BANCO DE ESPAÑA
Eurosistema

REINVENTING BRETTON WOODS COMMITTEE

INTERNATIONAL FINANCIAL INTEGRATION AND FRAGMENTATION: DRIVERS AND POLICY RESPONSES

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The new conditions facing emerging market economies (EMEs) create new challenges

Increase in global liquidity

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Improved quality of EME assets

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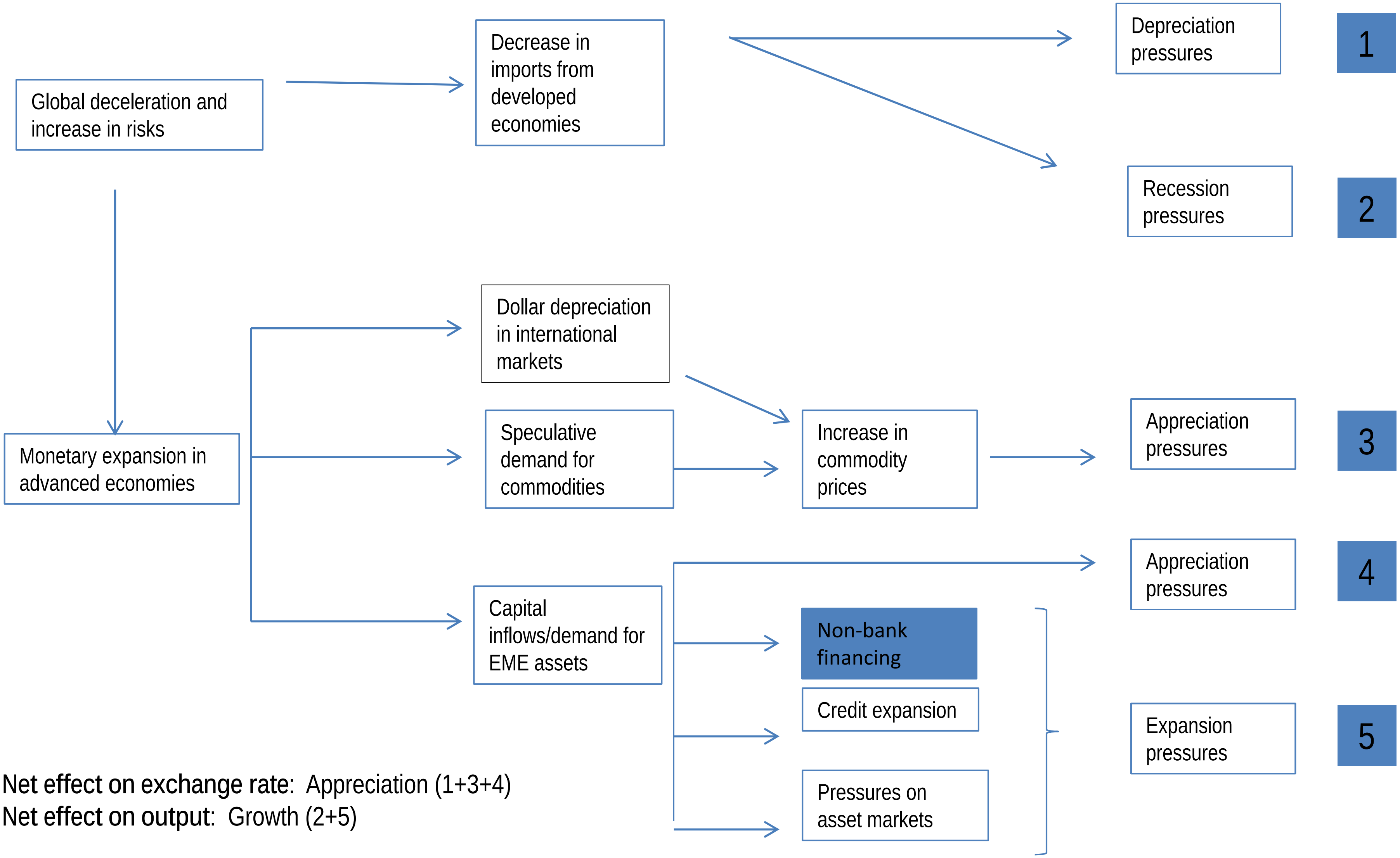
Changes in the composition of external financing.

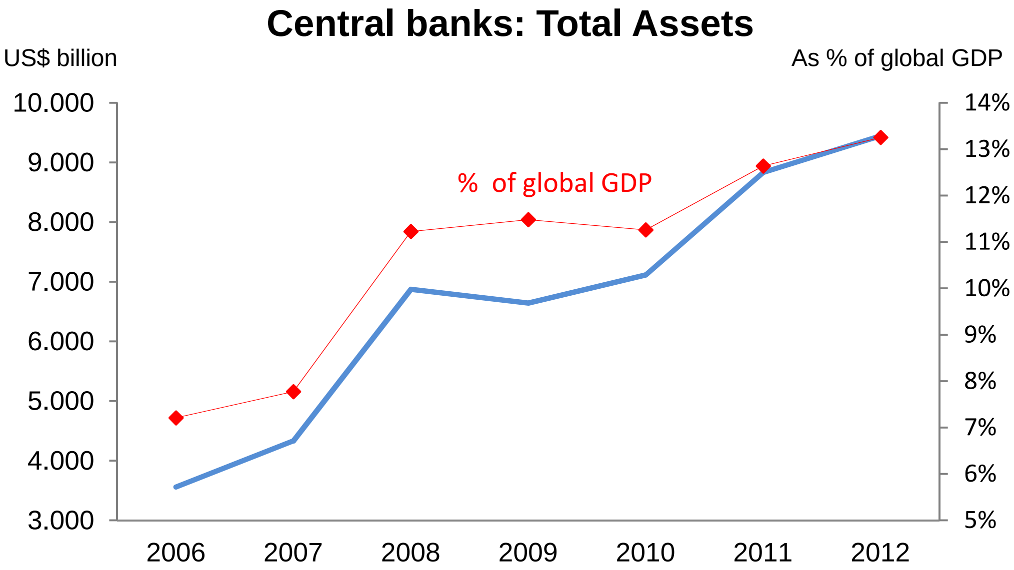
New policy dilemmas in EMEs

Transmission channels to EMEs

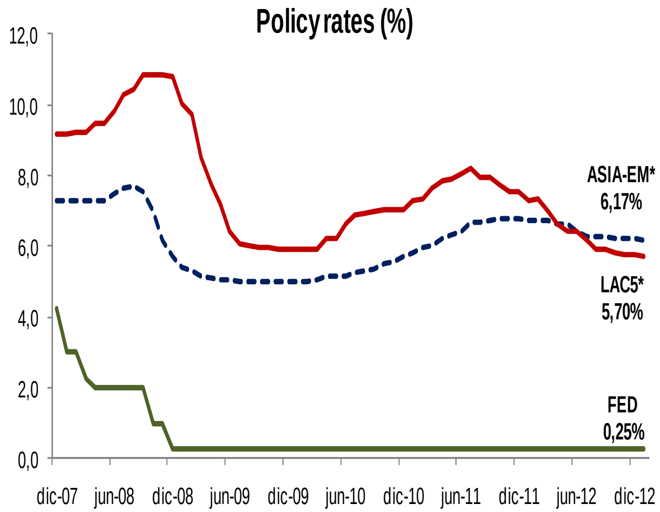


Net effect on exchange rate: Appreciation (1+3+4)
Net effect on output: Growth (2+5)

International money markets are currently dominated by record global liquidity and high interest rate differentials in favor of EMEs.

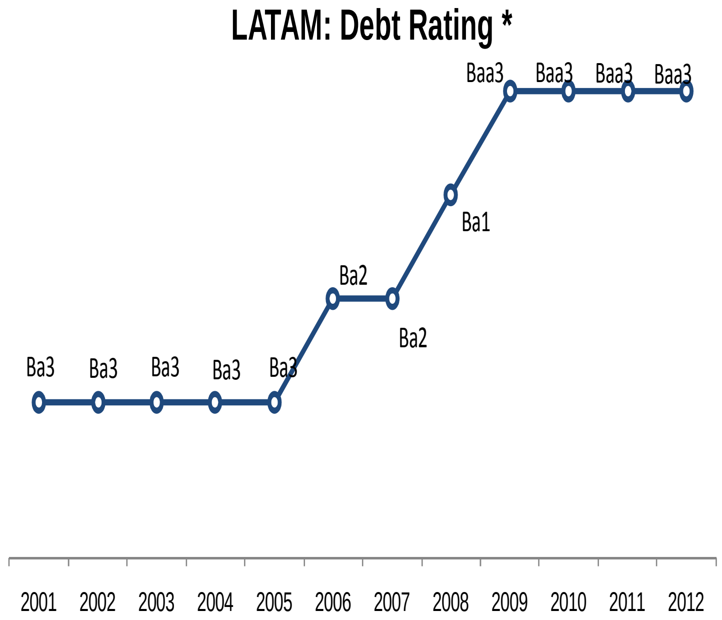


Includes FED, ECB, BoE and BoJ



(*) Includes Brazil, Colombia, Chile, Mexico and Peru.
(**) Includes China, India, Indonesia, Philippines, Malaysia and Thailand.

In contrast with past decades, Latin America's improved fundamentals have put the region on the investors' radar.



*Moody's debt rating: median for Argentina, Brazil, Chile, Colombia, Mexico, Venezuela, and Peru.

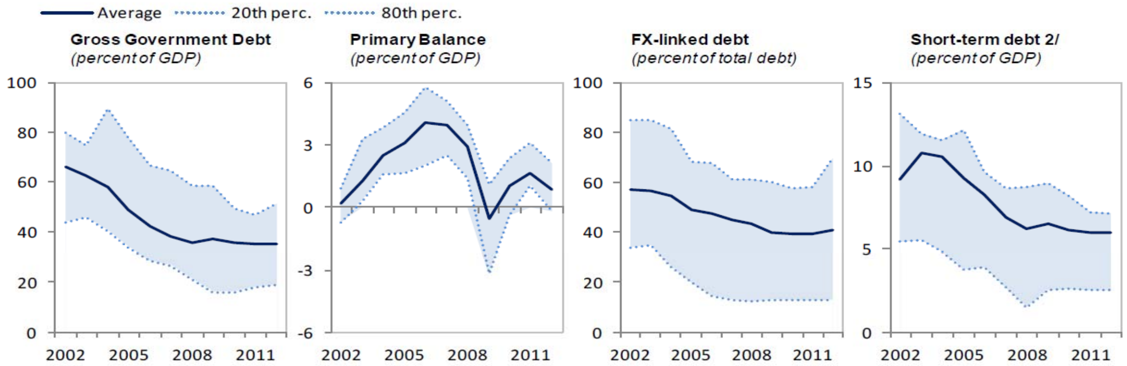
a. Eight Latam economies improved their credit rating in the pre-crisis period (2001-2007). Six continued to improve during the crisis.

b. As of 2001, Moody's had given investment grade only Mexico and Chile. Today, six Latam economies have it (Chile, Mexico, Peru, Brazil, Uruguay, Panama, Colombia, and Costa Rica)

c. As of 1981, only eleven emerging economies were rated by Moody's vs. 82 today.

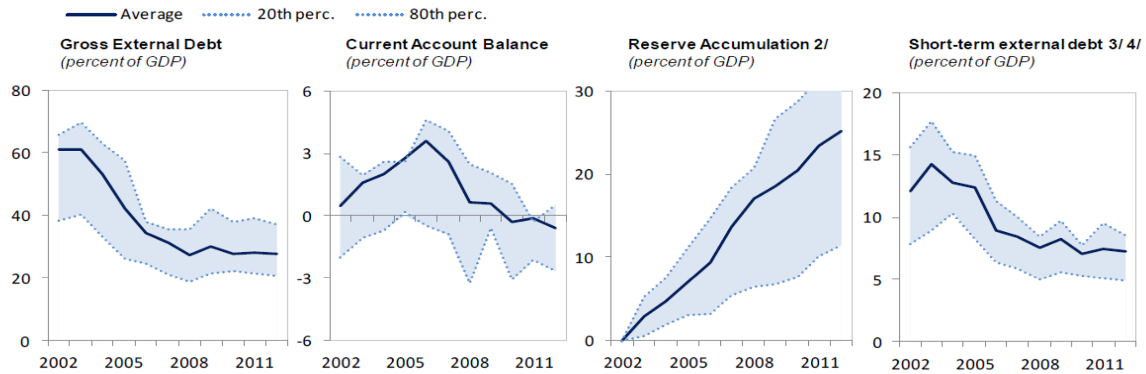
Low inflation, sustained growth, and a solid fiscal and external position support improved market sentiment.

Figure 1. Latin America. Key Fiscal Indicators, 2002-12 1/
(simple average and 20th and 80th percentiles)



Sources: IMF *International Financial Statistics*, and country desks.
1/ Latin America includes Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay and Venezuela.
2/ Excludes Bolivia and Paraguay.

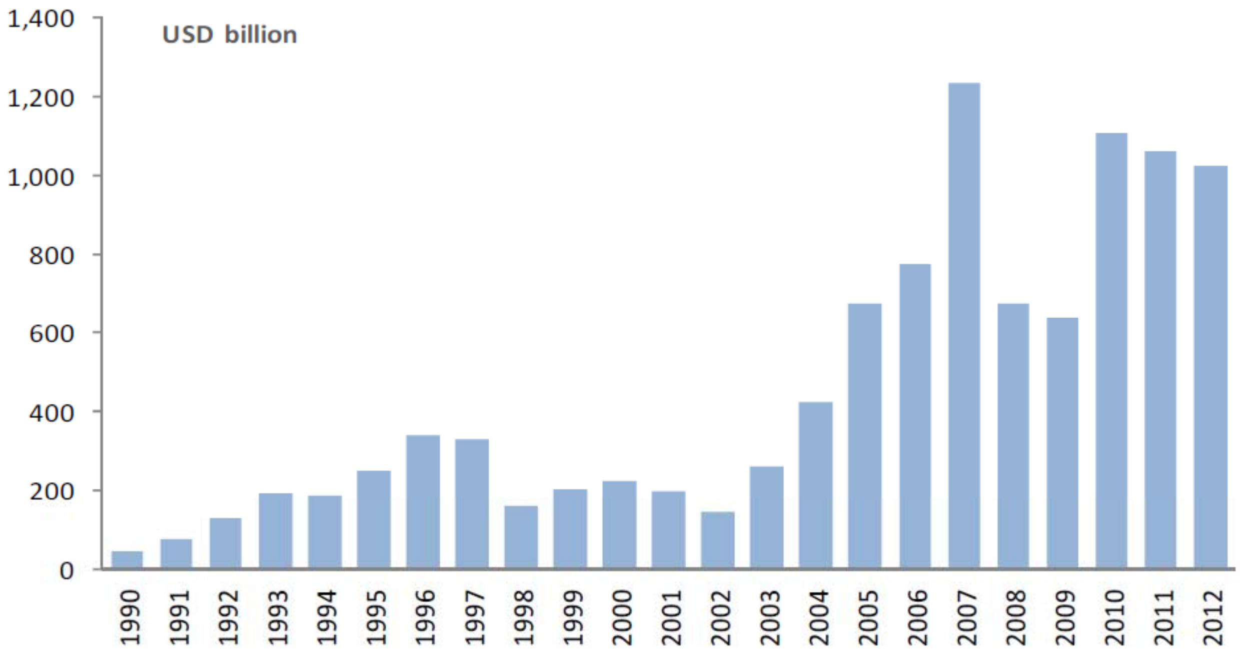
Figure 2. Latin America. Key External Indicators, 2002-12 1/
(simple average and 20th and 80th percentiles)



Sources: IMF *International Financial Statistics*, and country desks.
1/ Includes Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay and Venezuela.
2/ Cumulative flow of gross international reserves since 2002.
3/ At residual maturity.
4/ Excludes Bolivia and Paraguay.

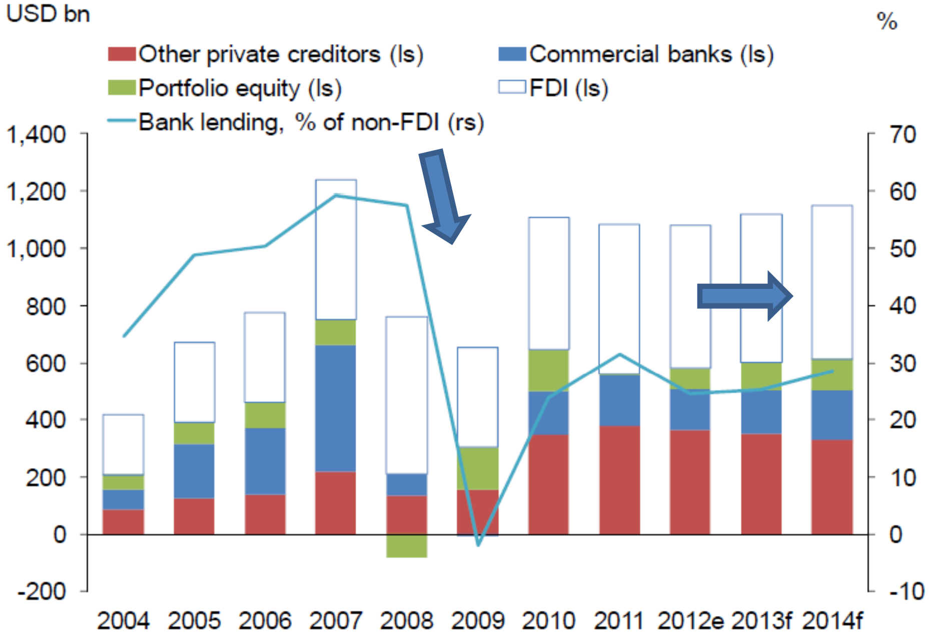
In this context, capital inflows are back to historical peaks, although with a different composition.

Net capital inflows to emerging market economies

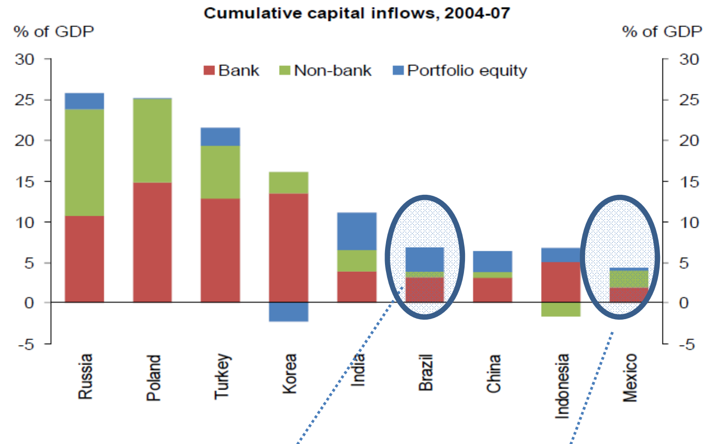


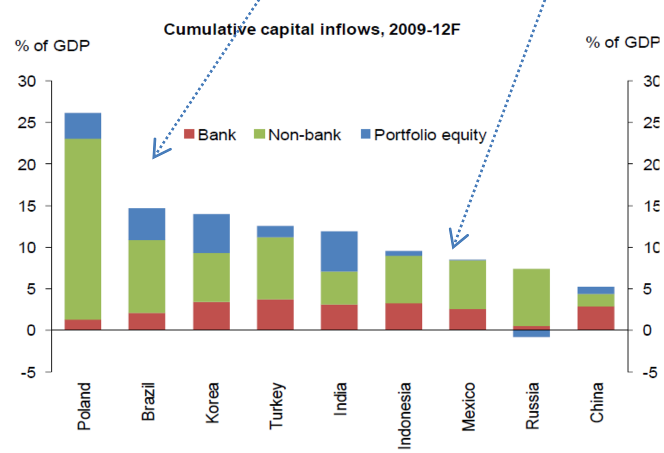
Source: IIF, DB.

Within these flows, bank credit (relative to other financial flows) has not recovered to pre-crisis levels.



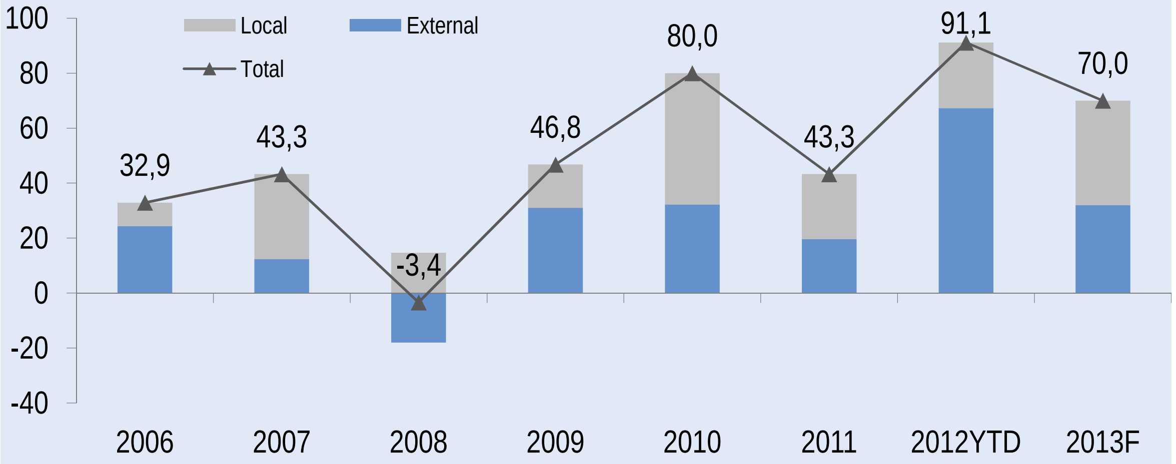
Source: IIF, Deutsche Bank.



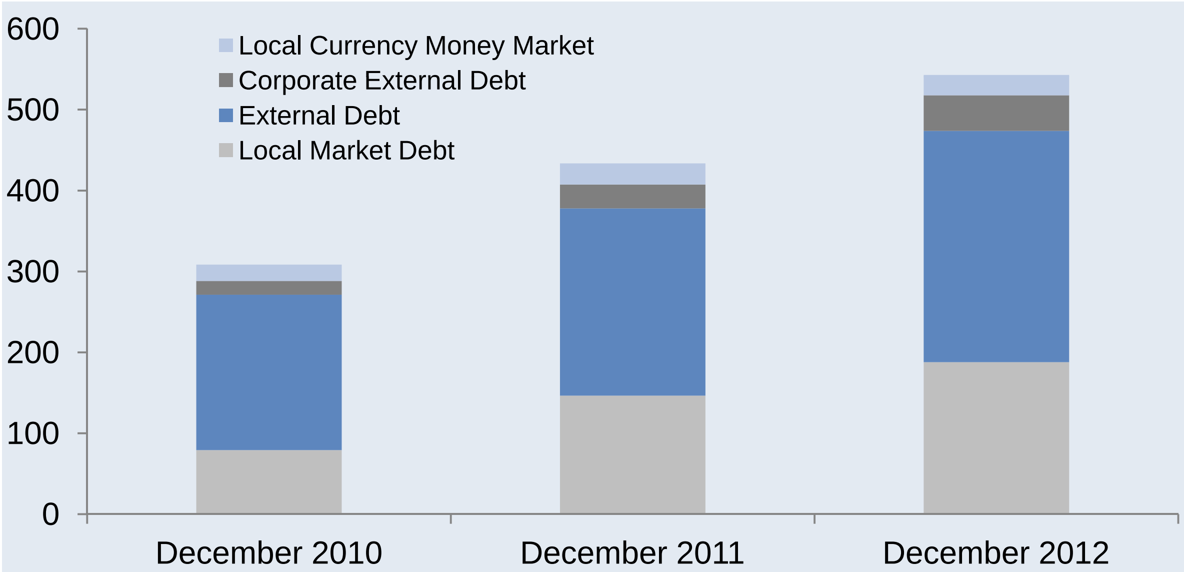


According to JP Morgan, flows into EME currencies are likely to increase in 2013

EM fixed income fund inflows (US$ bn)



Total AUM benchmarked to J.P. Morgan EM indices (US$ billion)

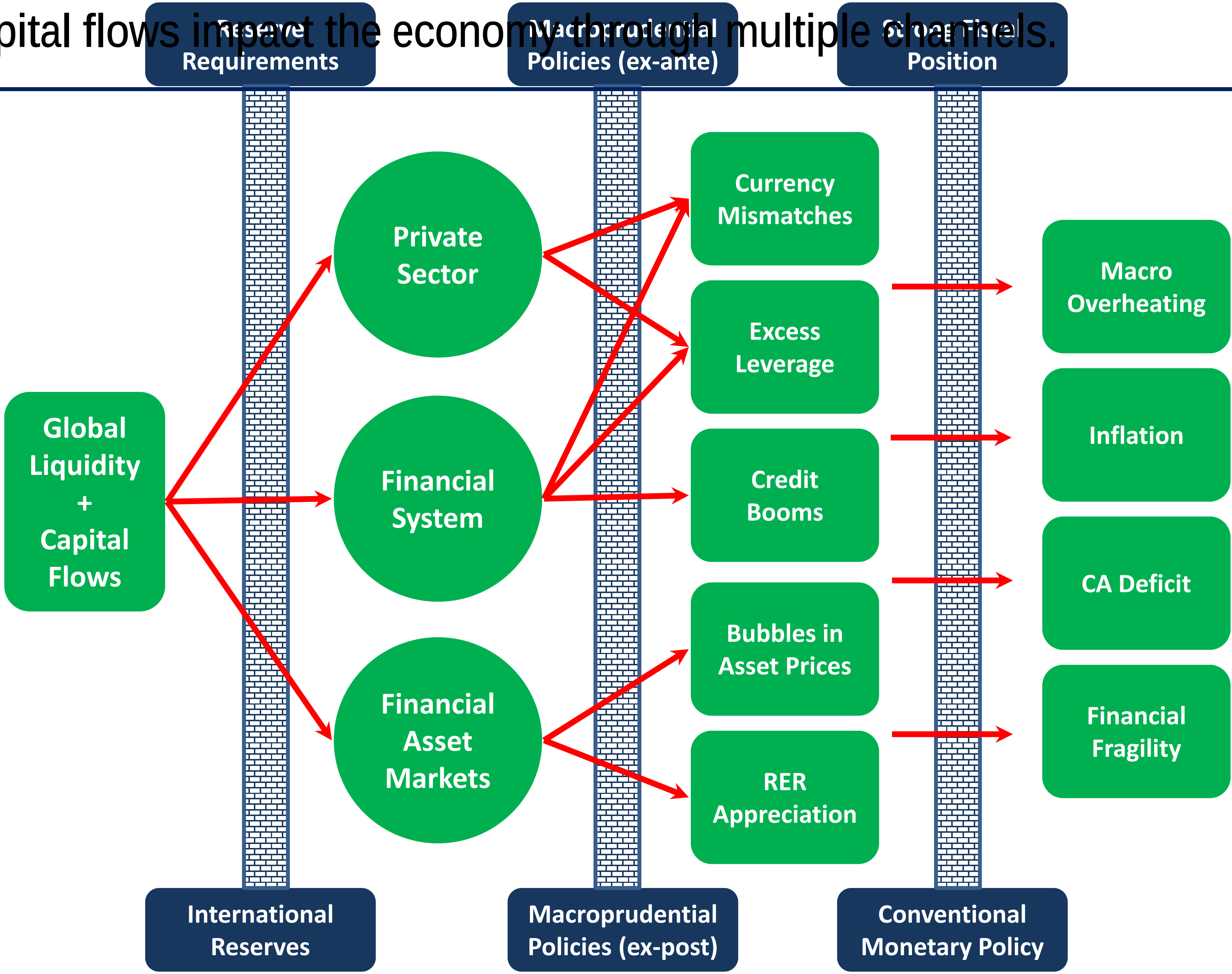


Bankers on Wednesday's dollar deal were primarily targeting "mainstream" US funds that focus on investment grade bonds, but it was expected to attract interest from hedge funds and some cash-rich emerging market fundas and taking off-benchmark positions, given the paucity of dollar-denominated sovereign supply in emerging markets

Financial Times, February 20.

Source: JP Morgan.

Capital flows impact the economy through multiple channels.



Preserving the benefits while controlling the risks of capital flows.

- Limiting short-term, volatile, capital flows without generating too much incentives to shadow banking is challenging.

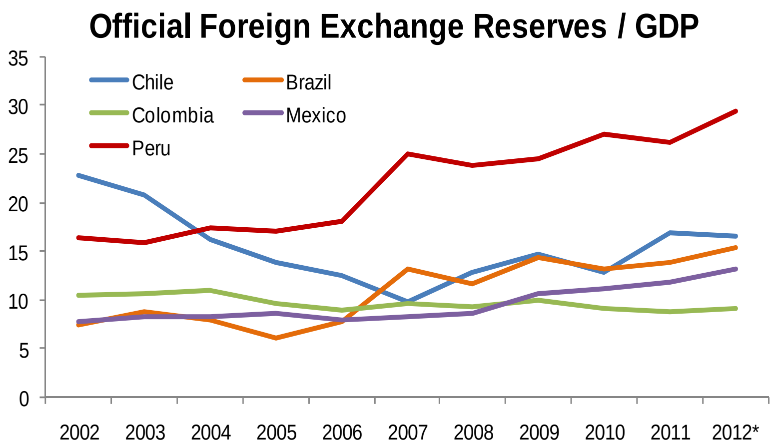
- Both foreign investors and domestic recipients are constantly innovating in order to bypass/elude regulation.

- Thus, Central Banks and regulatory agencies have to monitor the market closely, in order to adapt prudential policies accordingly.

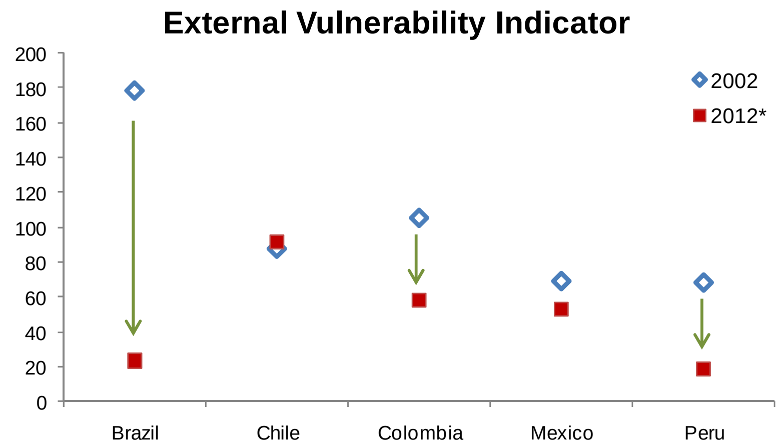
Preserving the benefits while controlling the risks of capital flows.

- A strong fiscal position can contribute to limit vulnerabilities by:
  - Reducing appreciation pressures on the equilibrium real exchange rate.
  - Offsetting excess demand generated by capital flows.
  - Strengthening fiscal buffers against the risk of “sudden stops”.

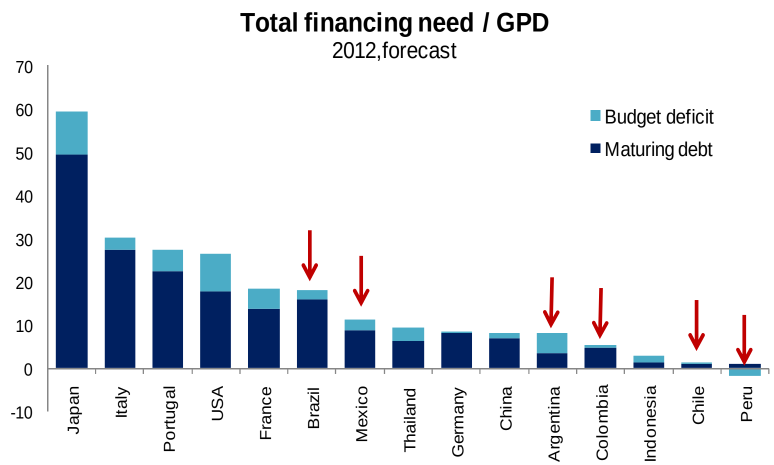
In this context, LAC countries are improving their fiscal and external positions to face potential capital reversals.



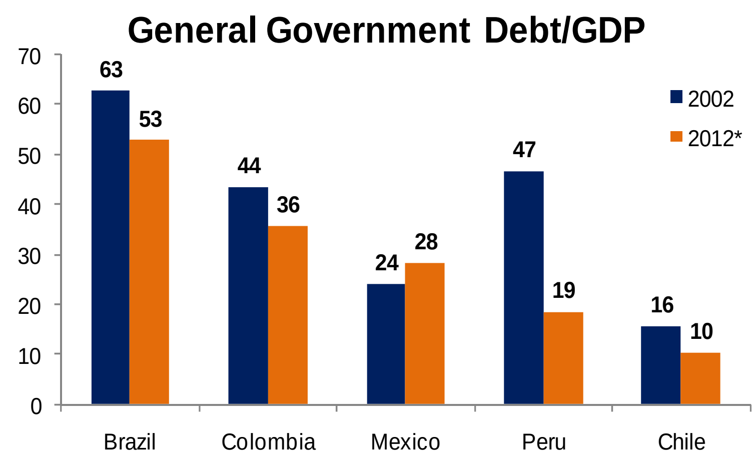
*Forecast.
Source: Moody's.



*Forecast.
Source: Moody's.



Source: IMF.



*Forecast.
Source: Moody's.

Prudential measures: most Latin American economies had implemented precautionary rules even before the current surge of international capital inflows.

	Measures\Countries		Argentina	Bolivia	Brazil	Chile	Paraguay	Peru	Uruguay
Foreign Exchange Interventions	Foreign exchange market intervention	Spot	✓	✓	✓	✓	✓	✓	✓
		Forward	✓		✓				✓
		Swap transactions			✓				
Macroprudential Policies	Reserve requirements			✓	✓			✓	
	Modifications to net FX position limits			✓	✓ 1/		✓ 2/	✓ 3/	
	Modifications to capital requirements				✓				
	Increase in the limit on investments abroad	Private Pension Funds				✓		✓	
		Insurance Companies		✓					
	Taxes, charges, and limits on entry/exit of international capital flows	Entry		✓					
		Exit	✓	✓					
	Taxes and charges on domestic asset holdings	Central Bank Notes						✓	
		Fixed Income Notes			✓				
		Variable Income Notes			✓				
		FX Forwards						✓	
	Non-remunerated deposits as percentage of capital inflows		✓						
	Limits on the permanence of capital flows		✓						

1/ Limit: the lowest of US$ 3 bn or the level of regulated equity in the FX short position.

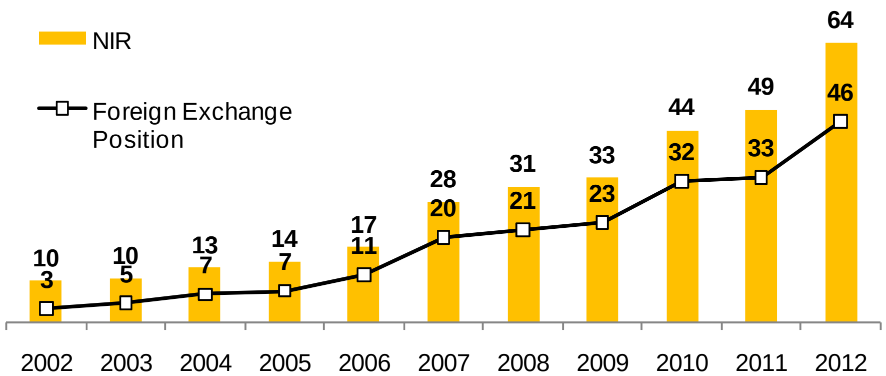
2/ Increase in the net FX position-to-effective equity ratio.

3/ Decrease in the aggregate FX over-purchase position and the net FX derivate position relative to the effective equity.

Source: central bank websites and other reports.

Official reserve accumulation and the declining dollarization of public debt have reduced Peru´s exposure to foreign shocks.

Net International Reserves and Central Bank's Foreign Exchange Position: Peru
(in billions of USD)



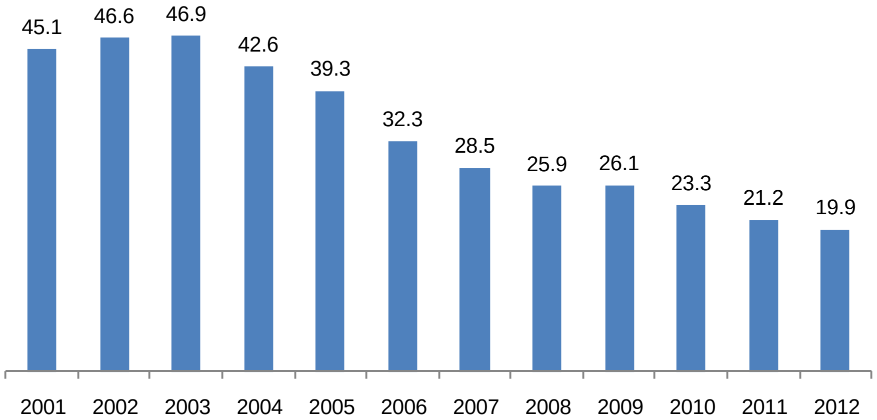
Indicators of International Soundness

	2009	2010	2011	2012
NIR/STFL[1/] (number of times)	4.8	5.3	5.7	5.6
NIR/(STFL[1/] + DLFE[2/]) (number of times)	1.4	1.7	1.6	2.0
NIR/GDP (as percentage)	26	29	28	34

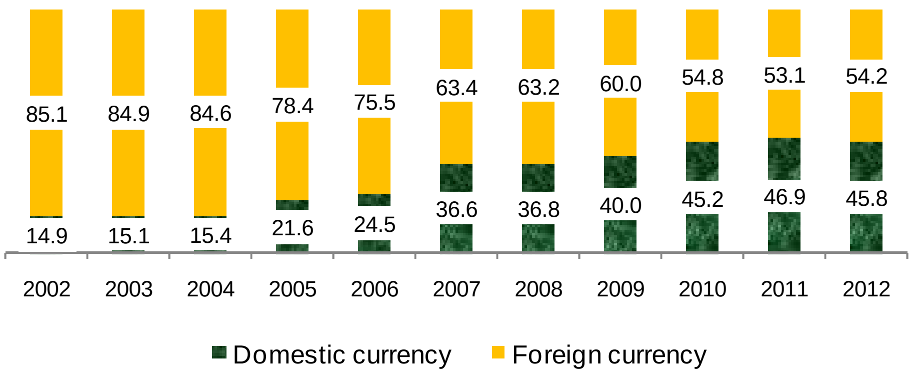
1/ STFL: Short-term foreign liabilities.

2/ DLFE: Domestic liabilities in foreign exchange

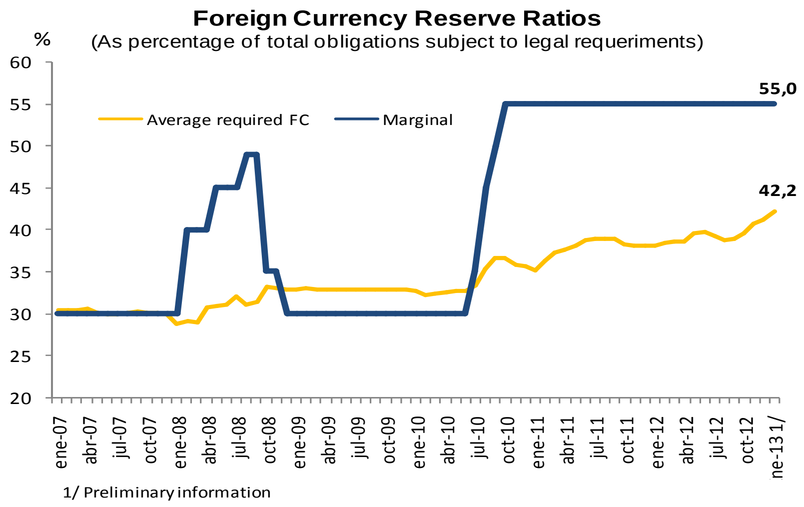
Public Debt: Peru
(As percentage of GDP)

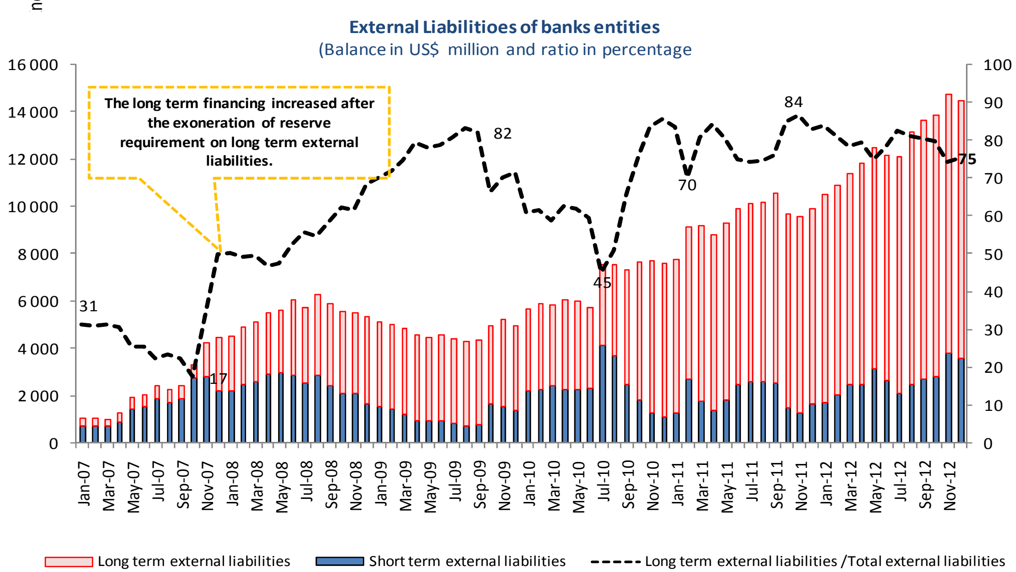


Public Debt: Peru
(currency composition)



Additionally, high reserve requirements on foreign currency deposits contribute to: a) ensuring adequate liquidity; b) reducing pressures on bank credit; and c) internalizing dollarization risks.





BCRP has progressively extended the scope of reserve requirements to a larger number of banks liabilities.

1990-2004

- Domestic currency deposits.
- Foreign Currency deposits.

2004-2008

- **Short-term bank´s foreign liabilities**
- Domestic currency deposits.
- Foreign currency deposits.

2008-2012

- **Deposits in domestic currency of non-residents financial institutions.**
- Short-term bank´s foreign liabilities
- Domestic currency deposits
- Foreign Currency Deposits

2012-2013

- **Long-term bank´s liabilities when they exceed 2.2 times bank´s net worth.**
- Deposits in domestic currency of non-residents financial institutions.
- Short-term bank´s foreign liabilities
- Domestic currency deposits
- Foreign Currency Deposits

Macro-prudential measures (Peru): Additional resources built during cyclical expansions through **counter-cyclical provisioning** provide protection during reversal episodes.

- **International experiences:**
  - Introduced in Spain in July 2000 (modified in 2005).
  - Recent introduction in the LAC region: Uruguay (2001), Colombia (2007), Peru (2000, modified in 2008), and Bolivia (2008).
  - Mexico and Chile (2011) use a variant based on expected losses.
  - Wezel et al. (IMF 2012): cyclical provisioning smoothes out the costs associated with severe recessions and reinforces financial stability.

- **Pro-cyclical rule in Peru (since November 2008):**
  - Triggered when the annualized average percent variation of GDP in the last 30 months is equal to or exceeds 5%.
  - Triggered when the annualized average percent variation of GDP in the last 12 months exceeds the same indicator one year before by 2 percent points.
  - Triggered in two periods: (i) November 2008-September 2009 (international financial crisis); and (ii) October 2010 to date.
  - Cannot be reverted and must be reallocated to other compulsory provisioning items.

Peru is implementing pro-cyclical capital provisioning (in line with Basel III)

Capital requirements

- Prudential capital ratio of 10% (*Tier 1* equal to or greater than 5%).
- Each entity is subject to an additional equity requirement associated with market concentration (a step towards the “too big to fail” requirement) and the economic cycle (greater requirements during the expansion phase).

Liquidity requirements in the process of being implemented

- Under implementation.
- Minimum short- and long-term liquidity requirements (liquidity coverage and net stable funding ratios, respectively), in line with Basel III recommendations.

Some lessons from the Peruvian experience (2)

- Preemptive action has proven valuable.

- International reserves accumulation and high liquidity requirements during “good” times can improve the resilience of the economy to sudden stops drastically.

- Coordination with fiscal authorities, particularly with respect to the management of their holdings of liquid foreign assets can provide yet another layer of defense against these shocks.

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