incentives for sound corporate finance. Clear rules and adequate financial disclosure help regulators and market participants monitor corporations, what push corporations to achieve good practices. Clear governance rules help prevent insider and group lending not subject to loan evaluation and creditworthiness and standards. A developed corporate bond and equity markets help companies obtain external financing, become more transparent, and be subject to market discipline. Claessens (1998) argues that the institutional structures that influence corporate behavior help
explain financial crises, especially through the link between the corporate sector and weakened financial institutions. In particular, Claessens claims that a country's legal origin, the strength of its equity and creditor rights, and the nature of its financial system can account for different degrees of corporate risk-taking.

A proper risk management helps to avoid and manage crises. First, as a preventive measure, countries with solid financial sectors will probably suffer fewer crises and less pronounced recessions.

Secondly, countries with sound financial sectors will have more flexibility to cope with external shocks and to take corrective measures during a crisis. Countries with a solvent banking sector and low corporate leverage ratios will be able to some extent to raise interest rates to contain speculative attacks on the exchange rate. Countries with large foreign exchange reserves and access to contingent liquidity facilities will be able to inject liquidity in the system, avoiding credit squeeze and bank runs.

The recent experiences with crises and contagion stress the importance of adequate risk management. Schmukler (2000) argues that one of the more important lessons of the East Asian crisis is that highly leveraged and vulnerable corporate sectors were a key determinant of the depth of the crisis. Currency devaluations suddenly inflated the size of external debt (measured in terms of the domestic currency) and debt service obligations, thereby driving the domestic corporations in financial pain. High interest rates also sharply increased domestic debt service obligations of the corporations. These vulnerabilities affected the banks with exposures to the corporations. Krugman (1999) argues that company balance sheet problems may have a role in causing financial crises. Currency crises lead to an increase in foreign denominated debt, which combined with declining sales and higher interest rates, weaken the corporate sector and in turn the financial system. Johnson (2000) also shows how weak corporate governance might obstruct the economy and lead to currency depreciations and recessions.

Can financial liberalization take place without the appropriate risk management in place? This leads to the issue of sequencing of liberalization. Having a robust financial sector is key for a successful globalization. But not all the conditions need to be in place before governments open up the financial sector. The liberalization and the gradual integration of the financial system with international financial markets and institutions can help fortify the domestic financial sector. In
fact, the integration with world markets and institutions tends to speed up the reform process to achieve a strong financial system. It is difficult to achieve a very robust financial system while the country remains closed.

5.3.3. Monetary and exchange rate policy

The choice of exchange rate regime floating or fixed has been a recurrent question in international monetary economics. This question has become more important with the increasing integration of financial markets. Countries have resolved the impossible trinity principle differently; as financial markets integrate, capital become mobile, so countries need to choose the appropriate mix of monetary and exchange rate independence.

Schmukler (2000) argues that after the crises of 1990s economists have become in favor of exchange rate regimes, according to which countries will either firmly fix their exchange rate or follow a flexible regime without pre-commitments. By fixing the exchange rate, countries tend to reduce transaction costs and exchange rate risk that can discourage trade and investment. At the same time, a fixed exchange rate has been used as a credible nominal attack for monetary policy. On the other hand, a flexible exchange rate allows a country to pursue independent monetary policy. A flexible exchange rate allows countries to respond to shocks through changes in the exchange rate and interest rate, to avoid going into recession. Under the combination of fixed exchange rates and complete integration of financial markets, monetary policy becomes completely powerless. Any fluctuations in the currency or currencies to which the country fixes its exchange rate will impact the domestic currency.
CHAPTER 6

LESSONS OF COUNTRIES THAT HAVE OPENED THEIR MARKETS TO FINANCIAL GLOBALIZATION

Some papers present country specific evidence on how financial liberalization leads to financial development. Agarwal (2000) analyzes in detail the case of India and argues that primary and secondary capital markets grew significantly in size and liquidity since the beginning of capital market reforms in 1992-93, while volatility of stocks declined. Laurenceson (1998) challenges the view that the financial sector in China remains unreformed. He presents evidence of significant financial liberalization since 1978 from a historical perspective. He then argues that it is this liberalization that has led to considerable deepening of the financial market in China. Another country where financial liberalization and integration with the global markets has resulted in a developed financial sector is Hungary. The World Bank (1999) claims that Hungary is at the front of financial sector reforms among transition countries and today has one of the most developed financial systems in Eastern and Central Europe.

6.1 The Chilean Case

Chile is a case of successful globalization, as evidenced by its spectacular economic growth, which averaged 6.5% during the 1990s, despite the effect of the Russian crisis, which caused widespread recession throughout Latin America in 1999. Even during the sharp global slowdown of the last two years, the Chilean economy has posted growth in excess of 2.5%, well above the regional average.

In addition, Chile has poverty reduction figures that are the envy of the rest of the continent. Extreme poverty today only affects 4% of the population, while poverty in general has been cut by half over the last 10 years – falling to 21% or 17% depending on how one measures the poverty.

Several factors have made these remarkable achievements possible, including: high investment and saving indices, an open economy, a consolidated and stable financial sector, an exceptionally prudent fiscal and monetary policy, a high level of human capital and the consolidation of sound and reliable institutions. Of course, of all these factors, economic growth has had the greatest
impact on poverty reduction. But equally important has been the effort made by three successive
democratic governments to implement policies aimed at providing opportunities and establishing
equity. The estimates show that social spending in Chile has had a significant redistributive
impact.

6.2. The Mexican Case

While international capital markets have been developing for some time, direct foreign entry into
the domestic banking sector of many countries has occurred only recently. Similarly, while
consolidation of the financial services industry is not new, it is now beginning to transcend
national borders in a more substantial way. These changes have occurred as a growing number of
countries have considerably loosened long-standing restrictions on the foreign ownership of
banks, thereby allowing financial globalization to advance on an unprecedented scale.

Most significant policy changes have their supporters and opponents, and the recent liberalization
allowing global financial services is no exception. Supporters say global banking promotes
improved practices and financial stability. But opponents claim foreign banks may lack
commitment to the host country or be extremely competitive with domestic banks, resulting in
risk too great for domestic bank supervisors to control. As global banking grows, the debate
continues.

The situation in Mexico may make it clearer on this debate. The globalization of Mexican
banking began in early 1994 with the North American Free Trade Agreement (NAFTA), which
represented a significant step away from the country’s history of a closed banking system. The
peso devaluation of December 1994 subsequently put Mexico’s banks on the edge of failure.
Since then, however, Mexico has made numerous moves to stabilize both its economy and
financial system, including further liberalization of foreign banking restrictions.

This process of deregulation, coupled with technological and economic factors propelling a
general trend toward globalization, recently culminated in the foreign acquisition of the three
largest Mexican banks, all within less than 18 months. As a result, Mexico is the largest economy
in the world where such a vast majority of commercial bank assets—almost 80 percent—are
controlled by foreign financial institutions. As such, Mexico provides a fertile testing ground for
assessing the merits of the arguments for and against financial globalization. While this new chapter in Mexico's modern history is only just beginning, the early evidence strongly favors an open policy toward global banking and financial services.

As stated by Bubel and Skelton (2001) prior to NAFTA, individual foreign banks could hold no more than a 5 percent stake in a Mexican bank, and total foreign ownership in any single bank was limited to 30 percent. The only exception was granted to a U.S. institution, Citigroup, whose presence dates back to 1929, when it opened a branch bank in Mexico. This branch was allowed to continue operating, even if under substantial regulatory restrictions. NAFTA opened the Mexican banking system to foreign banks by permitting entry through the establishment of newly chartered subsidiaries. In 1994, Citigroup converted its branch into a separate legal subsidiary, and Banco Santander Central Hispano (BSCH) of Spain established a presence in Mexico. In 1995, 13 other U.S., European and Japanese banks entered the Mexican market through the establishment of new charters. Most of these banks formed a holding company, or grupo financiero, which held their banking interests in addition to other financial subsidiaries, such as leasing companies and broker–dealers.

Near the end of 1994, the Mexican peso was devalued, highlighting the growing injury in the banking system, which was damaged severely in the economic crisis that followed. To attract much needed capital, the Mexican Congress passed financial reform permitting foreign investors to acquire all or part of most existing banks. Still, foreign acquisition of the three largest banks was effectively prohibited. These reforms led to the acquisition of medium-sized commercial banks (between $5 billion and $10 billion) by Banco Bilbao Vizcaya Argentaria (BBVA) of Spain in 1996 and BSCH in 1997. In addition, Citigroup expanded through the acquisition of Banca Confía, a medium-sized bank, in 1998. Each acquisition involved some form of financial assistance from the Mexican government. The government, meanwhile, took management control of 14 additional troubled banks.

By year-end 1998, Mexico already had more foreign than domestic banks. However, foreign banks controlled only 20 percent of banking system assets. BBVA, BSCH and Citigroup controlled 7, 6 and 5 percent of total commercial bank assets, respectively. None of the other foreign banks had a market share greater than 1 percent. Legislation removed all remaining market-share limitations on foreign ownership in December 1998 and created a deposit insurance and asset-resolution agency, Instituto para la Protección al Ahorro Bancario (IPAB), with stronger
Financial Globalization: Opportunities and Challenges for Peru

and well-defined powers, unlike its predecessor. Subject to overview by the Mexican Congress, IPAB immediately began resolving government-intervened banks through the auction of bank assets and, in some cases, entire banks, to domestic and foreign buyers.

In addition to deregulation, other forces in Mexico and around the world have driven the country toward greater integration with the international community. The economic fundamentals Mexico currently enjoys, especially in comparison with those of many other developing markets, have further increased the banking system’s attractiveness to foreign suitors. In addition to comprehensive financial system reform and modernization, Mexico has implemented and maintained strict monetary and fiscal discipline. Mexico has successfully hit inflation targets in recent years and anticipates an inflation rate of about 3 percent by 2003, compared with 52 percent in 1995. The president and Congress have exhibited a commitment to restraint in public spending, as evidenced by a decreasing budget deficit, and the political system itself has proven to be stable.

Common currencies, economic communities and trading coalitions are eliminating obstacles to global expansion, a primary example being the European Community and the euro, which have facilitated merger activity among European banks. In this regard, while Mexico has a local currency, almost one-third of its bank assets and liabilities are denominated in U.S. dollars, and the Mexican peso has been relatively stable in recent years. Moreover, trade with the United States has flourished under NAFTA. Additionally, technological innovations have changed bank products and revolutionized delivery systems. Advances in telecommunications and the Internet have especially benefited global expansion by enabling financial transactions and managerial control to easily traverse geographic boundaries. Such developments have reduced the information barrier traditionally associated with the distance between an organization’s head office and its subsidiaries.

Stimulated by these developments, a rapid sequence occurred in which foreign banks acquired Mexico’s three largest banks in less than a year and a half. In May 1999 IPAB took control of Grupo Financiero Serfin, and in May 2000 this financial group was auctioned to BSCH. Immediately following this transaction, BBVA acquired a controlling interest in Mexico’s second-largest financial group, Grupo Financiero Bancomer. The transaction was consummated in August 2000; dramatically increasing BBVA’s stake in Mexico and making the newly formed Grupo Financiero BBVA Bancomer the country’s largest banking group. This acquisition was the
first significant foreign acquisition completed without financial assistance from the Mexican government. In the second quarter of 2001, Citigroup announced it would buy Grupo Financiero Banacci Accival (Banacci), which owns Banco Nacional de México (Banamex). The transaction was completed in September 2001.

Reflecting these acquisitions, the Mexican commercial banking system currently consists of 11 domestic and 19 foreign organizations. The foreign banks include nine U.S. institutions, two Spanish banks, six other European banks, one Canadian bank and one Japanese bank. Foreign banks now hold nearly 79 percent of total commercial bank assets. Together, BBVA, Citigroup and BSCH hold 66 percent of these assets.

Mexico is not alone in these developments. Latin American banks in general have often been targets for foreign acquisition in recent years. As shown in Appendix 14, foreign banks now maintain a substantial presence in most Latin American countries. However, Mexico stands out in terms of the extent of foreign banking, especially given the large size of its economy.

6.2.1. Benefits for Mexico

Insufficient time has intervened to comprehensively assess any differences in overall banking system performance resulting from foreign institutions’ prominence in the Mexican banking system. Nevertheless, the trends have been positive. Each of the acquired banks has reported success in cutting costs, resulting in improved earnings and increased pressure on domestic banks to rationalize their own operations in order to remain competitive. As the cost synergies associated with recent acquisitions are fully realized, further operating-expense reductions are expected. More important, the capital adequacy of the three largest banks has improved, in some cases through capital injections provided by the new foreign parent companies.

In broader terms, the institutional changes since Mexico opened its financial sector to direct foreign entry correspond to the benefits claimed by the proponents of global banking in terms of improved practices and financial stability. A full analysis of the benefits of financial globalization must consider this process as a whole, rather than narrowly focus on the behavior of the foreign banks. In conjunction with the opening of its banking sector, the Mexican government has concentrated on stabilization, modernization, transparency and a drive toward internationally comparable standards and objectives.
Financial Globalization: Opportunities and Challenges for Peru

A look at some related industry developments clearly shows that Mexico’s financial system has been much improved and strengthened. The supervisory authorities have implemented a new bank monitoring and rating system, and accounting principles have continued to evolve closer to international standards. Furthermore, supervisors have moved quickly to promulgate new risk-management policies and processes for credit administration. For example, asset-liability management policies have been improved to better assess value at risk and mitigate liquidity and interest rate mismatches. While markets have generally stabilized over the past few years, the effects of these improvements in asset-liability management are reflected in less volatile market-related gains and losses. Moreover, the corporate community and governing authorities have enhanced the disclosure of financial information and established new corporate governance laws that strengthen the accountability of bank directors and increase the rights of minority shareholders.

These are the types of advances globalization supporters have argued would result from international banks’ direct entry into a domestic market. A strong foreign presence brings world-class banking practices, increased competitiveness, and the need for institutional and policy arrangements fully supportive of modern financial services. This process of change in Mexico undoubtedly began even before the arrival of direct foreign ownership, as international players had already been competing with domestic institutions to serve Mexico’s largest and most sought-after corporate borrowers.

6.2.2. Globalization concerns misguided

The path of progress has admittedly been a rough one for Mexico, as evidenced by the 1994 peso devaluation. But from a longer term perspective, even the peso crisis and its associated banking problems proved to be positive in that they helped stimulate the improvements and modernization subsequently undertaken by governing authorities and Mexican banks.

Opponents often emphasize the perceived weaknesses of an open financial system by referring to examples, such as Mexico’s, of financial liberalization followed by financial crisis. But this ignores the underlying institutional and policy problems that typically have accompanied financial crises. A more thorough assessment would consider the possibility that adverse financial developments in the context of a deregulated environment might reflect deeper problems, rather than being the direct result of financial globalization itself.
In Mexico's case, the 1994 peso crisis emphasized, among other things, the need to pursue the types of improvements to the financial infrastructure that Mexico has since successfully undertaken. Only through these efforts have domestic banking practices, the supervisory process, information quality and corporate governance been made commensurate with the demands of the global marketplace.

6.2.3. A Positive Direction

Mexico has established a strong foundation for economic growth and prosperity. Accompanying the banking sector's openness to foreign ownership and competition has been a large-scale modernization of regulatory practices and accounting standards, together with significantly increased disclosure and corporate governance requirements. In addition to opening its banking sector, Mexico has signed 10 free trade agreements in recent years, encompassing 35 countries that account for more than half of the world's GDP.

More time must pass before the full effect of these changes on financial and economic performance can be assessed. Nevertheless, developments point firmly in a positive direction, especially in terms of the banking system's capital adequacy. Reflecting Mexico's financial success, the peso has remained fairly stable over the past three years, whereas the currencies of many other major Latin American countries have depreciated.

Within less than 18 months, foreign institutions bought Mexico's three largest banks. Cause for concern? Experts think not. Rather, Mexico's policy of openness is likely to result in continuing economic benefits far greater than what was widely expected only a few years ago.
CHAPTER 7
CONCLUSIONS AND RECOMMENDATIONS

Considering the theoretical framework of globalization and financial globalization, determining what the opportunities and challenges for Peru are, and analyzing the Peruvian situation it was discovered that Peru could benefit of financial globalization. Therefore as analyzed, the experienced in other countries that can help as models to give guidelines on how to deal with financial globalization in Peru. It was analyzed how to deal with crisis and contagion and which the policy options are that the Peruvian Government can take in order to face with financial globalization. This chapter describes the study findings and recommendations to follow in order to take advantage of the opportunities and challenges that financial globalization entail for Peru.

In the last decades, Peru becomes more financially integrated, driven by the potential benefits of financial globalization. One of the main benefits of financial globalization is the development of the financial sector. Financial markets become deeper and more sophisticated when they integrate with world markets, increasing the financial alternatives for borrowers and investors. Financial markets operating in a global environment enable international risk diversification and facilitate consumption smoothing. Although financial globalization has several potential benefits, financial globalization also poses new challenges. The crises of the 1990s, after many countries among them Peru liberalized their financial system, have questioned in part the gains of globalization. Peru becomes exposed to external shocks and crises, not only generated in the own country, but also from contagion effects. In the initial stages of liberalization, if the right infrastructure is not in or put in place, financial liberalization can lead to increased risks. Moreover, in a financially integrated economy, policymakers in Peru have fewer policy instruments to conduct economic policy. The recent experiences with financial globalization yield some useful lessons for Policymaking in Peru.

7.1 Conclusions

1. Even though net private capital flows to developing countries increased in recent years, private capital does not flow to all countries equally. Some countries tend to receive large amounts of inflows, while Peru is receiving little foreign capital. The data shows that flows to developing countries increased. But among these countries - where is not included Peru-, the top 12 countries
Financial Globalization: Opportunities and Challenges for Peru

with the highest flows are receiving the vast majority of the net inflows. Also, the top 12 countries are the ones that experienced the most rapid growth in private capital flows during the 1990s. As a consequence, the share of flows dedicated to low-income and middle-income countries has decreased over time. This is important because if countries benefit from foreign capital, only a small group of countries are the ones benefiting the most.

2. The liberalization of the regulatory systems in Peru has opened the door for international firms to participate in local markets. The privatization of public financial institutions provided foreign banks an opportunity to enter local financial markets. Macroeconomic stabilization, better business environment, and stronger fundamentals in Peruvian emerging market ensured a more attractive climate for foreign investment and financial globalization in the country.

3. International relations have changed significantly since Fujimori government. The Toledo government is much more committed than its predecessor to work actively towards regional economic integration, which is important for financial globalization. Another level of Toledo’s international policy is the recognition of Peru as a full-developed democracy in the hemisphere. The Peruvian government is taking important initiatives in order to reintegrate the country into the international Community.

4. The legal framework in Peru, together with the recovery of its economy, gives financial transactions the necessary environment to make them viable and attractive. As a general rule, no authorization, consent, permit or other similar requisite is required for the companies to proceed with financial and hedging transactions or security contracts from any government authority, except banks and insurance companies that have to fulfill some requisites.

5. Peru is not excluded from the effects of the international financial crisis, though it was less vulnerable than other Latin American countries. According to some international entities, risk-rating agencies and investment banks the decision to keep the current macroeconomic policy will enable Peru to recover faster and reach dynamic growth again.

6. Though globalization can lead to crises, domestic factors also can cause crises. Domestic factors such as slow growth and a boom in domestic credit increase a country’s likelihood of experiencing a financial crisis. Crises occur mostly due to domestic factors, as the economy enters a recession following a period of prolonged boom in economic activity fueled by expanded credit.
Financial Globalization: Opportunities and Challenges for Peru

capital inflows, and an overvalued currency. Macroeconomic and microeconomic are important factors in determining banking crises. Not only typical macroeconomic indicators such as actual deficits but also other factors like large prospective deficits (associated with implicit save guarantees to failing banks) can determine crises.

7. Real linkages that cause contagion have generally been associated with trade and FDI, but also financial linkages can also generate contagion. This linkage is created when international investors engage in global diversification of financial portfolios and connect different economies financially.

8. Herding behavior leads investors to panic and run away from countries that do not necessarily share fundamental linkages, because information is too costly, so each investor might benefit from looking at the market reaction and mimic what other investors are doing because others may have better information. When investors observe a crisis in Argentina, they react to it thinking about a potential crisis in Chile and Peru, and a crisis indeed could take place. Both developed and developing countries markets are subject to these panics. Because investors know little about developing countries, investors are probably more prone to herding behavior in these markets.

9. Despite the fact that financial globalization can be related to crises and contagion, financial globalization can lead to the development of the financial system in Peru. A well functioning financial sector provides funds to borrowers (households, firms, and governments) who have productive investment opportunities.

10. Financial globalization can help improve the functioning of the financial system in Peru through two main channels. First, financial globalization increases the availability of funds and Secondly, financial globalization improves the financial infrastructure, that reduces the problem of asymmetric information. As a consequence, financial globalization decreases adverse selection and moral hazard, what enhances the availability of credit.

11. Borrowers and investors have incentives to move funds across countries. In a financially integrated world, funds can flow freely from countries with excess funds to countries where the marginal product of capital is high. In this context, both foreign institutions and individuals might provide capital to Peru if they expect this country to grow faster than developed economies. As a consequence, Peru can make investments financed by foreign capital. This flow of capital from
Financial Globalization: Opportunities and Challenges for Peru

developed to developing countries is reflected in the large current account deficits typically observed in many developing nations.

12. Foreign bank entry is another way through which financial globalization improves the financial infrastructure of developing countries. Foreign banks enhance financial development for at least three main reasons: First, foreign banks have more diversified portfolios as they have access to sources of funds from all over the world, what means that they are exposed to less risk and are less affected by negative shocks to the home country economy. Secondly, foreign entry can lead to the adoption of best practices in the banking industry, particularly in risk management but also in management techniques, what leads to a more efficient banking sector. Thirdly, if foreign banks dominate the banking sector, governments are less likely to help banks when they have solvency problems. A lower likelihood of bailouts encourages a more prudent behavior by banking institutions, an increased discipline, and a reduction in moral hazard.

13. Globalization can bring benefits by developing the domestic financial system in a developing country like Peru. But globalization can also be associated with crises and contagion. This is inescapable in a world of asymmetric information and imperfect contract enforcement. Though many crises are produced by domestic factors and countries have had crises for a long time (even in periods of low financial integration), it is the case that globalization can increase the vulnerability of Peru to crises. Peru has an open economy; the country is subject to the reaction of both domestic and international markets, which can generate crises. Moreover, the cross-country transmission of crises is characteristic of open economies. Completely closed economies should be isolated from foreign shocks. But when a country like Peru integrated with the global economy, it becomes exposed to contagion effects of different types and, more generally, to foreign shocks.

14. There are different views on how the Peruvian government can maximize the benefits of globalization and minimize its risks. One of the most important benefits of financial globalization is the development of the financial sector. This development tends to lead to deeper and less volatile financial markets. But, on the other hand, globalization can also be associated with some costs. The most important one involves a higher sensitivity to crises and contagion. The gains are likely to materialize in the long run, while the costs will tend to be more prevalent in the short run. In all the aspects of globalization, the action or inaction of the Peruvian government is important.

Julio Sipan Velasquez 27/07/2002
15. Opening weak domestic financial sector to large capital movements is potentially risky. If the domestic financial sector does not manage risk properly, does not have sufficient reserves and capital, or does not have the right incentives, large capital inflows and outflows can create severe problems in the domestic financial sector.

16. Foreign competition can also debilitate local financial intermediaries. Since financial crises can be very costly, for this reason is necessary an adequate regulation and supervision of the domestic financial system without distinguishing between "foreign capital" and "domestic capital."

17. One of the main consequences of globalization for policymaking is that the number of instruments at the country level diminishes when the economy is integrated. When the domestic financial system integrates with the rest of the world, it is more difficult for countries to monitor and regulate the transactions outside its borders. For example, local authorities are able to regulate the activities of the local subsidiary of an international bank, but it is more difficult to regulate the parent company and subsidiaries in other countries, which can be linked to the local bank. Also, the ability of capital to move freely in and out of the country makes government intervention less effective. There are more policy options at the domestic level when countries have a low level of financial integration. As countries become more integrated like in the Peruvian case, the need for international financial coordination grows.

18. When economies are partially integrated with the rest of the world, distinguishing between domestic and foreign capital becomes more difficult, that is why capital controls tend to be ineffective. In this case, governments can benefit by focusing on the stability of the overall financial sector to avoid financial crises or to make crises less costly. If there are imperfections in capital markets, it becomes even more important to avoid excessive risk taking.

19. Chile and Mexico are two Latin-America cases of successful financial globalization in the region, as evidenced by their spectacular economic growths which averaged 6.5% and 5% respectively during the 1990s, despite the effect of the Russian crisis which caused widespread recession throughout Latin America in 1999. Several factors have made these remarkable achievements possible, including: high investment and saving indices, an open economy, a consolidated and stable financial sector, an exceptionally prudent fiscal and monetary policy, a high level of human capital and the consolidation of sound and reliable institutions.
7.2. Recommendations

1. **Peru can benefit from globalization**: Peru can benefit from financial globalization and should take advantage of it. Financial liberalization tends to develop the financial system, enhancing the financing opportunities, reducing the cost of capital, and increasing investment and liquidity. At the same time, the evidence does not suggest that financial volatility increases after financial liberalization. It is true that crises have had a very large impact on growth in some countries like Indonesia. But in other cases, the recovery has been rapid, as in South Korea and Mexico.

Though the potential benefits can be large even in Peru, there is still an important home prejudice. Given the potential benefits of globalization, the scope is for a much deeper financial globalization and for much larger gains. Peru is already open and the prospect is for increased globalization of financial markets. Paradoxically, the increased globalization can reduce the scope for risk diversification, because integrated financial markets tend to be more correlated.

2. **Importance of sound fundamentals**: Sound macroeconomic and financial fundamentals are key in lowering the probability of crises and contagion and to be able to manage crises more effectively. Preventing currency and banking crises should be one of the primary objectives of any policymaker in Peru because of the high cost of crises. This is more important in a world of free capital mobility, because both foreign and domestic investors exercise market discipline and because foreign crises might have contagion effects at home. Attacks on currencies can occur whenever confidence is lost, even if Peru has sound fundamentals. A crisis in a foreign country can rapidly generate a crisis in a country like Peru. Weak fundamentals tend to alarm investors more easily and make crisis management more difficult. Countries with bad fundamentals, for example with large fiscal deficits and public debt, have fewer instruments to use in the middle of a crisis. Therefore, Peru should focus on key policies that help it prevents and manages crises. These policies include avoiding large current account deficits financed through short-term private capital inflows and large asset-liability currency mismatches.

3. **Initial conditions matter**: Peru should ensure that its financial sector is prepared to cope with open capital markets. If the domestic financial sector does not manage risk properly, does not have sufficient reserves and capital, or does not have the right incentives, large capital inflows and outflows can create severe problems in the domestic financial sector. However, it is not the
case that all the conditions need to be met before governments liberalize completely the financial sector. The process of integration to world financial markets can in some ways help improve the conditions of the domestic financial sector.

As Peru develops, more comprehensive policies for risk management will be needed. These measures should try to avoid imperfections in capital markets and the build up of vulnerabilities. In more developed economies, the distinction between foreign and domestic capital becomes increasingly difficult. As the economy becomes integrated with the rest of the world, restraints to capital movements are more difficult to be effective since they can be avoided easily. Therefore, a more comprehensive approach will be needed to Peru for building a solid financial economy. This approach involves a proper regulation and supervision of the financial system.

4. **Need for international financial coordination:** As economies become more integrated, Peruvian government has less policy instruments and has to rely more on international financial coordination. For example, governments tend to have fewer options about their monetary policy and exchange rate policy. In open economies there is a higher transmission of international interest rates and prices to the domestic economy. Moreover, bank regulation and supervision by one government is more difficult when liabilities and prices are denominated in foreign currency and when the banking sector is part of an international banking system. Also, in the middle of contagious crises, governments tend to lack sufficient resources to stop a currency attack and individual government can do little to stop crises being originated in foreign countries. In these cases, international financial coordination can help to Peruvian government achieves its goals.

A coordinated action among governments and the international financial institutions is necessary to overcome crises and contagion, at both regional and global levels. To minimize potential moral hazard, it would be necessary to involve the private sector so that private international investors share in the costs as penalty for excessive risk taking. Another policy that requires international coordination is to build a strong “international financial architecture” according to the IMF to prevent and manage, in a systematic way, financial crises. Even though there are different meanings of this architecture, in general terms it refers to international arrangements for mutual consultation, monitoring, and collaboration, covering a broad range of subjects of economic policy and possible financing in the event of crisis. The international financial architecture is still under construction. The initiatives under consideration focus on crisis prevention, crisis management, and crisis resolution. The current initiatives include setting international standards.
for transparency and information dissemination, bank supervision and regulation, disclosure in securities markets, accounting and auditing rules, bankruptcy procedures and corporate governance. The new initiatives also include the private sector involvement in financing packages, to complement IMF resources and to discourage moral hazard that could be associated with bailouts.

5. The Role of the Peruvian Central Bank: Central Reserve Bank of Peru (BCRP) should continue with the system of floating exchange rate, which has been essential for the Peruvian economy to come into line with the fluctuations of the exchange terms and other external shocks. Besides, it should continue intervening in the exchange market, to limit the volatility of the exchange rate, keeping the practice of not intervening in the forward market of foreign currency.

6. The activities of the Peruvian Government: The government intervention to restrict cross-country capital movements can be socially beneficial. Peruvian government can mitigate the cost of volatile capital flows, reducing excessive risk taking and making markets less vulnerable to external shocks, and still pursue integration with international financial markets.

Peruvian government should to regulate and supervise financial systems to ensure that the financial sector is managing risk well. Peruvian government should avoid large asset-liability mismatches, like unhedged foreign exchange borrowings invested in no tradable sectors and short-term assets for long-term investments, which can leave banks vulnerable to exchange depreciations and to interest rate flows. Also, the regulation and supervision should ensure that banks are sufficiently capitalized with appropriate loan classification and adequate loan loss provisions. Transparency for investors and depositors through mandatory public disclosure of audited financial statements will help enforce market discipline. The removal of explicit or implicit government guarantees and sharing risk with investors will decrease the potential for moral hazard.

The policies towards the financial sector should also be accompanied by the right incentives for sound corporate finance. Clear rules and adequate financial disclosure help regulators and market participants monitor corporations, what push corporations to achieve good practices. Clear governance rules help prevent insider and group lending not subject to loan evaluation and creditworthiness and standards. A developed corporate bond and equity markets help companies obtain external financing, become more transparent, and be subject to market discipline.
To avoid that foreign competition can also debilitate local financial intermediaries would be necessary to include the use of counter cyclical fiscal policy, the stability of prices, the active management of reserve requirements, and the implementation of contingent liquidity arrangements. Also, improved prudential regulation and increased market discipline, through more transparency and information, can be recommended as a way to avoid excessive risk taking.

The Peruvian government should establish solid financial sectors to avoid possible crises and recessions. Peruvian government should set up sound financial sectors to have more flexibility to cope with external shocks and to take corrective measures during a crisis. Peru should establish a strong banking sector and low corporate leverage ratios to be able to some extent to raise interest rates to contain speculative attacks on the exchange rate. Countries like Peru with large foreign exchange reserves and access to contingent liquidity facilities will be able to inject liquidity in the system, avoiding credit squeeze and bank runs.

7. Lessons of Latin-America Countries: Peru should follow the lessons of Chile - a country close to Peru -, which is a case of successful globalization, as evidenced by its spectacular economic growth, which averaged 6.5% during the 1990s, despite the effect of the Russian crisis, which caused widespread recession throughout Latin America in 1999. Even during the sharp global slowdown of the last two years, the Chilean economy has posted growth in excess of 2.5%, well above the regional average. Several factors have made these remarkable achievements possible, including: high investment and saving indices, an open economy, a consolidated and stable financial sector, an exceptionally prudent fiscal and monetary policy, a high level of human capital and the consolidation of sound and reliable institutions. Of course, of all these factors, economic growth has had the greatest impact on poverty reduction. But equally important has been the effort made by three successive democratic governments to implement policies aimed at providing opportunities and establishing equity.

Also, Peru should take into account the Mexican case, because is another case of successful globalization in Latin-America. The economic fundamentals Mexico actually enjoys, especially in comparison with those of many other developing markets, have further increased the financial system's attractiveness to foreign suitors. In addition to comprehensive financial system reform and modernization, Mexico has implemented and maintained strict monetary and fiscal discipline. Mexico has successfully hit inflation targets in recent years and anticipates an inflation rate of about 3 percent by 2003, compared with 52 percent in 1995. The president and Congress have
exhibited a commitment to restraint in public spending, as evidenced by a decreasing budget deficit, and the political system itself has proven to be stable.
REFERENCES


APPENDIX 1

The figures display net capital flows to developing countries. The top panel plots the evolution of private capital flows and official capital flows. Private capital flows are disaggregated into foreign direct investment, portfolio bond flows, portfolio equity flows, and bank and trade related flows. The bottom panel depicts the distribution of private capital flows among developing countries. The top 12 receiving developing countries are: China, Brazil, Mexico, Argentina, Korea, Rep., Malaysia, Russian Federation, Thailand, Chile, India, Indonesia, and Turkey.

Source: World Bank, World Development Indicators 2000 (WDI)
These figures illustrate the increase in the value of assets held by foreign banks and the increase in the importance of foreign banks in selected developing countries. In these figures, East Asia includes Korea, Malaysia, and Thailand. Eastern Europe includes The Czech Republic, Hungary, and Poland. Latin America includes Argentina, Brazil, Mexico, Peru, and Venezuela.

Source: International Monetary Fund International, Capital Markets September 2000
This figure depicts the value of bonds issued by developing countries in international capital markets during the 1990s.

APPENDIX 4

Internationalization of Emerging Stock Markets

Capital Raised by Companies' in ADRs
(in billions of U.S. dollars)

Value Traded by Companies' in ADRs
(in trillions of U.S. dollars)

The figures illustrate the amount of equity capital raised by developing countries in international capital markets and the volume traded by developing countries on ADRs during the 1990s. In these figures, the top six developing countries include Argentina, Brazil, China, India, South Korea, and Mexico; these countries were selected in accordance to their total capital raised during the period 1980-2000. High-income countries include Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Singapore, Slovenia, Spain, Sweden, Switzerland, Taiwan, and the United Kingdom. Middle-income countries include Bahrain, Chile, Colombia, Croatia, Czech Republic, Dominican Republic, Egypt, Estonia, Hungary, Jordan, Kazakhstan, Latvia, Lebanon, Lithuania, Malta, Morocco, Papua New Guinea, Peru, Philippines, Poland, Romania, Russia, Slovak Republic, South Africa, Sri Lanka, Thailand, Tunisia, Turkey, Uruguay, and Venezuela. Low-income countries include Ghana, Indonesia, Malawi, and Pakistan.

Source: Bank of New York
The figures display an index of the liberalization of the capital account and an index of the liberalization of domestic financial markets. The indexes cover the last 30 years for developed and developing economies. 3=High restrictions, 2=Medium restrictions, and 1=No restrictions. Developed countries include Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Norway, Portugal, Spain, Sweden, Great Britain, and the United States. Asian economies include Hong Kong, Indonesia, Korea, Malaysia, Philippines, Taiwan, and Thailand. Latin America economies include Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela. The variable restrictions on the capital account is the average of six indicators including: 1. Borrowing abroad by banks, 2. Borrowing abroad by corporations, 3. Acquisition by foreign investors, 4. Multiple exchange rates/others, 5. Repatriation of capital, and 6. Repatriation of income. The variable restrictions on financial markets is the average of five indicators including: 1. Lending interest rates, 2. Deposits interest rates, 3. Credit controls, 4. Reserve requirements, and 5. Deposits in foreign currency.

CAPITAL FLOWS AND FOREIGN DEBT

Foreign direct investment (FDI) inflows to Peru in the early 1990s led to surpluses on the capital account in 1993-94, but a widening trade deficit and a fall in inward private investment flows produced another deficit in 1995. As import growth slowed and investment flows recovered, the overall balance reverted to surplus in 1996-97. However, lower levels of FDI between 1998 and 2000 moved the overall balance of payments back into deficit.

Source: PROMPERÚ, March 2002
APPENDIX 7

PERUVIAN ECONOMIC INDICATORS AND PROJECTIONS

a. Peruvian Government has projected a real GDP growth of 3.5%-4% for year 2002. Although, according to analysts of ABN Amor, BBV, BCP Securities, Credit Suisse First Boston, Deutsche Bank, Dresdner Bank Lateinamerika, Goldman Sachs, ING Barings, JP Morgan and Santander Central Hispano, a 3.3% average growth is expected for Peru during 2002, while next year's production should rise 3.9%. These figures place Peru in an important position among the projected growth frame of the region for the next two years. The GDP rise will be perceived during the second semester of the year, period where international economy recovery will take place.

b. Inflation has been under control during the last decade, so the Government has established an inflation goal of 2.5% for year 2002. This goal should be obtained without problems, considering that during last months inflation has been negative. According to international analysts, the estimated average inflation for Peru during year 2002 is lower than the Government's projection (2.4%).

| Source: PROMPEX, March 2002 |

<table>
<thead>
<tr>
<th>GDP (GDP)</th>
<th>Inflation (Infl)</th>
<th>Fiscal Balance (Fiscal Balance)</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.0</td>
<td>2.0</td>
<td>-2.2</td>
</tr>
<tr>
<td>3.1</td>
<td>2.0</td>
<td>-2.2</td>
</tr>
<tr>
<td>3.1</td>
<td>2.1</td>
<td>-2.5</td>
</tr>
<tr>
<td>4.0</td>
<td>2.7</td>
<td>-2.3</td>
</tr>
<tr>
<td>3.0</td>
<td>1.0</td>
<td>-2.2</td>
</tr>
<tr>
<td>3.5</td>
<td>1.7</td>
<td>-2.3</td>
</tr>
<tr>
<td>3.0</td>
<td>2.8</td>
<td>-2.1</td>
</tr>
<tr>
<td>3.0</td>
<td>2.0</td>
<td>-2.4</td>
</tr>
<tr>
<td>4.0</td>
<td>2.0</td>
<td>-2.2</td>
</tr>
<tr>
<td>3.1</td>
<td>3.3</td>
<td>-2.2</td>
</tr>
<tr>
<td>3.0</td>
<td>4.4</td>
<td>-2.2</td>
</tr>
<tr>
<td>3.7</td>
<td>3.0</td>
<td>-1.7</td>
</tr>
<tr>
<td>3.5</td>
<td>2.8</td>
<td>-2.0</td>
</tr>
<tr>
<td>3.0</td>
<td>1.5</td>
<td>-2.0</td>
</tr>
<tr>
<td>3.3</td>
<td>2.2</td>
<td>-2.3</td>
</tr>
<tr>
<td>Average</td>
<td>3.3</td>
<td>2.2</td>
</tr>
</tbody>
</table>

| Source: PROMPEX, March 2002 |
APPENDIX 8

EXCHANGE RATE

Average interbank exchange rate during February was S/. 3,478; 0.5% higher than previous month, but lower than the levels of the previous year. This behavior was influenced by banks actions to face the growth of forward operations. In real terms, during February a 1.7% appreciation (compared with January) was reported. This is explained because the 0.5% nominal depreciation was lower than the difference between the estimated external inflation (-2.2%) and internal inflation (-0.04%). Despite of certain exchange volatility due to Argentina's crisis or internal events, there are no signals of pressure in the exchange market. The relative exchange stability is one of the factors that have allowed the Central Bank to concentrate in rising inflation.

Source: Central Reserve Bank of Peru (BCRP)
External Account, Exchange Rate and International Reserves

In the case of the fiscal deficit, there is a coincidence between the Government’s goal and international analysts estimates (2.2%). This projected figure is higher than the one settled with the IMF (1.9%), because to reach this goal implies the accomplishment of all assumptions, which hardly will be done, especially tax collection. Although, the sole intention of the Government to establish that fiscal deficit is good, because it implies fiscal discipline. Respect of exchange rate, projections indicate that it will end year 2002 at S/. 3.50. This represents a depreciation of 2.8% -after a 2.3% strengthen during 2001- as a result of the weak domestic demand and the deflation reported during the last months.

<table>
<thead>
<tr>
<th>Bank/Company</th>
<th>Trade Balance (US$m)</th>
<th>Current Account Balance (% GDP)</th>
<th>Exchange Rate (End of year)</th>
<th>International Reserves (US$m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABN Amro (Dec-01)</td>
<td>0.2</td>
<td>-3.0</td>
<td>3.53</td>
<td>3.0</td>
</tr>
<tr>
<td>BBVA (Jan-02)</td>
<td>2.4</td>
<td>-3.5</td>
<td>3.61</td>
<td>2.5</td>
</tr>
<tr>
<td>Banco Santander Central Hispano (Jan-02)</td>
<td>0.1</td>
<td>-1.9</td>
<td>3.62</td>
<td>3.2</td>
</tr>
<tr>
<td>BCP Securities (Jan-02)</td>
<td>0.2</td>
<td>-2.2</td>
<td>3.59</td>
<td>3.4</td>
</tr>
<tr>
<td>Credit Suisse First Boston (Jan-02)</td>
<td>-1.1</td>
<td>-2.4</td>
<td>3.50</td>
<td>2.7</td>
</tr>
<tr>
<td>Deutsche Bank (Dec-01)</td>
<td>0.4</td>
<td>-1.4</td>
<td>3.57</td>
<td>2.6</td>
</tr>
<tr>
<td>Dresdner Bank Latinoamericana (Dec-01)</td>
<td>0.0</td>
<td>-1.8</td>
<td>3.50</td>
<td>3.0</td>
</tr>
<tr>
<td>Dresdner Kleinwort Wasserstein (Jan-02)</td>
<td>0.1</td>
<td>-2.2</td>
<td>3.50</td>
<td>2.6</td>
</tr>
<tr>
<td>Goldman Sachs (Dec-01)</td>
<td>0.1</td>
<td>-2.5</td>
<td>3.51</td>
<td>2.9</td>
</tr>
<tr>
<td>ING Barings (Jan-02)</td>
<td>0.1</td>
<td>-2.9</td>
<td>3.51</td>
<td>2.9</td>
</tr>
<tr>
<td>Merrill Lynch (Dec-01)</td>
<td>0.2</td>
<td>-2.2</td>
<td>3.50</td>
<td>3.0</td>
</tr>
<tr>
<td>Scotiabank Group (Jan-02)</td>
<td>-0.6</td>
<td>-2.7</td>
<td>3.50</td>
<td>2.7</td>
</tr>
<tr>
<td>The Economist Intelligence Unit (Jan-02)</td>
<td>-0.3</td>
<td>-2.3</td>
<td>3.50</td>
<td>2.7</td>
</tr>
<tr>
<td>UBS Warburg (Nov-01)</td>
<td>-0.1</td>
<td>-2.2</td>
<td>3.49</td>
<td>2.7</td>
</tr>
<tr>
<td>Average</td>
<td>0.0</td>
<td>-2.8</td>
<td>3.49</td>
<td>2.7</td>
</tr>
</tbody>
</table>

Source: PROMPEX, March 2002

Reserves are now equivalent to 14 months of imports, the highest in the region and in Peruvian history.

Source: PROMPEX, March 2002
INTEREST RATES

Due to the negative inflation rates reported during last months, added to a lower country risk and lower international interest rates, the Central Bank assumed a more expansive monetary policy. This situation made the internal interest rates to continue its downward trend. Corporative interest rate during February was 3.9%, while the same rate in foreign currency was 2.9%. March 5th average interbank interest rate was 2.5% (2.6% during February), while corporative interest rate decreased to 3.8%. Interbank interest rate in foreign currency was 2.2% on March 5th (during February was 1.9%), while corporative interest rate fell to 2.8%, compared with the previous month.

With such low levels, the tendency will be to stabilize, until international interest rates begin to increase again, which is foreseen to occur during the year.

Source: Central Reserve Bank of Peru (BCRP)
APPENDIX 11

COUNTRY RISK

At the beginning of March, the spread between Peruvian Brady bonds and the Treasury Bonds, considered as a country risk approximation, was 4.5%, lower than the reported in February (4.8%). In the case of the Peruvian 10 years bond, the spread compared with the US Treasury bond diminished from 4.7% in February to 4.5% during March.

Spread on Sovereign Bonds
January 1997 - March 2002

Source: Central Reserve Bank of Peru (BCRP)

According to Fitch Inc, Moody's Investors Service and Standard & Poors, Peru obtains a country risk rating of 6 (BB- or Ba3), above Brazil, Argentina, Venezuela and Ecuador. However, Peru is still below Chile and Mexico's levels, the countries with the lowest country risk rating in the region.

Source: Fitch Inc, Moody's Investors Service, Standard & Poors
PERUVIAN BANKING SYSTEM

The banking system continues to adjust to the weak domestic market conditions. Given the absence of creditworthy clients, and the decline in demand for loans, banks are downsizing and cutting financial costs (savings interest rates).

The reduction in financing sources has allowed banks to better manage their excess liquidity, which has had a positive impact on their financial results. The financial system is becoming healthier little by little. In February, past-due loans fell to 9.3% of total loans, while past-due and refinanced loans remained constant at 17.2% of loans.

Source: PROMPEX March 2002
The figure in the top panel illustrates the evolution of stock markets in developed and developing countries during the 1990s. The figure in the bottom panel illustrates, for a group of selected countries, the equity trading in international markets relative to the domestic markets. The figure plots the average ratio of ADR trading in New York over the total value traded in the domestic markets for the years 1990-1995 and 1996-1999.

Source: Bank of New York (For ADRs)
### Foreign Banks Presence in Latin-America

<table>
<thead>
<tr>
<th>Country</th>
<th>2000 GDP (Billion of US. Dollars)</th>
<th>Foreign Bank Market Share (Percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>1,194</td>
<td>24.0</td>
</tr>
<tr>
<td>Mexico</td>
<td>875</td>
<td>78.8</td>
</tr>
<tr>
<td>Argentina</td>
<td>403</td>
<td>54.7</td>
</tr>
<tr>
<td>Colombia</td>
<td>291</td>
<td>24.1</td>
</tr>
<tr>
<td>Chile</td>
<td>219</td>
<td>47.0</td>
</tr>
<tr>
<td>Venezuela</td>
<td>205</td>
<td>49.7</td>
</tr>
<tr>
<td>Peru</td>
<td>133</td>
<td>67.9</td>
</tr>
<tr>
<td>Ecuador</td>
<td>59</td>
<td>8.7</td>
</tr>
<tr>
<td>Dominican Republic</td>
<td>53</td>
<td>7.0</td>
</tr>
<tr>
<td>Uruguay</td>
<td>33</td>
<td>39.2</td>
</tr>
<tr>
<td>Bolivia</td>
<td>27</td>
<td>7.1</td>
</tr>
<tr>
<td>Panama</td>
<td>23</td>
<td>54.7</td>
</tr>
<tr>
<td>El Salvador</td>
<td>20</td>
<td>13.0</td>
</tr>
<tr>
<td>Jamaica</td>
<td>10</td>
<td>59.0</td>
</tr>
</tbody>
</table>

Source: BUBEL and SKELTON, 2001