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“Comparative Policies on Foreign Exchange and Capital Mobility: Argentina, Brazil, Chile and Peru”

María Luisa Streb

Agosto de 2008

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“Foreign Exchange Framework: Foreign Currency and Foreign Capital Mobility Policies”

María Luisa Streb¹

Summary

Financial liberalization in the capital market is expected to avoid undesired arbitrages, boost international and regional capital mobility, promote investment, and encourage growth. But to be successful, financial liberalization requires a stable macroeconomic policy environment and prudential regulations supported by efficient supervision of financial intermediaries.

While capital controls generate distortions, overabundance of capital mobility has been in part responsible for financial crisis in emerging markets. The discussion in academic and policy forums regarding possible gains and risks for recipients of international capital flows is not settled and there is an extensive literature on both sides. There is consensus among some economists, based on empirical evidence, that financial liberalization may generate instability in the short run, but in the long run it has a positive influence on investment and growth. The path to financial development is certainly not straightforward.

This paper deals with the asymmetries in the foreign exchange framework between Argentina, Brazil, Chile and Peru, focusing on the foreign currency and foreign capital mobility policies, as well as the transactions costs when issuing securities.

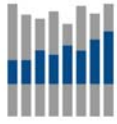
As seen through the essay direct and indirect controls, prudential norms... are variants used by the four countries to slow down the volatility of capital flows, the pressure over the foreign exchange rate and/or foreign shock transmissions. Chile and Peru are the most liberalized of the sample. Although, Brazil experienced a gradual process of liberalization during the nineties that was reinforced in the current century, the country still has important restrictions showing certain resistance to financial integration. In Argentina, the liberalization of its capital account in the nineties was deeper than in Brazil. Nevertheless, currently Argentina is the country of the sample with most capital controls and interventions in the foreign exchange market.

An alternative approach to capital controls in order to manage risks associated with capital flows is to strengthen prudential policies in the capital markets to restrain excessive risk-taking behavior on the part of financial institutions. Prudential regulations do not focus on capital flows directly, but they do affect their composition, volume and volatility, and may well be used to manage capital flows. In fact, capital controls and prudential controls are becoming gradually intertwined as countries deregulate their financial sector and liberalize the capital account. The relationship between them requires careful study and coordination in order to put limits in the balance sheet risks while liberalizing. The set up and upkeep of prudential standards rely on public regulation and supervision, internal practices and controls together with market discipline.

Códigos JEL: F3, G1 y O5.

Palabras clave: Finanzas Internacionales, Mercados Financieros en General, Estudios Globales de Países.

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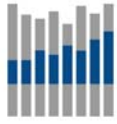


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GLOSSARY OF TERMS

ADR	American Depositary Receipt
AFIP	Tax Authority Administration – <i>Administración Federal de Ingresos Públicos</i>
BCC	Central Bank of Chile – <i>Banco Central de Chile</i>
BCRA	Central Bank of Argentina – <i>Banco Central de la República Argentina</i>
BCRP	Central Bank of Peru – <i>Banco Central del Perú</i>
CAIVAL	Securities Depository – <i>Caja de Valores</i>
CMN	Nacional Monetary Council - <i>Conselho Monetario Nacional</i>
CNV	Argentine Securities and Exchange Commission – <i>Comisión Nacional de Valores</i>
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IFS	Internacional Financial Statistics
IMF	International Monetary Fund
NASDAQ	National Association of Securities Dealers Automated Quotation System
NYSE	New York Stock Exchange
MERCOSUR	Southern Common Market – <i>Mercado Común del Sur</i>
MULC	Single Free Exchange Market – <i>Mercado Unico y Libre de Cambios</i>
S&P	Standard & Poor's

1. Introduction

The issues addressed in this paper are the asymmetries in the foreign exchange framework between Argentina, Brazil, Chile and Peru, focusing on the foreign currency and foreign capital mobility policies. Financial liberalization in the capital market is expected to avoid undesired arbitrages, boost international and regional capital mobility, and promote investment. Inflows may help to smooth consumption or to accumulate capital encouraging growth. Additionally, inflows strengthen the institutional performance through technology transfer and the use of corporate government practices. Nevertheless, financial liberalization, to be successful, requires a stable macroeconomic policy environment and prudential regulations supported by efficient supervision of financial intermediaries.

There is an extensive literature regarding possible gains and risks for recipients of international capital flows. While capital controls generate distortions, overabundance of capital mobility has been in part responsible for financial crisis in emerging markets. Some authors state that *“as long as capital flows to emerging markets remain volatile and potentially disruptive, the discussion of controls in academic and policy circles will remain alive...”* (Magud et al., 2007, page 22).

Although the removal of controls increases capital mobility and therefore may foster investment, there are some facts to be taken into account. Prasad *et al.* (2006) mentions Lucas's paradox: capital does not go from rich to poor countries in the amount the neoclassical model would predict². Furthermore, in the recent years it has been flowing in the opposite direction. These authors affirm that emerging markets do not have the same absorptive capacity for foreign capital as the developed countries do. Additionally, in the former foreign capital flow produce overvaluation of the local currency, damaging their competitiveness. Carvalho *et al.* (2006) add that in less developed markets capital controls smooth exchange appreciation and allow the central bank certain dominion over its monetary policy. Additionally, capital controls provide insulation of reserves and local prices from transitory shocks in the capital account. On the other side, more developed financial markets can avoid the use of capital controls since they have substitute assets that are used to engineer financial transactions preventing the costs incurred by the capital controls.

The design of a well-functioning system of capital controls is not an easy task. If some transactions are liberalized, some controls may be averted by disguising controlled transactions as uncontrolled ones³. Although the aim of the capital control is to contain short-term capital inflows the impact foreign portfolio investment can have on financial market is correlated with the financial liberalization. That is, the possibility residents have to purchase assets and liabilities in foreign currency and the access non residents have in local financial markets⁴.

² The marginal product of a unit of capital is higher in labor abundant countries, as the less developed countries are.

³ The main disadvantages of outright prohibitions are that they may prevent sound as well as risky transactions. The use of administrative discretion, e.g., licensing system for capital flows, can soothe this matter but at a higher cost. Price-based controls, such as unremunerated reserve requirements on inflows used by Chile in the 90's and currently by Argentina, are less distorting but more difficult to administer than blanket prohibitions or quantitative restrictions.

⁴ In Brazil and Argentina the degree of financial liberalization changed after the financial crisis in each country, 1999 and 2001 respectively. While in the latter the financial liberalization was complete before the crisis, capital controls were introduced afterwards. In Brazil the process was reverse. Peru carried out liberalization policies from the nineties onwards. While Chile applied unremunerated reserve requirements since 1991 together with an exchange-rate band and revoked these measures by the end of the century (Baldini, 2001, Magalhaes *et al.*, 2007; Morris, 2008).

Nevertheless, there is consensus among some economists that financial liberalization will lead to destabilizing effects since it may foster over lending due to the restricted monitoring capacity of regulatory agencies, the deficiency of financial institutions to distinguish solid projects from unfounded ones during investment booms and the existence of explicit or implicit insurance against financing failures.

Loayza and Ranciere (2005) state from an empirical perspective that financial liberalization may generate instability in the short run, but in the long run it has a positive influence on investment and growth. Financial liberalization is not only linked with financial deepening but with financial fragility as well, displayed through systemic banking crisis, cycles of ups and downs and financial volatility. These factors explain the negative short run effect of intermediation on growth. Other authors⁵, as well, support the positive relation between growth and financial openness in the long run and the negative relation in the short run. The different explanations given regarding the channels through which this may happen have in common the fact that they link the negative short run impact of financial intermediation to the financial volatility and likelihood of banking crisis.

The path to financial development is certainly not straightforward since economic growth can experience financial fragility, intrinsic to the process of development or due to inadequate policies that hampers economic growth until maturity is attained. But as financial development promotes a deepening of markets, mobilizes a higher level of savings allocating them efficiently to investments, and allows risk diversification; in the long run it gives rise to higher economic growth.

Larrain and Lazen (2008) recognize that although Chile after liberalizing its capital account in the seventies suffered a major recession in 1982, the contrary has happened during the recent integration of Chile to world financial market. They assert that access to financial market is expected to bring the “golden dream” of consumption smoothing, isolating domestic consumption from output shocks. Their findings corroborate this statement. In fact, they show how Chilean consumption compared to output has turned out to be a more stable process since 2001.

An alternative approach to managing risks associated with capital flows is to restrict vulnerabilities of the economy to the risks related with those flows in lieu to controls. Prudential policies applied to financial institutions can help achieve this purpose by containing excessive risk-taking behavior on the part of financial institutions. These institutions are crucial to international capital transactions, since they receive foreign currency deposits, make foreign loans and investments and intermediate in cross-border transactions. Regulation in security markets plays a crucial role as well since it aims not only to reduce systemic risk, but also to protect investors and guarantee efficient and transparent markets. These markets are becoming an important source of financing of larger corporate players in developing countries. Public and private pension funds and collective investment schemes are also turning out increasingly significant in these countries.

The paper is structured as follows. Section 2 focuses on the exchange rate regimes and foreign exchange regulations on capital flows in the four countries, as well as the transactions costs when issuing securities. Section 3 deals with the recommendations. Finally, the Annex provides a brief history of the evolution of the regulations in Argentina and Brazil since the nineties.

⁵ Rajan (1994), Dell’Ariccia and Marquez (2004).

2. Regulations in Argentina, Brazil, Chile and Peru

In Argentina, the foreign exchange regulations are controlled by the Central Bank of Argentina/*Banco Central de la Republica Argentina* (BCRA). Foreign exchange transactions must be carried out through authorized entities, e.g., banks, exchange agencies, financial companies, which are subject to specific regulations. In Brazil, the National Monetary Council/*Conselho Monetario Nacional* (CMN) is responsible of formulating the general guidelines of the foreign exchange policy, and in Chile it is the Central Bank of Chile/*Banco Central de Chile* (BCC). In Peru, on the other side, by law there are no restrictions on foreign exchange transactions.

2.1 Exchange rate regimes

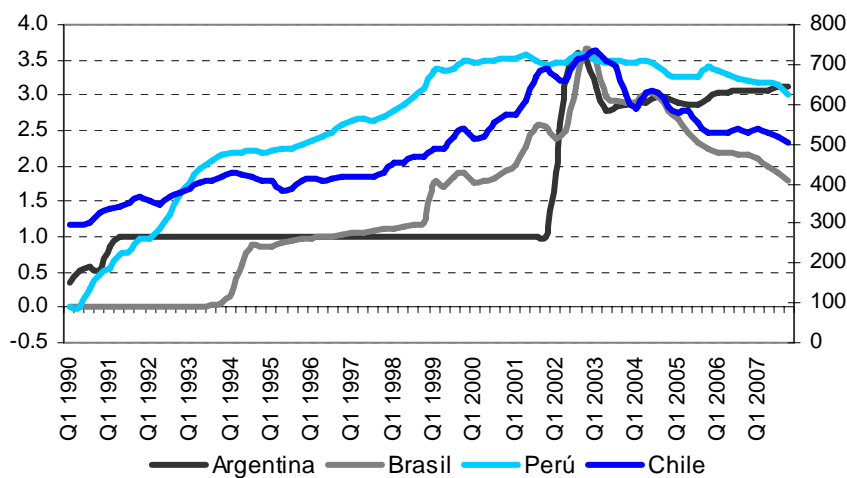
Argentina claims an independently floating foreign exchange regime. Nevertheless, due to the interventions of the BCRA in the foreign exchange market the regime could be considered a managed floating one (Chart N° 1).

Brazil's foreign exchange regime is dirty floating, since the Central Bank of Brazil/*Banco Central do Brazil* (BCB) eventually intervenes in the foreign exchange market in periods of capital flows volatility and more recently its intervention fulfills a policy of accumulation of international reserves. Transactions in the foreign exchange markets are accomplished by banks, brokers and tourist agencies allowed to operate in foreign exchange.

Chile has an independently floating foreign exchange regime, BCC interventions are uncommon.

Peru has a managed floating regime although there is no commitment to determine the exchange rate. The Central Bank of Peru/*Banco Central de Reserva del Peru* (BCRP) has intervened in the foreign exchange market to smooth fluctuations in the foreign exchange rate, sometimes with bonds indexed to the exchange rate.

Chart N° 1: Nominal US Dollar Exchange Rates
- Local currency per dollar, period average -

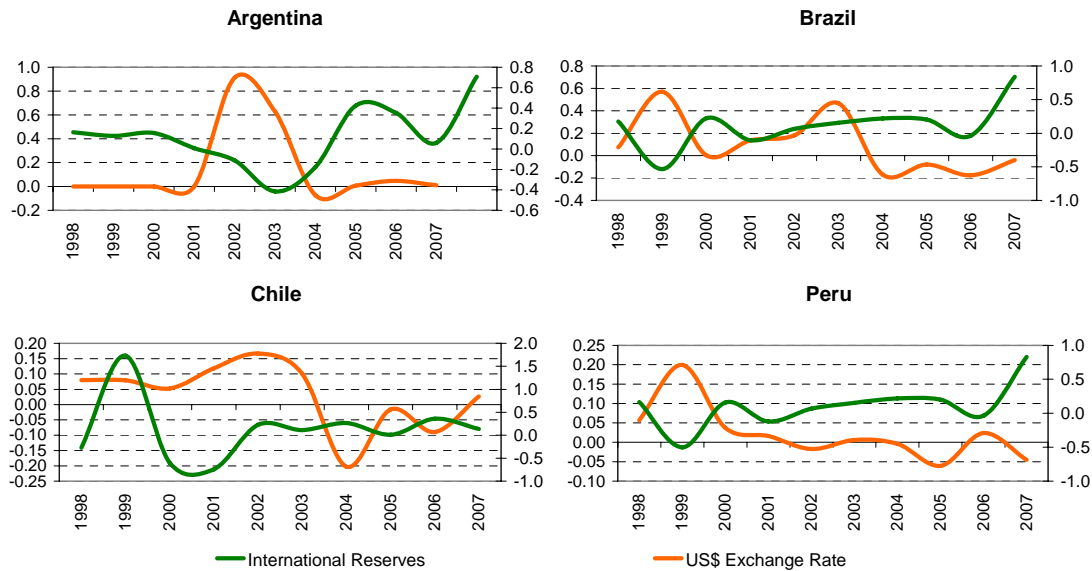


Note: Chile right axis, rest of the countries left axis.
Source: IFS

In all countries there is a single foreign exchange market.

The interventions of BCRA, BCB and BCRP have delimited the US dollar exchange rates volatility, notably in Argentina since 2004 (Chart N° 2).

Chart N° 2: Annual variation rates in US\$ Exchange Rates and International Reserves
- Local currency per dollar and International Reserves measured in US dollars -



Note: International Reserves right axis, US\$ Exchange Rate left axis.
Source: IFS.

2.2 Impact of foreign exchange regulations on capital flows⁶

2.2.1 Foreign trade payments and trade of foreign currency

In Argentina and Brazil there are repatriation requirements for exports, but not in Chile or Peru. In Argentina, exporters of goods and services are required to settle foreign exchange receipts from exports in the Single Free Exchange Market/*Mercado Unico Libre de Cambio* (MULC) within a term that depends on what is exported. In Brazil, 70% of the proceeds from exports of goods and services are subject to surrender requirements within the 365 days from the shipment date.

Additionally, there are financing requirements for imports in Argentina and Brazil. Although in Argentina, advance payment for import of goods is allowed, there must be proof that the goods have entered within a certain period of time⁷.

In Brazil, external financing of imports for periods exceeding a year must be registered in the BCB's electronic system, the Financial Operations Registry. The BCB must be informed of prepayments of import financing at least 30 days in advance.

⁶ The main source for this section has been IMF (2006-2007). For a specific review of regulations in Argentina and Brazil see the Annex, for Chile look up to Larrain & Lazen (2008), and for Peru consult Morris (2008).

⁷ The period of time is a year of the advance payment or 90 days of the spot payment.

In Argentina, exports of foreign currency (or goods import payments) exceeding US\$ 10,000 are subject to the BCRA's approval. These can only be made through entities supervised by the Superintendency of Financial and Foreign Exchange Entities. Imports of domestic currency (or foreign exchange sales to nonresidents) through outward transfers of foreign currency that surpass US\$ 5,000 per month require the BCRA's consent.

In Brazil, transfers on trade related payments for invisible transactions are ruled. The National Council on Private Insurance sets regulations on insurance and reinsurance transactions in foreign currency. For investment related payments, nonresident investments must be registered electronically at the BCB.

In Chile and Peru there are no restrictions on foreign trade payments or trade of foreign currencies.

2.2.2 Capital Transactions

In Argentina, the regulation of capital controls is quite extensive⁸. Foreign currency transactions and transfers to and from the local market must be put through the MULC. For capital inflows a 30% of the total sum is retained in a 365 day-interest-free deposit with local financial institutions for the following operations: (i) financial and non-financial private sector financial liabilities; (ii) primary issues of shares of resident companies that are neither listed nor traded in regulated markets; (iii) nonresident portfolio investment for domestic currency holdings, and financial sector and non-financial private sector assets and liabilities; (iv) nonresident portfolio investment to acquire a right in secondary markets over government securities; (v) nonresident portfolio investment allocated to the primary subscription of BCRA securities; (vi) external assets sales by private sector residents, for the surplus exceeding the equivalent to US\$ 2,000,000 per calendar month; and (vii) inflows to the local foreign exchange market allocated to subscribe primary issues of securities, debt instruments, or share certificates issued by a trust fund trustee, whenever the above requirements are applicable to the acquisition of any of the goods held in the trust.

The financing of public and private primary offering of stock or bonds listed and traded in self regulated markets, foreign trade transactions, foreign direct investment and inflows from International Financial Institutions are exempted from controls.

In relation to outflows of funds the restrictions are: (i) residents individuals and legal entities outside the financial sector may access the MULC to purchase foreign exchange up to US\$ 2,000,000 per month; (ii) foreign exchange purchases by non-residents that exceed US\$ 5,000 per month must be approved by the BCRA; and (iii) portfolio investment repatriation need the BCRA's prior consent if it exceeds US\$ 500,000 per month.

In Brazil, nonresident capital transactions must be registered electronically with the BCB. A 5% exchange tax applies to inflows associated to external loans with a minimum maturity of up to 90 days and a 2% tax to remittances due to obligations of credit card companies related to their clients' purchases.

In Chile, the exchange controls imposed in the late eighties and early nineties have been revoked as well as the minimum stay period for foreign investments. Nevertheless, some restrictions on capital transactions apply, e.g., capital transactions higher than US\$ 10,000 must be done through the formal

⁸ The Annex mentions the main BCRA's rules that define the restrictions to capital flows.

foreign exchange market and the BCC regulates foreign credit transactions denominated in local currency but payable in foreign currency.

In Peru, the capital account of the balance of payments has been liberalized since the nineties. However, capital transactions may face minimal restrictions.

2.2.2.1 Capital flows and capital market instruments: in Argentina and Brazil, specific regulations must be observed in the securities market.

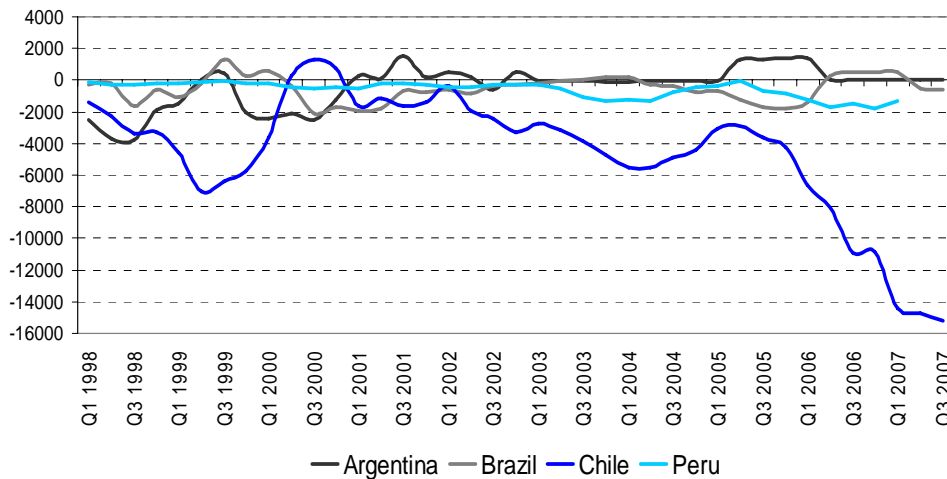
In Argentina: (i) a 30% unremunerated deposit requirement during 365 days affects the purchase of shares and bonds in the local market by nonresidents; (ii) controls apply for purchase abroad of shares and bonds by residents; and (iii) foreign exchange proceeds of issues of bonds abroad by residents should surrender within 365 days⁹ and a minimum maturity of one year is requested. On the other hand, primary issues of debt securities that are publicly offered and listed on self-regulated markets are excluded from the minimum maturity requirement.¹⁰

In Brazil: (i) restrictions apply in the purchase of shares by nonresidents in the domestic market in some economic activities; (ii) nonresidents may issue locally traded bonds only through private placements; and (iii) specific regulations apply to the transfer of funds due to the purchase of shares and bonds by residents abroad.

In Peru and Chile there are no restrictions. Currently, the Chilean portfolio investment abroad exceeds 15 billion dollars a year (Chart N° 3).

Chart N° 3: Portfolio assets

- Annualized flows in million US\$ -



Note: increase (-), decrease (+)

Source: IFS

The incidence of the flow of assets portfolio in the country's own gross domestic product (GDP) for the four countries is shown in Chart N° 4. Chile stands out above the rest. Peru follows from distance.

⁹ Communications A 3820 and A 4643.

¹⁰ Communication A 4359.

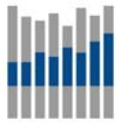
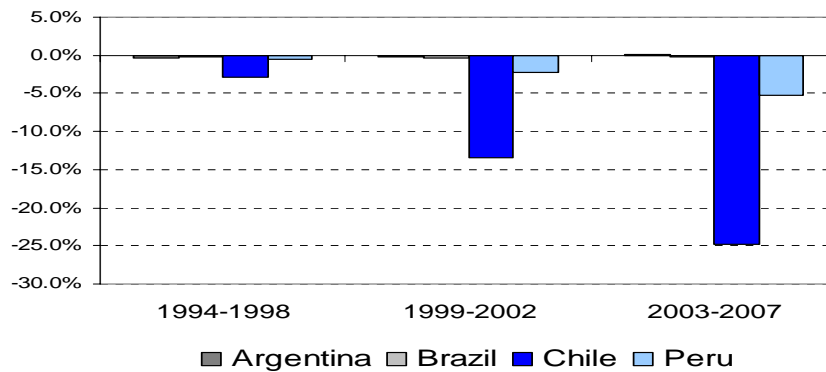


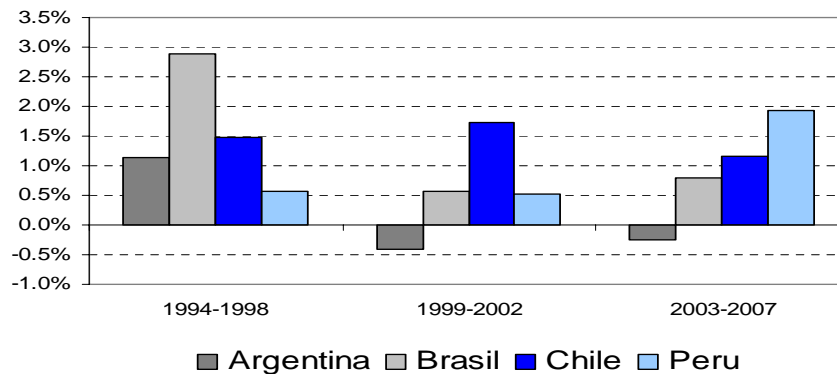
Chart N° 4: Portfolio assets as a % GDP
- Annualized flows -



* 2007 provisory
Note: increase (-), decrease (+)
Source: IFS

Chart N° 5 shows the flows of portfolio liabilities as a percentage of GDP where Peru's indicator bulges during 2003-2007.

Chart N° 5: Portfolio liabilities as a % GDP
- Annualized flows -



* 2007 provisory
Note: increase (+), decrease (-)
Source: IFS

According to Larrain and Lazen (2008), in 1990 the Compañía de Teléfonos de Chile (CTC) was the first Latin-American company to issue an ADR (American Depositary Receipt) opening the doors to other Chilean companies to list in NYSE or NASDAQ. The following year CTC also placed the first foreign bond issued by a local company. These authors state that a factor that encouraged the capacity of foreign financing by local companies was the sovereign risk rating of Chile which was given the investment grade by the rating agency Moody's in 1992 and by the rest of the rating agencies the next year. Grandes, Panigo and Pasquini (2007) show that for Latin America, on average, 40% of the variation of the cost of capital is explained by sovereign risk; and they are positively related¹¹.

The current sovereign credit rating of the countries of the sample is shown in Table N° 1, where the political and economical risk level of the investing environment of a country is assigned. Chile is the

¹¹ Also consult CEF (2007).

country better placed according to the rating agencies Moody's, Standard & Poor's (S&P) and Fitch. Recently, S&P and Fitch upgraded Brazil and Peru to the category of investment grade (IG).

Table N° 1: Sovereign risk ratings

- As qualitative assessments of the probability of default by central governments -

Rating Agency	Argentina	Brazil	Chile	Peru
Moody's ⁽¹⁾	B3	Ba1	A2	Ba2
S&P ⁽²⁾	B+	BBB-	A+	BBB-
Fitch ⁽²⁾	B	BBB-	A	BBB-

⁽¹⁾ Rating system: AAA, Aa1, Aa2, Aa3, A1, A2, A3, Baa1, Baa2, Baa3, Ba1, Ba2, Ba3, B1, B2, B3, Caa1, Caa2, Caa3, Ca, C. IG is considered if the credit rating is Baa3 or higher.

⁽²⁾ Rating system: AAA, AA, A, BBB, BB, B, CCC, CC, D. IG is considered if the credit rating is BBB- or higher.

Source: Bloomberg

According to Larrain and Lazen (2008), Chile indeed “enjoys several strong characteristics such as sound macroeconomic policies, solid institutions including supervisory agencies, low corruption and criminality rates, good connections with the rest of the world, skilled human resources, and strong local institutional investors”¹². Nevertheless, these authors recall that a certain lack of competition in the financial sectors and a high dependence of the sector's development on legislative and normative advances¹³ have made Santiago loose the leadership in financial development.

2.2.2.2 Derivatives: while in Chile and Peru there are no restrictions on derivatives operations, in Argentina and Brazil regulations have been implemented.

In Argentina, operations related to futures in regulated markets and forward transactions, if settled locally by netting in domestic currency, have no restrictions on private financial and non financial sector arrangements within the country. Additionally, futures, forward options, and other derivatives transactions that have no limits are: i) purchases of options to hedge variable-yield term deposits; (ii) foreign exchange hedging contracts by financial institutions to cover their own long positions in the general foreign exchange position; (iii) foreign exchange and interest rate hedging contracts by financial institutions and the non-financial private sector to cover foreign liabilities; (iv) commodity price hedging contracts by local exporters and/or importers providing coverage for Argentine foreign trade operations; (v) external financing transactions in the form of repos with a minimum maturity of 365 days; and (vi) hedge contracts between foreign currencies by exporters to cover the risk of shipments pending payment. These transactions must be carried out with the rest of the world through institutionalized markets in world financial centers or foreign banks that meet certain requirements and other authorized financial institutions. The rest of the transactions require the approval of the BCRA.

The derivatives operations not listed above, according to Fernandez (2008), are implicitly affected by the unremunerated reserve requirement, e.g., commodity price hedging contracts that do not cover Argentine foreign trade operations or foreign exchange hedging contracts providing coverage for Argentine foreign trade operations. This “regulatory hollow”, suggests Fernandez, pushes these operations to be settled abroad, therefore, shrinking their development in Argentina.

¹² Larrain and Lazen (2008), page 12.

¹³ Larrain and Lazen (2008) highlight the reforms introduced by other countries, such as the demutualization of the Sao Paulo Stock Exchange and the Self Regulatory Authority of the Colombian Securities Market, and point out the contrast with the delays to implement changes in the Chilean capital market regulation.

In Brazil, the banks are allowed to operate within statutory limits of the foreign exchange position and the transactions should be settled in no more than 750 days. Nonresidents have access to derivative markets if registered locally.

2.2.2.3 Foreign Direct Investment: no controls apply on foreign direct investment (FDI) in Argentina, Chile, and Peru for outward FDI. In Brazil, transfers of funds for investments abroad by institutions allowed operating by the BCB and other funds must comply with specific regulations related to prudential regulations. Outflows such as transfers and remittances require the BCB authorization, while individual and corporations have no restrictions. Nevertheless, in 2006, the FDI outflows reached a peak of US\$ 28.2 billion, overtaking for the first time the FDI inflows¹⁴. As a percentage of the GDP, Chile stands out above the sample (Table N° 2).

Table N° 2: Foreign Direct Investment – Net Outflows
- Annual average in millions of dollars -

	1994-1998		1999-2002		2003-2007*	
Argentina	-923.7		-740.1		-1077.7	
as % GDP		-0.3		-0.3		-0.6
Brazil	-484.6		-1177.4		-8242.8	
as % GDP		-0.2		-0.8		-4.1
Chile	-492.8		-2132.0		-2091.6	
as % GDP		-2.5		-11.8		-7.6
Peru	-24.9		-56.4		-50.3	
as % GDP		-0.2		-0.4		-0.3

* 2007 provisory

Note: increase (-), decrease (+)

Source: IFS

All countries have limitations on inward FDI in few economic activities¹⁵. Brazil and Chile received the largest relative growth in FDI in 2007. In Brazil, the increase was due to investments in a large variety of sectors and not to a single transaction as in previous years of FDI surges (ECLAC, 2007). As percentage of the GDP, again Chile leads the sample (Table N° 3).

¹⁴ The main acquisitions are the purchases of the Canadians mining companies Inco Ltd. and Canico Resource Corp. by the Companhia Vale do Rio Doce (CVRD) and the Bank of Boston by Banco Itaú (ECLAC, 2006, page 48). The former was not completed until 2007, although most of the payments were made during 2006.

¹⁵ In Argentina, these activities include media, Internet companies, shipbuilding, fishing, border-area real estate, nuclear power generation (US DoS, 2007). In Brazil, they are nuclear energy, health services, media, rural property, fishing, mail, telegraph, aviation and aerospace. (Heritage Foundation, 2008). In Chile, restrictions apply in areas that include coastal trade, air transport and the mass media. In the case of fishing, restrictions are subject to the rules of international reciprocity (Larrain & Lazen, 2008). In Peru, prior approval is needed to invest in banking and defense-related industries. Domestic ownership is required to invest in broadcast media, national air and water transportation or to purchase land (Heritage Foundation, 2008).

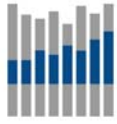


Table Nº 3: Foreign Direct Investment – Net Inflows
- Annual average in millions of dollars -

	1994-1998	1999-2002	2003-2007*
Argentina	2818.9	10252.8	3770.0
as % GDP	1.0	4.0	2.2
Brazil	6690.4	27368.5	17199.1
as % GDP	3.4	17.9	8.6
Chile	1747.5	5200.9	6919
as % GDP	8.7	28.8	25.2
Peru	921.2	1401.6	2350.6
as % GDP	7.0	10.4	12.8

* 2007 provisory

Note: increase (+), decrease (-)

Source: IFS

2.2.2.4 Entrance/Exit Barriers: The legal framework regarding the capital market in the four countries is applied to local as well as foreign companies.

In Argentina, liberalization of the banking system to the foreign institutions was promoted by the financial reform of 1977. Through Decree 1853 of 1993, foreign companies may invest in the country without registration or prior government approval as resident investors and face the same tax liabilities as local firms. Under the Argentine Securities and Exchange Commission/Comisión Nacional de Valores (CNV) regulations, foreign and local issuers meet the same requirements to make a public offering of securities¹⁶.

In Brazil, in 2000 new rules liberalized considerably equities and put foreign investors on the same level as Brazilians. Still, foreign investment in the banking sector is approved on a case by case basis (Magalhaes *et. al.*, 2007). In 1996, the insurance sector was opened to foreign investment and, in 2007, reinsurance was opened after many years of government-owned monopoly¹⁷.

In Chile, a foreign company must be legally incorporated in Chile and is considered a Chilean company for legal and tax purposes. A series of reforms including capitalization requirements and shareholder obligations have widened the range of financial services (Larrain & Lazen, 2008).

Peru is open to foreign banks and insurance companies; nevertheless investment in banking requires prior approval. The entrance and exit barriers in the security market are the ones that exist in any well regulated developed market and foreign and local investors are subject to the same regulations when purchasing or selling financial instruments (Morris, 2008).

Table Nº 4 shows the current scores of Investment Freedom and Financial Freedom for the four countries according to Heritage Foundation. While the former is a quality measure of free capital flow, mainly foreign, the Financial Freedom is an assessment of financial institutions security and independence from government control. Chile has the highest scores. Brazil and Argentina are even.

¹⁶ Both must have a permanent representative office and domicile in Argentina. Nonresident issuers must clarify whether the securities are being offered in their own country and list the information requirements to which they are submitted. Issuers of public offerings of securities domestically and abroad should present to the CNV the same information requested by the entities authorizing the public offering and listing offshore.

¹⁷ Law 126/2007.

Table N° 4: Investment Freedom and Financial Freedom

	Argentina	Brazil	Chile	Peru
Investment Freedom	50	50	80	60
Financial Freedom	40	40	70	60

Source: Heritage Foundation (2008)

2.2.3 Financial sector

This section discusses the foreign exchange regulations that have incidence on financial transactions.

2.2.3.1 Commercial banks

Some of the foreign exchange regulations that affect commercial banks are more restrictive to capital inflows than others that have a prudential nature. While the former can be found in the regulation of Argentina and Brazil, the latter prevails in Chile and Peru.

In Argentina: (i) banks may open in the domestic market time deposit accounts in dollars and euros, other foreign currencies require the BCRA approval; (ii) accounts in domestic currency held abroad are not convertible into foreign currency; (iii) when borrowing abroad, the regulations of the non financial sector apply; (iv) if lending to nonresidents, funds must be used in the country to finance investment, production, commercialization, consumption or exports; (v) lending locally in foreign exchange applies to certain operations¹⁸; (vi) there are limits to the purchase of locally issued securities denominated in foreign exchange¹⁹; (vii) differential treatment of deposit accounts in foreign currency, e.g., reserve requirements²⁰; (viii) transactions abroad by banks are restricted; and (ix) there are limits in the open exchange position.

In Brazil: (i) foreign exchange accounts held domestically are held by certain groups²¹; (ii) accounts in domestic currency held abroad are allowed only to natural persons and financial and non financial institutions, and although they may be convertible into foreign currency, they can not be used for transfers in *reais* of third parties; (iii) it is not permitted lending to nonresidents; (iv) financial institutions are prohibited from lending locally in foreign exchange; (v) purchase of locally issued securities denominated in foreign exchange are not allowed; (vi) regulations apply for investment abroad by banks or in banks by nonresidents; and (vii) there are limits in the open exchange position.

In Chile: (i) accounts held domestically or abroad are permitted; (ii) when borrowing abroad, loans with up to one-year maturity are subject to a 3,6% reserve requirement; (ii) banks may maintain accounts

¹⁸ These operations include: (i) pre financing and financing of exports; (ii) financing of investment projects or manufacturers to be exported; (iii) financing to commercial borrowers importing capital goods; (iv) debt securities or financial trust participation certificates; (v) loans made from one financial entity to another; and (vi) foreign currency debt securities or financial trust participation certificates whose underlying assets are securities in order to finance export transactions.

¹⁹ There is a maximum amount a bank may hold from an issuer and purchases of securities against delivery of assets and require the BCRA permission.

²⁰ Demand deposits are subject to a cash requirement of 19% in peso or 30% in foreign currency and a differential requirement applies for fixed-term deposits.

²¹ Certain group of residents (authorized exchange dealers, tourist agencies not allowed to deal in foreign exchange and companies that administrate credit card, companies responsible for execution of projects in the energy sector, insurance and reinsurance companies, reinsurance brokers), and non residents (embassies, international organizations, reinsurance companies, foreign transportations companies, foreign citizens in transit and Brazilians living abroad).

abroad, but not non-bank financial institutions; (iii) lending to nonresidents is subject to prudential provisions determined by the BCC; (iv) lending locally in foreign exchange is constrained to a limit on market risk exposure (interest rate and currency); (v) differential treatment of deposit accounts in foreign currency: liquid asset requirements²², interest rate controls²³ and credit controls; (vi) prudential regulations apply for investments abroad by banks. Regarding investment in banks by nonresidents, banks may issue CDs and bonds offshore; and (vii) there are limits in the open exchange position.

In Peru: (i) no regulation restraints regarding accounts held locally or abroad; (ii) banks may maintain accounts abroad but the capital income on investment abroad is subject to income tax, while domestic investments are exempt; (iii) lending to nonresidents, the same as lending to residents, is subject to prudential limits; (iv) differential treatment of deposit accounts in foreign currency: reserve requirements²⁴ and liquid asset requirements²⁵; and (v) there are limits in the open exchange position.

2.2.3.1 Institutional investors and insurance companies

Foreign exchange regulations that impact on insurance companies are far from homogeneous to be able to categorize according to its less or more restrictive nature.

In Argentina, the maximum limit on investing reserves on securities issued by non resident is the greatest of 50% of the capital requirement or of net commitments. Same applies to the maximum limit on investment portfolio held abroad, which determines the minimum limits on investment held locally. Regarding currency-matching regulations on assets/liabilities composition, insurers with liabilities derived from insurance and reinsurance contracts payable in foreign currency must set up technical reserves.

In Brazil, regulation applies to the maximum limit on investment portfolio held abroad, which is 10% of the technical reserves in investments fund shares offshore.

In Chile, the maximum limit on investment portfolio held abroad is 20% of the insurance companies' technical reserves and risk assets. There are also currency-matching regulations on assets/liabilities composition.

In Peru, the maximum limit on securities issued by non-resident and on investment portfolio held abroad must not exceed 40% of technical liabilities.

Regarding the provisions related to pension funds, countries differ in there limit to allow investment abroad. Chile is the most liberalized country regarding this issue, followed by Peru.

In Argentina, the maximum limit on investment portfolio held abroad is 10% of the resources of the fund. By the end of 2007, this limit became extensive to investments in MERCOSUR²⁶ countries.

²² Foreign currency deposits and reserves must be held in US dollars.

²³ Foreign and domestic currency loans have statutory ceilings on interest rates.

²⁴ Morris (2008) mentions recent measures taken by the BCRP in order to reduce the pressure over the foreign exchange market, which focus on the increase of minimum and marginal mandatory bank reserves for deposits in local and foreign currency and those abroad.

²⁵ A liquid asset requirement as a percentage of short-term liabilities, 8% in local currency, and 20% in foreign currency, is demanded.

²⁶ Southern Common Market/*Mercado Común del Sur*.

In Brazil, with respect to the maximum limit on investment portfolio held abroad is 50% of the reserves in shares of open companies, bonds for subscriptions to shares issued by open companies, publicly issued convertible debentures, and certificates of deposit for shares issued by companies in MERCOSUR.

In Chile, in relation to the maximum limit on investment portfolio held abroad, the amount of the investments of the five types of funds managed by the same pension fund manager in foreign securities plus the amount of their investments made abroad through mutual fund and national investment shares until now could not go beyond 35% of the value of the sum of the funds. This limit has been increased to 40% according to Larrain & Lazen (2008).

In Peru, private pension funds may invest up to 20% in foreign securities. Nevertheless, the BCRP may set a lower operational limit. This limit was in December 2005 10, 5% and has been gradually increased from 12 to 13,5%. More recently the limit rose from 16 to 20% as stated by Morris (2008).

2.3 Transaction Costs

A company faces different types of costs when deciding to issue debt or equity securities. As found in Zervos (2004) these costs are due to:

- ✓ Investment banks fees for structuring, placement and underwriting, based on issue size.
- ✓ Lawyer's fees: either local or international.
- ✓ Regulators' and stock exchange's fees, as a percentage of the issue size and issue type.
- ✓ Rating agencies fees.
- ✓ Fees due to credit enhancement.
- ✓ Marketing and publishing expenses.
- ✓ Road shows fees: local or international.

Regarding costs of operating or issuing securities in the capital market, in Argentina²⁷, Brazil and Chile²⁸, issuing equity in the domestic market is cheaper than in international markets given the need of the firms to comply with foreign regulatory standards besides the local ones in the latter. According to Zervos (2004), higher legal tariff and "other" fees, which include auditor fees and listing fees paid to the NYSE explain the difference in costs (Table N° 5) for Brazil and Chile.

The results of comparing costs between domestic debt and international debt are not so straightforward. In Argentina, the fees in the bond market are highly competitive in the local market and therefore its impact is not very different from the fees paid in international debt issues. Same applies to Brazil. The higher rating fees and legal costs of entering in the international markets are compensated by the lower investment banking costs. These costs have a greater incidence in the domestic fees given the smaller amount of the issues. The fees in Argentina and Brazil, according to the interviews, do not differ very much between each other and therefore do not determine the localization of the issue. A holding that has the possibility of issuing in Argentina or Brazil will not take the fees into account while deciding; rather it will seek the highest expected return. The implementation of corporate governance practices may also be a factor to be pondered when investing. According to Rachman (2008) the broad use of these practices in Brazil explains part of the good performance of Bovespa in recent years. But on the

²⁷ Statement based on interviews made to investment bankers, local banks and rating agencies.

²⁸ Zervos (2004) calculates the components of issuing costs for corporate debt and equity in the local market and abroad for Brazil, Chile and Mexico. All bond deals are plain vanilla and equity issues are for common share as part of an initial public offering for a firm with a minimum of a BBB rating deciding to access capital markets with a US\$ 100 million issue.

other hand, an issue to be considered is the fact that domestic institutional investors in emerging markets invest mainly in their own countries, notwithstanding rapidly growing assets under management in other countries. As described in IMF (2007a), since initiating investment abroad forces the investor to become familiar with the regulatory environment of the new market but also comply with it and maybe requires the fulfillment of a licensing process, domestic institutional investors in emerging countries usually invest primarily in their own national boundaries.

While nonresidents may deposit their Argentine securities in Euroclear²⁹ – exception applies to new series of BCRA's securities-, in Brazil, Chile and Peru foreign investors must open local custodial accounts (Chang *et al.*, 2007).

In Chile, due to the 1, 6% issuance tax in the local market, it is cheaper to issue bonds abroad (Table N° 5). As Zervos (2004) mentions, although it is cheaper to issue equity than debt domestically, corporations rely more on fixed income when accessing markets.

According to Morris (2008) findings, in Peru the cost to issue debt domestically is substantially lower. While in Brazil, Investment Banking represents more than 90% of the total cost, in Peru the incidence is much lower (25%) for a big issue. Nevertheless, this has not helped the development of corporate debt issuance in Peru. Although fees seem to be relatively low compared to other countries, Morris highlights the need to reduce them and make more transparent the information related to fees in the Stock Exchange Agents in Peru, particularly to improve access of small and medium size firms.

**Table N° 5: Category Fees as a Percent of Total Issuance Costs
Brazil and Chile**

	Equity			Debt		
	Domestic		International	Domestic		International
	Brazil	Chile		Brazil	Chile	
Investment Banking	91.2	92.4	70.5	86.9	36.6	56.2
Legal	0.3	3.1	11.1	1.1	1.8	24.7
Regulatory	0.6	0.4	0.3	1.2	0.2	0.6
Tax					58.8	
Publication	1.3	1.2	0.6	3.8	0.3	0.9
Rating	2.8	2.5	0.0	5.8	0.4	13.5
Other	3.7	0.4	17.5	1.3	0.3	4.1
Total Issuance Costs as % of US\$ 100 million issue	2.2	1.6	5.0	2.4	2.7	2.2

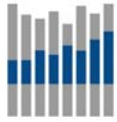
Source: Zervos (2004).

Below are the costs of issuing equities and bonds in the primary market in Argentina and Brazil during 2007 (Table N° 6). The data belongs to firms/banks with different credit range, therefore the deals are not necessarily the same³⁰ and the issue size and maturity of the deals are not uniform. These factors explain why these fees are not comparable with those shown in Zervos (2004)³¹.

²⁹ Euroclear has been used by some investors to elude the capital controls in Argentina. See note 47.

³⁰ Since the fee to be paid will be higher the riskier the deal.

³¹ For tariffs in Peru, look up to Morris (2008).



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**Table Nº 6: Costs of Issuing Equities and Bonds in Primary Market ⁽¹⁾
Argentina and Brazil - 2007 –**

	Argentina			Brazil	
	Issue Size (US\$ mm)	Fee (%) ⁽²⁾		Issue Size (US\$ mm)	Fee (%)
Equity Issuance					
Emdersa	61	4.1	Group 1	< 200	3.9
Grupo Clarín	527	2.8	Group 2 ⁽³⁾	200 - 399	4.2
Mercado Libre	333	4.5	Group 3	400 - 1000	4.3
Banco Patagonia	290	3.4	Group 4	> 1000	2.8
Edenor S.A.	379	3.5			
Weighted Average		3.5			3.6
Debt Issuance					
Banco Macro	150	0.650	GP Investments	150	1.875
Bco Rio-Santander	150	0.300	Cosan	400	0.875
Transp. Gas del Sur	500	0.325	Minerva	150	1.250
Edesur	54	\$300k	ISA Cap. do Brasil	200	0.460
			ISA Cap.I do Brasil	354	0.460
			Sul Amerca	200	1.000
			Republic of Brazil	714	0.300
			Fed. Rep. of Brazil	361	0.300
Weighted Average		0,4			0.6

⁽¹⁾ Mostly international.

⁽²⁾ In percentage, except for Edesur where the fee is thousand pesos.

⁽³⁾ Group 2 concentrates 42 issuers, 70% of the sample.

Source: based on information given by JP Morgan.

Summarizing,

- ✓ a holding that has the possibility of issuing in Argentina or Brazil seeks highest expected return, fees are not decisive;
- ✓ domestic institutional investors in emerging countries prefer to invest primarily in their own national boundaries;
- ✓ in Chile corporations rely more on fixed income when accessing markets whereas in the local market issuing equity is cheaper than debt; and
- ✓ the low cost to issue debt locally has not fostered the expansion of corporate debt issuance in Peru.

These issues put in doubt the importance of fees as decisive in the access to capital markets, at least for international issuance. It can be inferred that other factors, different than fees, are taken into account when deciding to issue debt or equity securities, the expected return was mentioned as one of them. Nevertheless, the transaction costs maybe relevant for small issues, usually domestic. As seen, the investment bank, regulators' and stock exchange's fees are a function of the issue size. This fact restricts the access of small and medium firms to capital markets.

3. Recommendations

As said in the introduction, Prasad *et al.* (2006) observe that opening up to foreign capital will bring benefits only if the local financial and the tradable sectors are mature. Nevertheless, financial integration is needed in order to foster domestic financial development. This requires the removal of asymmetries in the foreign currency markets and capital controls. The mentioned authors propose to commit to integrate financial markets at a future date, as China did in the banking sector, giving time for the local financial system to develop. This may apply for the countries of the sample, given the many asymmetries between them.

Some analysts consider impossible to have a managed exchange rate, monetary policy autonomy and open capital accounts. Magud *et al.* (2007) point out that if there is a desire to retain certain monetary policy flexibility, then something has to be put off. Sacrifice capital mobility seems a better option than surrendering monetary policy autonomy. The mentioned authors make a distinction between the instruments to be used. They state that some measures are more market friendly, e.g., reserve requirements, than others, such as sudden quantitative requirements. They also add that while capital flows in emerging markets continue to be volatile and potentially damaging, academic and politicians will keep discussing the pros and cons of capital controls.

Direct and indirect controls, prudential norms... are variants used by the countries to slow down the volatility of capital flows, the pressure over the foreign exchange rate and/or foreign shock transmissions. Chile and Peru are the most liberalized of the sample.

Although, Brazil experienced a gradual process of liberalization during the nineties that was reinforced in the current century, the country still has important restrictions - e.g., foreign investment in the banking sector is approved on a case by case basis - showing certain resistance to financial integration.

In Argentina, the liberalization of its capital account in the nineties was much more profound than in Brazil. Nevertheless, currently Argentina is the country of the sample with more capital controls and interventions in the foreign exchange market. Some economists may state that financial liberalization processes lead to crisis. Actually, the two financial liberalizations in Argentina, the first during the second half of the seventies and the second in the nineties, ended up in the crisis of 1982 and 2001, respectively (Albrieu, 2008). Regarding this issue Loayza and Ranciere (2005) argue that although financial liberalization may cause instability in the short run, in the long run a boost in growth is expected. However, they admit that the overall effect of financial liberalization on the economic activity is a combination of both impacts, where the relative incidence of financial deepening and fragility will depend on the stage of financial development of each country. The route to financial development is not necessarily smooth.

Larrain and Lazen (2008) describe the Chilean experience. While the financial liberalization during the seventies led to a slump, the recent integration to the international financial market gave way to consumption smoothing. In other words, the variance of consumption and output in Chile are no longer strongly associated. These authors assert that financial integration is not the result of simply opening the capital account. While the recession of the eighties was followed by the implementation of a prudent approach to financial regulation, the Asian crisis of the late nineties, that caused a mild depression in Chile, inspired several reforms³² that allowed a successful financial integration.

³² These reforms, implemented between 1998 and 2000 can be summarized as: (i) a commitment to run a 1% of GDP surplus; (ii) the adoption of a floating regime; and (iii) the implementation of an inflation targeting approach.

IMF (2007a) suggests that vulnerabilities are reduced through the promotion of effective regulation of domestic financial markets. In fact, an alternative approach to manage risks associated with capital flows is not to attempt to control flows directly, but to restrict the vulnerability of the economy to the risks related with those flows. Strengthening prudential policies applied to financial institutions can help achieve this aim by acting upon excessive risk-taking on the part of financial institutions and by making more robust the financial system to external shocks. Financial institutions are key parties to international capital transactions, as they accept foreign currency deposits, intermediate cross-border transactions, make foreign loans and investments. Sometimes financial institutions have exhibited extreme risk-taking behavior. By requiring more effective risk management to these institutions, prudential policies have contributed to weaken transmission and contagion. Prudential regulations do not focus on capital flows directly, but they do affect their composition, volume and volatility and may well be used to conduct capital flows. The set up and upkeep of prudential standards and effective supervision rely on public regulation and monitoring, internal practices and controls together with market discipline (Ariyoshi *et. al*, 2000).

In the four countries of the sample steps taken to strengthen bank supervision have helped to limit the riskiness of capital flows³³. Securities markets offer an alternative to bank financing by transforming savings into financing for the real sector. These markets are starting to become a source of financing of large corporate players in emerging-markets. Same applies to pension funds and collective investment schemes. Therefore, further steps to strengthen the prudential framework to capital markets and guarantee an effective enforcement will help reduce the need of capital controls. According to IMF (2007b), capital controls and prudential controls are becoming gradually intertwined as countries deregulate their financial sector and liberalize the capital account. The relationship between them requires careful study and coordination in order to put limits in the balance sheet risks while liberalizing.

³³ As per Heritage Foundation (2008), Chile's financial system is one of the most developed among emerging markets due to vast reforms, e.g., capitalizations requirements and shareholder obligations that expanded the scope of financial transactions.

4. Annex: a little bit of history...

4.1 Regulations in Argentina

After a period of strong financial liberalization during the nineties, Argentina implemented restrictions to its capital markets.

4.1.1 Exchange rate and Capital Flows during the nineties

During the nineties the Argentine government implemented a process of financial liberalization together with a monetary stabilization program, known as the “Convertibility Program”. Its purpose was to establish strict discipline on monetary and fiscal policy, eliminating the hyperinflation and reversing the process of demonetization by making legal the dollarization of the monetary and financial relations that had begun in the previous decade.

The program established a currency board fixed exchange rate of one *peso* per U.S. dollar, putting limits to the monetary policy. With the commitment to convertibility, money supply responded passively to changes in money demand. This meant that if the residents wanted to hold more domestic currency, they could exchange their foreign currency assets for local currency at the fixed rate and vice versa. Contracts could be done in foreign currency and the monetary base became a function of the variations in the international reserves or net inflow of foreign resources.

The capital inflow was the main origin of the reserves during the Convertibility period. The monetary expansion had no bounds if it was backed with dollars. The sterilization of the monetary effects of a rise in the foreign assets was limited (Redrado *et al.*, 2006).

4.1.2 Exchange rate and Capital Flows during the current century

4.1.2.1 Exchange rate

In December 2001, the Argentine foreign debt was defaulted and the bank deposits were blocked after a massive withdrawal of money by the biggest depositors. Thus, the convertibility ended. The contracts in dollars were “*pesificated*”³⁴, causing unbalances between the bank assets and liabilities. By January 2002, the *peso* lost 40% of its value. A dual exchange rate system was implemented but did not last³⁵. The foreign exchange market was quickly unified and the currency floated.

The dollar became an attractive asset, given the wide distrust on the banking system and government securities. Local financial assets were substituted by foreign assets between 2001 and mid 2002 giving way to an increase in the nominal exchange rate during the first semester of 2002 (Chart N° 6). The BCRA started to carry out transactions with securities, named *Lebac*, as an alternative to the foreign currency. In June, more controls were implemented and the foreign exchange market was intervened in

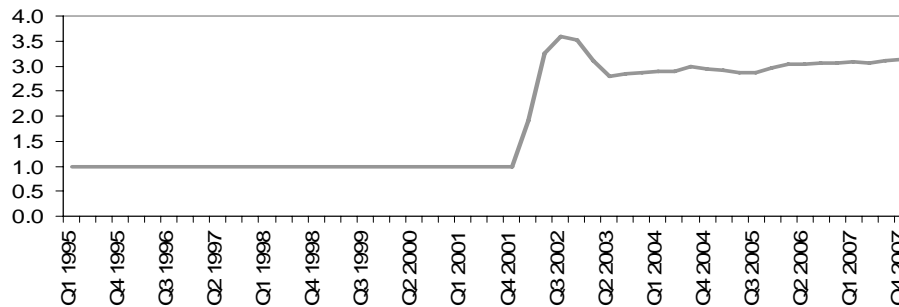
³⁴ That is a forced conversion of dollar-denominated to *peso*-denominated contracts. See US Embassy (2003).

³⁵ In December 2001, the *corralito* froze bank demand deposits, dollar- and *peso*-denominated in order to restrain the exchange rate bubble. A month later, there was an easing of the bank withdrawals restrictions followed by an asymmetric “*pesification*”: while the “*pesification*” of dollar deposits were at 1.4 pesos per dollar; the dollar debts were “*pesificated*” at market exchange rate. The *corralón* was imposed to bank term deposits.

order to stabilize the value of the peso and, therefore, expectations. The exporters were forced to settle in the BCRA the exports over one million US dollars, allowing the accumulation of reserves (Frenkel and Rapetti, 2007).

Chart N° 6: Argentina's Nominal Exchange Rate

- Pesos per dollar, period average -



Source: IFS

After reaching a maximum, the foreign exchange market began to stabilize. Nevertheless, expectations towards the appreciation of the local currency together with high interest rates increased the demand for local assets and bank deposits started to recover. The appreciation in the nominal exchange rate stopped in mid 2003 due to a public policy aimed to preserving competitiveness, while avoiding increases in interest rates. The goal was to maintain the nominal parity between the ranges \$2.85-\$3.1 per US dollar. Within an announced floating exchange regime, the BCRA has been intervening to prevent pressure for nominal peso appreciation and soften brief periods of weakening. The daily spot trading averaged US\$ 300 million, although BCRA's interventions are quite variable³⁶ since they aim to offset the seasonality of exports and accommodate money demand while accumulating reserves (Chang, J. *et al.*, 2007).

The intent to trade the nominal exchange rate within a range has been accomplished with a policy based on money creation quantitative goals. The BCRA committed to maintain the monetary aggregates within a certain range announced at the beginning of each year. The monetary policy was aimed to watch the price stability through the monetary expansion target³⁷ that appears in the monetary program (BCRA - Objectives Monetary Program).

As a result, the BCRA began to implement a less expansive policy, dealing with two objectives in conflict: the maintenance of the real exchange rate through the intervention in the foreign exchange market and the commitment to the monetary program in order to guarantee price stability (Frenkel and Rapetti, 2007).

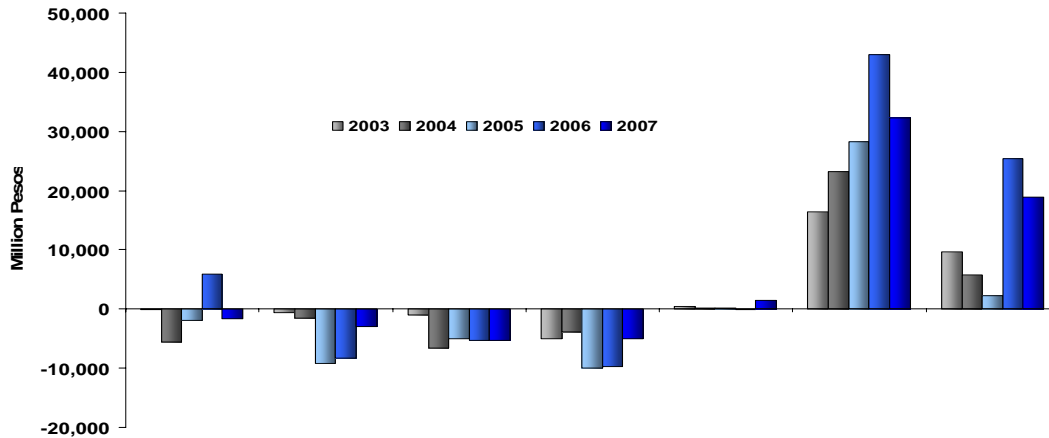
At first, the lack of liquidity and the economic recovery, gave way to a quick absorption of the expansion in the monetary base through the private sector. But during the following years the pace of monetization of the economy slowed down its growth which caused the need to neutralize the monetary "excess". The latter was due by the official intervention in the foreign exchange market. One of the main instruments to neutralize the excess of money has been the sterilization through the issuance of securities. Additionally,

³⁶ During 2007 purchases fluctuated between US\$ 4 million and US\$ 148 million (Chang, J. *et al.*, 2007).

³⁷ Between 2003 and 2005 the monetary programs committed in relation to the Monetary Base. From 2006 onwards, the aim was the M2 growth (currency in circulation, private and public sector's account in pesos, and savings in pesos).

the improvement in the fiscal account in 2003 allowed transactions between the government and the BCRA that contracted the monetary base as also did the repayment of the banks debts³⁸ through rediscounts (Chart N° 7).

Chart N° 7: Monetary Explanatory Factors



Source: BCRA - Monetary Base.

4.1.2.2 Capital Flows

In the local foreign exchange market, several regulations were applied to stabilize the expectations value of the US dollar and allow the accumulation of reserves. As mentioned in the previous section, since 2002 exporters of goods and services were required to settle foreign exchange receipts from exports in the BCRA within a term dependent on the type of exported goods³⁹. This procedure is known as “exports surrender” or “surrender requirements”.

Residents are not obliged to repatriate and settle their foreign income in the Single Free Exchange Market/*Mercado Unico y Libre de Cambios* (MULC), except for companies purchasing foreign assets for direct investment financed with foreign fund that need the Central Bank’s consent due to the amount⁴⁰.

Financial and nonfinancial private sector external loans involving securities, financial loans and external financial credit lines must be repatriated and settled through the MULC⁴¹. Private sector debt securities in foreign currency whose principle and interest services are not exclusively payable in *peso* in Argentina must be paid in foreign currency and the resulting funds settled in the MULC⁴². Funds must be repatriated within 365 days⁴³.

³⁸ These debts were carried out with the monetary authority during the financial crisis 2001-2002.

³⁹ BCRA Communication “A” 3473, 02/02. There are exemptions, only 30% of the hydrocarbon must be settled and sales of minerals are exempt (Communications “A” 3978, 07/03 and “A” 3990, 08/03).

⁴⁰ BCRA Communication “A” 3473, 02/02 and “C” 39547, 10/04.

⁴¹ BCRA Communications “A” 3712, 09/02 and “A” 3972, 07/03

⁴² BCRA Communications “A” 3820, 12/02 and “C” 46971, 01/07

⁴³ BCRA Communication “A” 4643, 04/07

The conflict, mentioned in the prior section, between the maintenance of the exchange rate through the intervention in the foreign exchange market and the commitment to the monetary program in order to guarantee price stability gave way in 2003 to the introduction of capital controls. Decree 285/03 determined that investors had to keep foreign currency flows in Argentina for a minimum of 180 days for all portfolio investments⁴⁴. In 2005, the minimum holding period for capital inflows was increased and an unpaid mandatory bank reserves over some capital inflows was implemented. This strategy was inspired in the Chilean experience during the nineties where short term capital movements were discouraged (Frenkel and Rapetti, 2007).

The strategy was implemented in June 2005 through the Executive Order 616/05 that regulated 365 day-interest-free deposits with local financial institutions. These deposits cannot be used as collateral and should be made in US dollars with 30%⁴⁵ of the equivalent in that currency to the total sum when there are foreign exchange inflows into the foreign exchange market for the following operations:

- ✓ financial sector and non-financial private sector financial liabilities, except for primary issues of debt securities listed and traded in self-regulated markets;
- ✓ primary issues of shares of resident companies that are not listed nor traded in self-regulated markets, as far as they are not direct investment funds;
- ✓ nonresident portfolio investment for domestic currency holdings, and financial sector and non financial private sector assets and liabilities, not related to the primary subscription of debt securities listed and traded in self-regulated markets, and/or primary subscription of shares of resident companies listed and traded in self-regulated markets; and
- ✓ nonresident portfolio investment to acquire a right in secondary markets over government securities.

The Resolutions 365/05 and 637/05 of the Ministry of Economy and Production added three more operations:

- ✓ nonresident portfolio investment allocated to the primary subscription of Central Bank securities;
- ✓ external assets sales by private sector residents, for the surplus exceeding the equivalent to US\$ 2,000,000 per calendar month; and
- ✓ all inflows to the local foreign exchange market allocated to subscribe primary issues of securities, debt instruments, or share certificates issued by a trust fund trustee, whether listed and traded in self-regulated markets or not, whenever the above requirements are applicable to the acquisition of any of the goods held in the trust.

If an inflow exceeds US\$ 50,000, the Tax Authority/Administración Federal de Ingresos Públicos (AFIP) must be informed in order to justify its origin⁴⁶.

In relation to outflows of funds,

- ✓ purchases of foreign exchange by residents individuals and legal entities outside the financial sector⁴⁷ may access the MULC to purchase foreign exchange up to US\$ 2,000,000 per month⁴⁸;

⁴⁴ BCRA Circular 3972. Circular 3973 eased access to the foreign exchange market to repay financing with anticipation.

⁴⁵ Some investors avoid this control entering and taking out foreign currency through bonds and shares. The investor sells the Argentine bonds operating in Euroclear instead of CAIVAL (Securities Depositary/Caja de Valores), receiving the US dollars from abroad. The opposite can be done to enter funds. Alternatively, instead of bonds, the operation can be made with the purchase or sell of Argentine shares that are quoted abroad through American Depositary Receipts or ADR (Argentine share certificate in US dollars). This mechanism is known as cash settlement/*contado con liquidación*.

⁴⁶ General Resolution 1926/2005.

⁴⁷ Communication A 4306 defines the cases in which it applies (real estate investments abroad, direct investment abroad by residents, loans to nonresidents, portfolio investments abroad, among others).

- ✓ foreign exchange purchases by non-residents that exceed US\$ 5,000 per month must be approved by the Central Bank⁴⁹; and
- ✓ portfolio investment repatriation need the BCRA's prior consent if it exceeds US\$ 500,000 per month.

All foreign currency transactions and transfers to and from the local market should be registered with the BCRA. Since December 2006, capital inflows and outflows must be registered under a person's or business name, no longer in a generic way as under the local exchange house (US DoC, 2007).

4.2 Brazil

4.2.1 Exchange rate and Capital Flows since the nineties

Although mild compared to Argentina in the previous decade, during the nineties the Brazilian government took some steps toward financial liberalization and continued doing so during the current century.

The result, according to many authors, is that the Brazilian exchange rate and capital controls legislation has turned out to be very puzzling. It gathers recent resolutions with other from the thirties. Carvalho and García (2006) summarize the main issues of the exchange rate legislation:

- ✓ foreign exchange must be converted into national currency, the only legal tender,
- ✓ foreign exchange transactions are monopolized by the BCB; and
- ✓ funds ensured abroad or mentioned in the Law 4131/62 – that regulates foreign capital in Brazil - must be brought back, as well as export revenues.

4.2.1.1 Exchange rate

In relation to the exchange rate policy regime, the decade of the nineties can be separated in two periods. The first, between 1990 and 1994, was characterized by a crawling peg exchange rate regime with nominal daily devaluations followed by a policy of high real interest rates. The following period, during the *Rea*/Plan, the nominal anchor -a crawling exchange rate band- was used to stabilize together with a strict monetary policy (De Paula, 2007).

The floating exchange rate market and the commercial segment that concentrated the commercial and financial accounts, created in 1988 with the aim to take foreign exchange operations in the “black” segment to a regulated market⁵⁰, were aligned in 1996 and unified in practice in 1999 (Goldfajn and Minella, 2005).

In 1999, the *rea*/was devaluated and since then the BCB eventually intervenes in the foreign exchange market in periods of capital flows volatility and more recently its intervention fulfills a policy of accumulation of international reserves but is not committed to determine the exchange rate. The

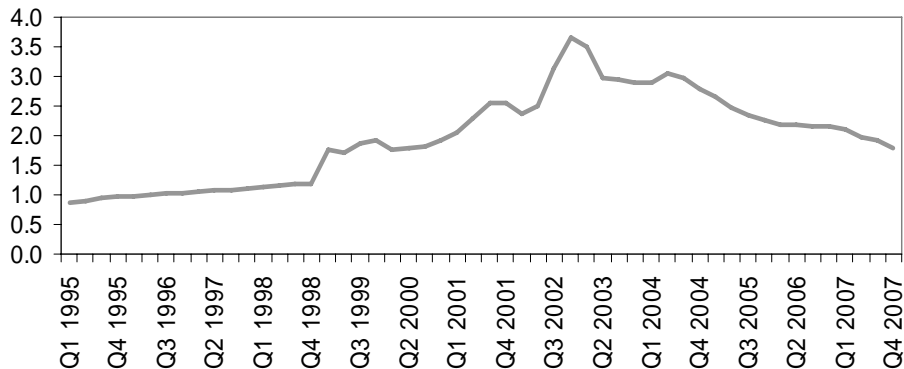
⁴⁸ The ceiling can be exceeded in few cases, e.g., pay external debt within 360 days and subscribe primary issues in foreign currency of public debt.

⁴⁹ There are exceptions listed in Communication A 4129.

⁵⁰ Since the sixties, foreign currency only could be accessed through imports and remittances associated with inflows registered priory, giving way to an increasing “parallel” foreign exchange market.

economic policy since January 1999 is based on a floating exchange rate regime, inflation targeting regime and the generation of primary fiscal surpluses, resulting in lower interest rates compared to the previous period. The combination of inflation targeting, floating exchange regime and the opening of the capital account has led to a considerable volatility of the nominal exchange rate according to De Paula (2007) as seen in Chart N° 8.

Chart N° 8: Brazil's Nominal Exchange Rate
- Real per dollar, period average -



Source: IFS

At the beginning of 2005, the BCB announced the unification of the foreign exchange markets⁵¹, the Free Rate with the Floating Rate Exchange Market, and although the *real* remains a non-convertible currency the procedures to convert local currency into foreign currency have been simplified (Siqueira, 2007). Foreign exchange transactions must be done through authorized financial institutions and reported to the BCB (Chang, J. *et al.*, 2007).

4.2.1.2 Capital Flows

The core of the legislative framework (that dates from 1930s) is that the local currency, the *real*, is the only legal tender, therefore, payments in foreign currencies are not allowed,⁵² neither are banking deposits in foreign currencies.⁵³ (Goldfajn and Minella, 2005).

The Decree 20452/31 granted the BCB the monopoly of foreign exchange transactions, imposing the so called "centralization of foreign exchange transactions. The Decree 23258/33, still in effect, consolidated the foreign exchange policy through the demand of converting the export revenues into local currency (export surrender). The netting of payment is not permitted; exporters must first convert their income into *reales* before paying any foreign debt or import⁵⁴ (Carvalho and García, 2006).

⁵¹ Resolution 3265.

⁵² Decree 23501/33, supplanted by Decree-Law 857/69. The Provisory Measure 1053/95, later Law 10192/01, reasserted these constraints.

⁵³ Exceptions apply to foreigners transitorily in the country or Brazilians living abroad; embassies and international organisms; companies from certain sectors (oil, electric energy, insurance, foreign cargo, Brazilian postal service); institutions that deal in the floating foreign exchange market.

⁵⁴ Decree-Law 9025/46.

The main parts of capital flows legislation were introduced in the 1960s⁵⁵ to regulate loans and FDI and remains till today with few changes. Foreign capital inflows should be enrolled and income tax paid previous to obtain permission for associated outflows registered priority, e.g., royalties and capital gains. (Goldfajn and Minella, 2005).

The first change in the capital regulation since the sixties towards capital account liberalization occurred in 1987 with the BCB's Resolution 1289⁵⁶ that provided incentives for foreign investments through the exemption of the income tax on capital gains in Brazil. Portfolio inflows were possible through foreign capital investment companies and funds and also stock and bond portfolios (Annexes I to III). In 1991, the securities market was liberalized to foreign institutional investors (Annex IV) (Goldfajn and Minella, 2005).

Specialized investment funds were created as an alternative for nonresident individuals to invest in the domestic share market. These funds were subject to application criteria and taxes when entering in the country and on capital gains⁵⁷. The resources should be invested in fixed rent bonds, with a minimum percentage in public bonds (Magalhaes *et. al.*, 2007).

The foreign investors had access to the Brazilian financial market through the nonresident accounts of the floating exchange market or CC5. In 1992, the BCB allowed foreign financial institutions to operate more freely with the CC5 accounts. As a result, these accounts turned out to be the main channel of short term capital flights in periods of speculative attacks against the local currency⁵⁸ (Goldfajn and Minella, 2005).

The nineties were characterized by periods of abundant capital inflows (1992-1995 and 1996-mid 1997) and of shortage of flows due to international crisis during the following years. Between 1993 and 1996, the monetary authority adopted restricted measures on capital inflows. These measures were a rise in financial transaction tax on capital inflows and in the minimum maturity requirements for these flows, and other quantitative restrictions on portfolio investments⁵⁹. FDI were not covered by these measures.

At the same time, measures aimed to stimulate outflows including the permission for prepayment of foreign borrowing and import finance. The Brazilian Depositary Receipts regulation gave way to Brazilian investment abroad through the purchase of securities of nonresidents companies in Brazil and the creation of foreign investment funds to purchase debt securities by residents in international markets.

With the Asian and Russian crises in 1997 and 1998, followed by the Brazilian foreign exchange crisis, capital controls on inflows were relaxed. The restrictions imposed in 1993-1996 were gone by 1999 and Brazil floated its currency. Brazil adopted a clear trend toward liberalizing the capital account, e.g., in August 1999, the Financial Operation Tax/Imposto sobre Operacoes Financeiras or IOF tax was lifted for fixed income foreign investments of over 90 days that were previously under Annex IV. In November,

⁵⁵ Law 4131/62, Law 4390/64, Decree 55762/65.

⁵⁶ Resolution 1289 was revoked by Resolution 2689 in 1999.

⁵⁷ The most important specialized investment fund was the Fixed Rent Foreign Capital Fund/Fondo de Renta Fija Capital Extranjero. Other funds were created to purchase corporate bonds of firms being privatized, investment funds of emerging firms and real estate investment funds.

⁵⁸ Residents in Brazil could make deposits in nonresident's bank account held in the local banks allowed to convert from local to foreign currency and buy foreign currency transferring the money abroad through the nonresident financial institution and depositing it in an account abroad, giving way to a *de facto* convertibility.

⁵⁹ Foreign investment under Annexes I to IV were forbidden to channel resource to fixed-yield bonds and debentures, restrictions were imposed on investment in derivatives as well as certificates of privatization and related securities, financial investment funds, and futures and option markets (Goldfajn and Minella, 2005).

Brazil accepted the obligations of the VIII Article of Agreement of the IMF⁶⁰. This article prevents the country members from applying restrictions on payments and transfers for international transactions and discriminatory currency arrangements (Goldfajn and Minella, 2005) and (De Paula, 2007).

The Resolution 2689/00 ruled out differences in the application through the commercial foreign exchange segment. New form of investment in the financial market were introduced, e.g., the same requests for residents operations were applied to nonresident investors, including the financial derivative market that had been permitted up to then only to residents (Magalhaes *et al.*, 2007). In Annex V of Resolution 2689 there are rules for Depositary Receipts, when shares of Brazilian companies are issued abroad with counterpart shares in Brazil (Carvalho and García, 2006).

The results of the financial liberalization are shown in the indexes⁶¹ reproduced in Charts N° 9 and N° 10.

Chart N° 9: Capital Inflows Control Index

- Jan/83=100 -

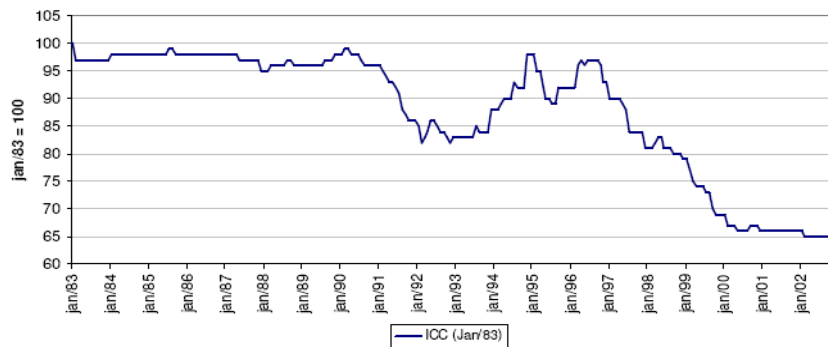
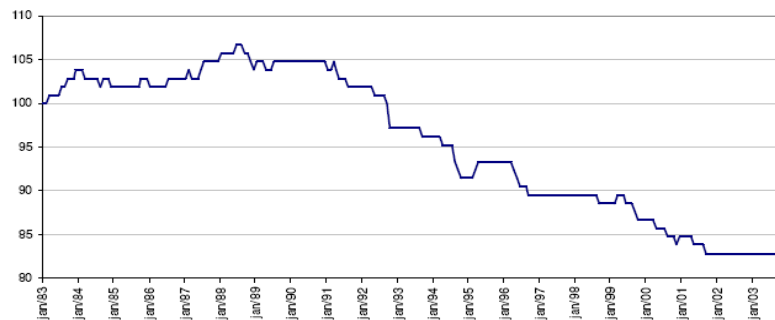


Chart N° 10: Capital Outflows Control Index

- Jan/83=100 -



Source: Carvalho and García (2006)

At the beginning of 2005, the currency legislation was simplified with the aim to reduce costs of capital flow in Brazil and correct asymmetries of legislation governing currency transactions with other countries. New regulations were published, although the legal framework remained. The foreign exchange markets were unified and the CC5 accounts were removed. The restrictions to convert domestic currency into foreign currency and send them abroad were lifted (Carvalho and García 2006; Magalhaes *et al.*, 2007).

⁶⁰ Argentina had done so in May 1968.

⁶¹ The methodology, based on Cardoso and Goldfajn (1997), consists in adding a 1 to the base index if the control restrains a capital inflow or outflow and subtracting a 1 if it releases it.

Although export income is still strictly regulated, the period to bring the revenues to the country has been extended. In March 2005, the term was prolonged from 180 to 210 days after shipping⁶². Currently, the period is 360 days⁶³, nevertheless since August 2006, exporters can maintain abroad the maximum of 30% of their exports income⁶⁴ (Siqueira, 2007).

In February 2006, the Temporary Measure 281 concessions of fiscal incentives were sanctioned in order to encourage foreign investors to buy local public debt bonds⁶⁵ (Magalhaes *et. al.*, 2007).

In spite of the gradual liberalization in Brazil, there is not totally unrestricted convertibility⁶⁶ and current convertibility, as Goldfajn and Minella (2005) mention, is based on monetary authority's rules, not laws, and can be lifted at any time⁶⁷. Exports are required to settle in the foreign exchange market and there are restrictions on foreign currency deposits. Residents and nonresidents cannot have deposits or loans in foreign currency in local banks, although there are exceptions, such as public bonds indexed to the exchange rate and credits with exchange rate adjustments (Magalhaes *et. al.*, 2007).

In the current century, under the new floating foreign exchange regime nonresidents are finally allowed to invest in the same instruments in the financial and capital markets as residents⁶⁸. The prior approval of external loans by the BCB has been eliminated: the current registration process for capital flows is a documentary requirement instead of part of an active authorization process. Nonetheless, the BCB must approve direct investment outflows in some cases, including transfers and remittances (Heritage Foundations, 2008).

The foreign exchange regulations in Brazil have been the result of macroeconomic conditions and a turn in the ideology of policy makers towards liberalization and, as Goldfajn and Minella (2005) suggest, a unification of the whole regulation in a single law approved by Congress and further reduction in bureaucratic requirements are pending.

⁶² Resolution 3266/05.

⁶³ RMMCI, Chapter 11.

⁶⁴ This 30% does not pay the Provisional Contribution on Financial Movement (CPMF).

⁶⁵ Since January 2000, the purchase of public and fixed rent bonds by foreign investors was allowed through Resolution 2689. Nevertheless, the high taxes (rent tax, IOF and CPMF), bank commissions, and the possibility of alternative options, e.g., derivatives related to the real interest rates, have made these investments less attractive.

⁶⁶ Certain operations, such as investments through financial institutions and funds, pension funds, others, must follow specific rules (Siqueira, 2007).

⁶⁷ The article of the Law 4131/62, which remains in force, states that, "*Any time there is extreme imparity in the balance of payments, or serious grounds for assessing there will be, the National Monetary Council may impose restrictions, for a limited period of time, on the entry and exit of revenues in foreign currency, and to this end, grant the Banco do Brasil a complete or partial monopoly on foreign exchange transactions*" (Carvalho and García, 2006, page 5).

⁶⁸ Resolution 2689/00.

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