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# The FTAA After The Emergence Of the Euro\*

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## Abstract

The aim of this paper is to inquire into the possible relation between the FTAA (Free Trade Area of Americas) and the progressive internationalization of the Euro. We will sustain that the actual productive situation (globalization) makes impossible to think of an FTAA without a kind of dollarisation of the Latin American countries (LAC). In fact we argue, helped by empirical analysis, that an economic area can use a sound currency if, and only if, it has a strong link with its issuing country. That is why we analyze, with the principal component analysis, the economic situation of the LAC focusing on their dependence on the U.S. and E.U. economies. We obtain that the LAC, candidates for FTAA, are much more dependent from E.U. rather than U.S.; moreover, the future evolution of the banking assets, in relation to external and internal debt, could strengthen this dependence. For these reasons we conclude that the FTAA process could meet some difficulties in the next years, because the LAC economies could prefer to use the Euro as the reference currency for international trade.

**J.E.L. Classification:** N16, N26, C82, F02

**Keywords:** Latin America, Principal Component Analysis, Globalization, Currency Areas

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# 1 Introduction

The aim of the paper is to discuss the capability of the diffusion and the internationalization of the Euro to displace the FTAA (Free Trade Area of Americas) implementation.

The FTAA project is focused on the creation of a free trade and free investment area from Alaska to Tierra del Fuego, including, in this way, all the American countries, except for Cuba. Clearly, the FTAA would be an extension of the NAFTA (North American Free Trade Agreement), created in 1994 between U.S., Mexico and Canada, to the other LAC and to the Caribbean ones too.

Many works investigated on the LAC sustainability of this agreement, as in Rojas-Suarez (2002), Iglesias (2001), Schott (2001) e Pastor (2001); each analysis has not considered the recent Euro's introduction and its rapid diffusion. From a different perspective, the CEPAL [Economic commission for the Latin American countries] (2003a) highlighted that the emergence of a new strong currency, as the Euro, could create a new scenario for the whole Latin American economy. One of the most relievable conclusions, obtained using the principal component analysis, is that the Latin American economic area, differing from other areas of developing countries, shows a high level of dependency on the U.S. economy; moreover this paper underlines the possibility that this situation might change specially because the new currency has the potentiality to alter this consolidated equilibrium.

In the section 2, we analyze the internationalization of the European currency in relation to the actual productive structure dominated by the concept of globalization. In the section 3 we inquire on the eventual relation between the dollarization and the FTAA; then, in the section 4, using the principal component analysis (PCA), we describe the actual economic situation of the LAC economies; finally, the section 5 deals with the banking sector of the LAC and the eventual perspectives.

## 2 Euro-Dollar, Almost a Currency Duopoly

The international economic scenario shows a deep transformation since 1999, year of the birth of the Euro, causing the definitive economic and politic integration of the E.U. countries. Many works, as Portes and Rey (1998) and McCauley (1997), highlight how the progressive internationalization of the

new European currency can gradually create new monetary scenarios, involving the globalisation process on the production and the financial level. We agree with Portes and Rey (1998) and we argue that the principal reason making a currency international depends on the costs reduction of the international capital (FDI and portfolio investments) and goods trade. Alogoskoufis and Portes (1997) estimate the international transaction costs, between countries with low volatility currencies<sup>1</sup>, as 0,04%<sup>2</sup>. Nevertheless, it is just a little lower than a half of the Tobin Tax. Toussaint (1998) argues that this tax, applied only on international portfolio investments, could guarantee a fiscal drag of 50 billion dollars every year; but the transaction costs, as Alogoskoufis and Portes have calculated, have to be applied to the whole of the international relations, including capitals, goods and services. Moreover, Bénassy-Quéré (1998) notes that this estimation is valid for the transactions between sound currency countries, or between those with partial or complete peg these currencies. If exists a high degree of volatility, these costs grow more and more.

The globalisation generates a new costs structure, because of the definitive creation of a global market. The great costs structure complexity generates the actual world economic scenario: in fact it has characterized by productive and financial big '*filières*'. They always cross themselves, involving in this process almost each country in every continents, generating a considerable number of transactions between different countries every day. The outsourcing (as the FDI) increases dramatically every year (Unctad 2003) as the portfolio investments flow; for these reasons the international trade of goods and capital becomes, probably, the most important variable. That is why we can sustain, as Portes and Rey (1998), that the global market is creating a new structure in which the relations between regional blocks (European Union, Africa, Middle-East, Japan-Southeast of Asia, North America, Latin America) are more important than those between single countries. Consequently, we argue that it should be optimal to reduce as much as possible, the number of currencies with the aim of the firm cost minimization; consequently we argue the optimal condition is to use only one of those as in De Cecco (1971) on McKinnon (1969). At the same time, it is clear that the emergence of the new European currency has gone in the other direction of the optimal one (in the sense of Optimal Currency Areas classical theory).

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<sup>1</sup>The analysis was made on the old currencies of Europe in 1997 and the Usd;

<sup>2</sup>The European Commission (1990) estimation was 0,035%;

This process has produced a reduction of the international currencies removing the old European ones; on the other side, its emergence was the birth of a real concurrent of the U.S. dollar, as in BIS Quarterly Review (2004). It shows, in fact, that the exceptional issue of bonds by residents in the Euro area was the principal reason for the amount of 460,4 billions of Usd of international debt bonds issued in all the world in the fourth trimester of 2003. The sum of the European bonds, in fact, was exactly the half of the total, and it was two times bigger than the same trimester of 2002; the sum in 2003 (834 billions of USD), was bigger of 60% than the previous year. On the other hand, the bonds issued by U.S. residents (in USD), in the same period, amounted at 150 billions of dollars increasing only by 10% from the 2002. Another observation can confirm the process of internationalization of the Euro: the North American issues of bonds in Euro increased by 30%, staying, nevertheless, much under the amount of bonds issued in USD that decreased by 27% compared with the year before.

### 3 The Ftaa and The Dollar: Empirical Evaluations

We sustain that the American economic integration process (FTAA) has to proceed with a kind of peg to dollar<sup>3</sup> (or dollarisation) of the economies of LAC countries<sup>4</sup>, where the experience of the *The Plan de convertibilidad* (1999) of Argentina, that previewed a currency board between the Argentinean currency (initially the Austral, then the Peso) and the USD and after, on 2000, the complete dollarization of Ecuador are the ‘parents’ of a latin-american dollar-currency area<sup>5</sup>. Empirical studies confirm this intuition. Cepal (2003a), for example, analyzes the correlation coefficients between in-

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<sup>3</sup>In this section we will not talk about the IMSA (International monetary stability act) proposed by the U.S. senator Connie Mack in 1999, that, substantially talks about the possibility of every developing country of dollarize itself, talking about, rhetorically of the great advantages that a dollarized country could have. The reference to the South American countries is clear, as the same Connie Mack said in more than one occasion. That is why we we talk about Ftaa, don’t forgetting the parallel process of IMSA;

<sup>4</sup>See also Nakatani (2004)

<sup>5</sup>Moreover, the rate of dollarization, not official, of the other countries on the Latin american sub-continent is very high;

Table 1: Correlation between prevalent external trade partners and currency peg

Currency peg	USD	EURO
Prevalent External Trade Partner		
US	0,355	-0,352
EU	-0,451	0,458

**Source: Cepal 2003a**

ternational trade and peg to sound currencies as in table ??<sup>6</sup> and confirms our analysis.

From Table ??, We can observe a positive correlation between the prevalent external trade (import and export) partner of 93 developing countries and the predisposition to peg to its currency. Moreover, we observe that the cross correlation coefficient between the prevalent partner and the currency peg is negative if the latter is U.S. and the former is Euro and vice versa as in table ?. This result confirms another time what we argued: therefore, if a country is dependent on external trade from one of the two ‘blocks’, it will peg itself to the currency of the block or, at least, it will use it as the reference currency for the external trade. Since we are talking about correlation coefficients we can revert this observation: if a developing country will peg or will use as referent a sound currency, it will choose, as prevalent partner of external trade, the country that issues it.

From the same study, we can get out another indication: the denomination of external debt is able to determine the propensity to peg to a sound currency and vice versa. As before, the cross correlation coefficients are negative<sup>7</sup>.

Consequently we don’t repute sufficient talk about the applicability of the FTAA, watching only at financial or real indicators of every single LAC economy. It is important analyzing these structures focusing, in particular,

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<sup>6</sup>The link between trade openness and currency peg is one of the parameters of the classical Optimal Currency Areas theory [Mundell (1961), Kenen (1969), McKinnon (1963)] as reported in Hughes Hallet and Anthony (2003);

<sup>7</sup>Dooley, Lizondo and Mathieson (1989), Eichengreen and Mathieson (2000) confirm these results observing a dependence of the currency used for international trade from the denomination of external debt and the loans payed for, passing through the international reserves;

on the relation with the dependence of every single LAC country from the two economic and currency blocks (U.S. and EU), deducing the perspectives.

## 4 The actual situation in Latin America

In this section, we will use the multidimensional statistical analysis of principal components<sup>8</sup> to observe which is the actual situation of the LAC, in relation to the degree of dependence from U.S. and EU. The data set (Table 2) contains the 19 biggest countries of LAC, in relation to the variables that describe the external dependence:

1. Import from U.S. and EU;
2. Export to U.S. and EU;
3. Foreign direct investments coming from residents in U.S. and in EU;
4. Financial activities of U.S. and EU banks that work in LAC countries;
5. The currency used to denominate the external debt;

In order to obtain an analysis that considers the relative weight of the different economies, we use, as variable, the relative weight of GDP. Every data represent the incidence of the single variable on the total, for every country. With the PCA, we have been able to synthesize all the informations given by table ??, on three principal factors<sup>9</sup>:

From table ??, we deduce that 60% of the total variability is explained by the first and the second axis. Then, we analyze only the graphic with the scatter and the correlation circle on the first two axes (Figure??): Axis 1 has to be considered as the dependence degree of the single country from the U.S. (positive part) and from the EU (negative part). On the other hand, axis 2 seems to be influenced more from the Gdp variable than from the FDI one. Therefore we consider only the informations that the countries sitting in a position very far from the zero of the axis 2 give because the variability

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<sup>8</sup>Dunteman, G.H. (1989), Principal component analysis, Sage University Paper series on Quantitative Applications in Social Science, 07-069, Beverly Hills, Sage Publications; Lebart, L., A. Morineau, and M. Piron (1995), Statistique exploratoire multidimensionnelle, Paris, Dunod; S.Bolasco, Analisi Multidimensionale dei dati, Carocci 1999;

<sup>9</sup>The outputs are in table ??;

Table 2: Data Set

	Export U.S.	Import U.S.	Export EU	Import EU	Banking assets U.S.	Banking assets EU	External Debt in \$	External debt in EUR	Gdp Weight	Fdi U.S.	Fdi EU
Argentina	7,91	20,41	14,62	29,46	16,21	57,77	64,1	11,3	11,91	64	12
Bolivia	22,95	17,35	23,64	17,35	18,18	71,79	46,9	9,5	0,66	34	20
Brasile	19,35	22,98	24,58	27,05	21,23	44,9	70,8	4,3	35,83	22	36
Chile	16,41	24,92	24,03	21,11	16,55	57,15	83,2	1,7	4,41	39	39
Colombia	38,32	34,98	24,23	19,14	20,59	47,17	77,6	2,6	6,65	9	31
Costa Rica	48,37	45,88	21,26	11,08	30,37	28,98	72,3	0,7	0,65	62	9
Ecuador	36,53	31,08	20,12	16,37	33,37	36,31	83	2	1,28	58	12
El Salvador	57,6	42,08	15,03	9,46	38,39	30,04	68,3	4,7	0,81	36,3	16,5
Guatemala	52,08	44,85	11,42	10,58	51,18	25,79	75,3	4,4	1,30	70	20
Haiti	87,07	59,64	10,54	10,68	27,96	50,54	80,6	2,3	0,38	80	0
Honduras	38,55	49,32	21,72	10,52	34,65	37,91	62,9	4,2	0,37	78	0
Jamaica	39,82	51,55	27,81	10,95	24,7	18,03	57,7	2,5	0,28	98	0
Mexico	87,92	75,14	3,33	8,96	23,85	48,01	77,3	5,4	24,94	66	22
Nicaragua	45,21	32,11	16,54	10,19	29,05	52,7	70,6	7,6	0,26	95	0
Paraguay	2,66	11,86	21,58	10,63	6,74	74,59	46,6	5,1	3,44	35,1	22,35
Peru	33,54	25,76	21,55	17,88	9,71	75,5	72,6	4,1	0,75	8,4	34,4
Trin- Tobago	37,84	43,59	15,57	18,03	11,86	47,03	61	0,8	0,42	100	0
Uruguay	5,78	11,14	16	20,07	16,56	65,9	76,8	4,1	0,93	62,9	10,2
Venezuela	47,28	43,65	7,63	17,94	21,18	50,31	80,4	7,9	4,54	25	19

Source: Cepal (2000a), Cepal (2003b), Unctad 2003

Table 3: Output PCA 19 countries, 11 variables

	Export U.S.	Import US	Export EU	Import EU	Banking assets US	Banking assets EU	External Debt in \$	External Debt in EUR	Gdp Weight	Fdi U.S.	Fdi Eu
Export U.S.	1										
Import U.S.	0,91	1									
Export EU	-0,589	-0,501	1								
Import EU	-0,621	-0,583	0,228	1							
Banking Assets Usa	0,516	0,475	-0,237	-0,482	1						
Banking Assets EU	-0,452	-0,605	0,011	0,364	-0,759	1					
External Debt in \$	0,394	0,297	-0,377	0,096	0,311	-0,216	1				
External Debt in	-0,22	-0,294	-0,266	0,272	-0,117	0,403	-0,329	1			
Gdp Weight	0,011	0,067	-0,121	0,419	-0,141	0,025	0,127	0,173	1		
Fdi U.S.	0,281	0,425	-0,213	-0,381	0,302	-0,426	-0,111	-0,15	-0,272	1	
Fdi EU	-0,28	-0,357	0,19	0,426	-0,281	0,364	0,207	0,042	0,469	-0,855	1
	Export U.S.	Import U.S.	Export EU	Import EU	Banking Assets Usa	Banking Assets Eu	External Debt in \$	External Debt in	Gdp Weight	Fdi U.S.	Fdi EU

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Source: Elaboration with the software MVSP, database Tab.2

Table 4: Eigenvalues

	Axis 1	Axis 2	Axis 3
Eigenvalues	4,306	2,042	1,468
Percentage	39,145	18,568	13,347
Cum. Percentage	39,145	57,713	71,060

**Source: Elaboration with the software MVSP, database Tab.2**

Table 5: PCA variable loadings

	Axis 1	Axis 2	Axis 3
Export U.S.	0,402	0,257	-0,132
Import U.S.	0,418	0,193	-0,073
Export EU	-0,22	-0,291	0,565
Import EU	-0,352	0,169	0,003
Banking Assets Usa	0,349	0,081	0,139
Banking Assets EU	-0,354	-0,021	-0,338
External Debt in \$	0,14	0,489	0,185
External Debt in EUR	-0,168	-0,016	-0,643
Gdp Weight	-0,115	0,457	-0,114
Fdi U.S.	0,309	-0,358	-0,15
Fdi EU	-0,295	0,447	0,203

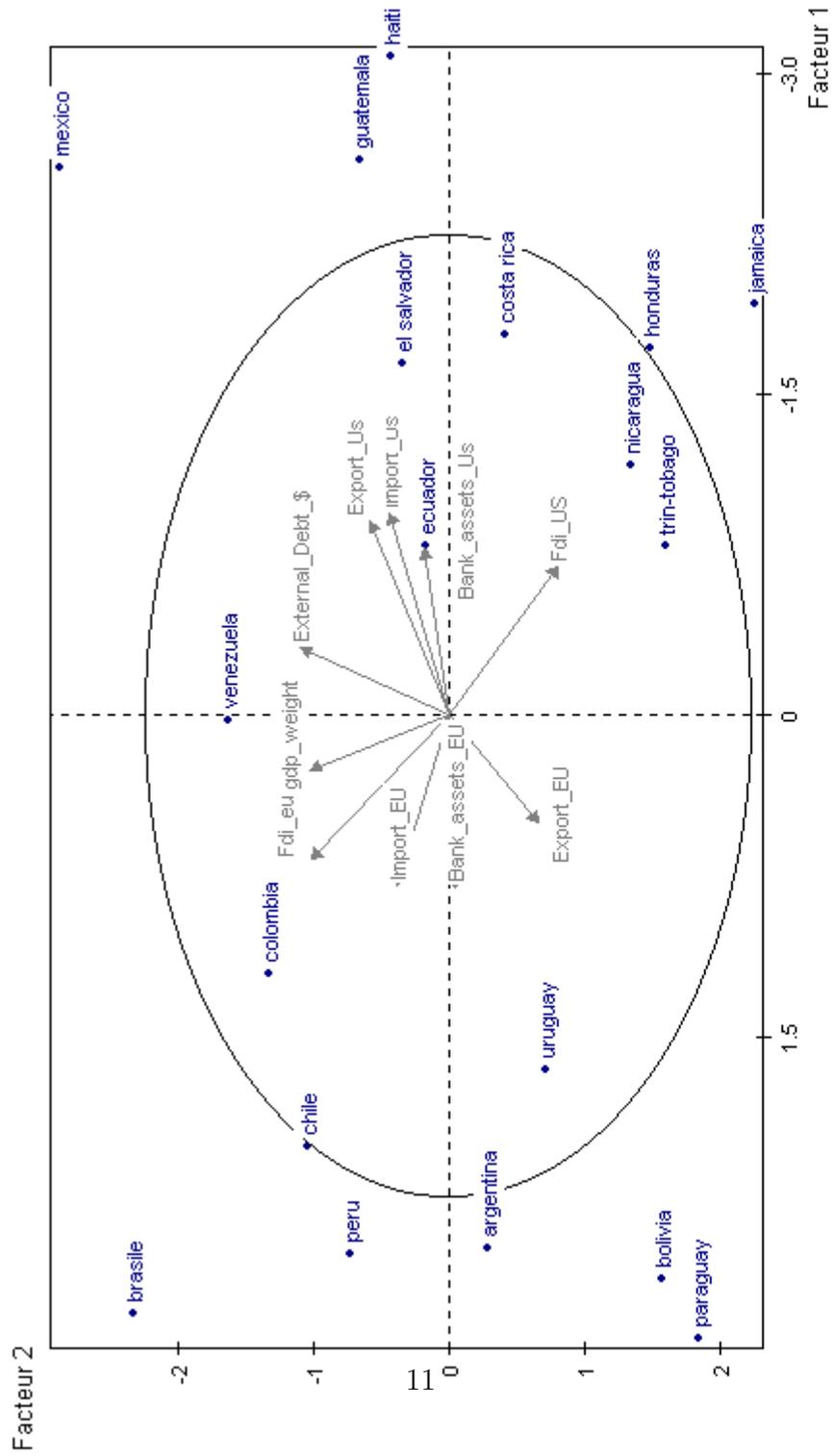
**Source: Elaboration with the software MVSP, database Tab.2**

Table 6: PCA care scores

	Axis 1	Axis 2	Axis 3
Argentina	-0,568	-0,065	-0,506
Bolivia	-0,602	-0,362	-0,276
Brasile	-0,638	0,533	0,227
Chile	-0,46	0,238	0,409
Colombia	-0,275	0,305	0,365
Costa Rica	0,411	-0,095	0,346
Ecuador	0,184	0,038	0,315
El Salvador	0,38	0,079	0,06
Guatemala	0,596	0,151	0,064
Haiti	0,709	0,098	-0,158
Honduras	0,396	-0,342	0,06
Jamaica	0,443	-0,518	0,292
Mexico	0,59	0,661	-0,471
Nicaragua	0,27	-0,307	-0,296
Paraguay	-0,666	-0,423	-0,104
Peru	-0,574	0,168	0,086
Trin-Tobago	0,183	-0,367	-0,027
Uruguay	-0,376	-0,166	-0,049
Venezuela	-0,003	0,373	-0,337

Source: Elaboration with the software MVSP, database Tab.2

Figure 1: Correlation Circle and the scatter



Source: Elaboration with the software SPAD4.5

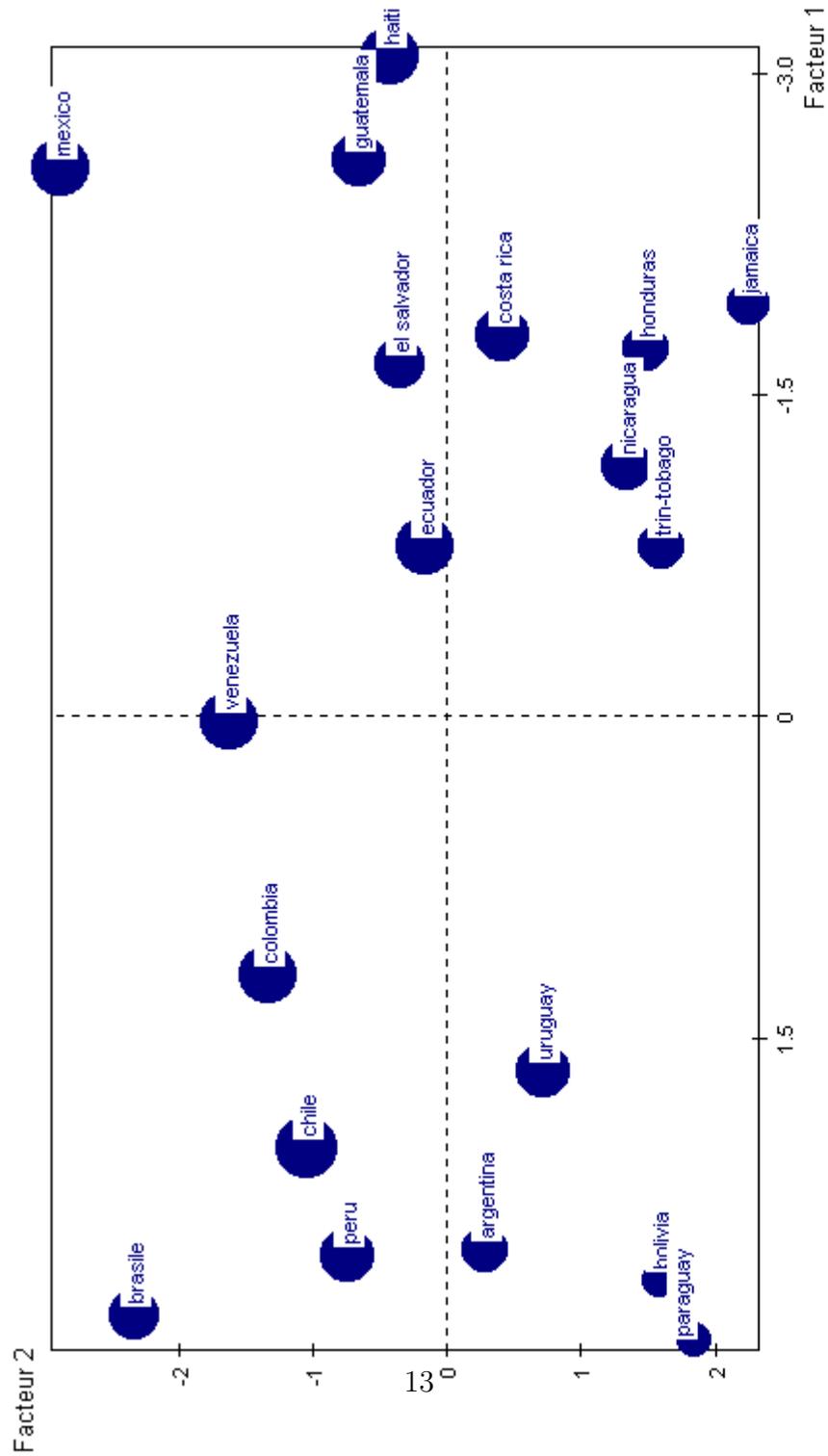
explained by this axis is very low (18%). We analyze, at this step of the work, the single condition of every country in relation to these variables:

1. In regard to axis 1, the Central American and the Caribbean countries appear very dependent from the North American economy; in this group we want to underline the position of Mexico - in the Nafta from 1994 - the one of Venezuela that is very close to zero - this country is one of the best petroleum partners of the U.S., and this, presumably, is the reason why it has not in the same position of the other South American countries - and the one of Ecuador, the only LAC economy totally dollarized from 2000. The South American countries, on the other hand, stay on the negative part of the axis 1, showing their strong dependence from the European economies.
2. The axis 2, divides in the positive part the biggest countries, and in the negative part the smaller ones, although the effect is influenced by the FDI.

Clearly, the ‘point of view’ showed by the axis 1 is very important for the aim of our analysis. The described is clear enough: actually the economics of the candidate countries to the FTAA (as an extension of NAFTA) show that the most influent and big countries are linked to the E.U. economy. This result involves that they should naturally be more inclined to use the Euro although nowadays, as we said, it has not developed all its potentialities as international currency. In fact what might happen if the internationalization process of the Euro will grow rapidly influencing, naturally, the external debt structure of the LAC countries?

To find an answer, we are going to analyze other multidimensional graphs, coming from the same principal component analysis, and we show the relative weight of external debt in Usd (fig.2) and of the bank assets of U.S. and E.U. for each country. In figure ?? we can observe that the relative weight of external debt in Usd is more or less the same for every country and, as it can be seen from table ??, it is very high: in fact the dimension of each bubble measures the percental weight of the variable for the country. Probably it is a consequence of the historical evolution of the international monetary system. In fact after the death of the British Pound as an international currency, it was totally hegemonized by the U.S. dollar (Usd) as the most reliable currency for the developing countries’ external debt, even after the end of the Bretton Woods agreement. That gives a lot of importance to the

Figure 2: The relative weight of the external debt in Usd



Source: Elaboration with the software SPAD 4.5

analysis of the different relative weight of the bank assets of U.S. and U.E. banks. On the other hand, the bank assets, as in figure ?? and ??, show that the most dependent countries from the U.E. have a big relative weight of bank assets of European banks and the most dependent countries from the U.S. have a big relative weight of bank assets of U.S. banks<sup>10</sup>.

## 5 The Latin American Banking sector

The enormous flow of FDI in the decade of 90s in the LAC countries interested, particularly, the banking sector; it was characterized especially by the acquisition of national banks by foreign ones (process of centralization). It is important to see how these foreign banks entered the LAC economy and began to grow reaching the actual enormous dimensions. One of the most important reasons resided in the governmental role. For example, we underline the case of Brazil. The Brazilian government, in 1996, following the goal of reducing the amount of external debt accumulated since the decade of the 70s, used the PROES, a program of incentives to restructure the public financial system of every state of the country, and started the privatization of the most important banks of the state. By this way, which other LAC countries followed in other forms, the government confirmed its radical intention to increase the operative efficiency of the banking sector, increasing the competition, diversifying the financial services supply and introducing new financial skills<sup>11</sup>. Clearly, this process was a part of the global expansion of financial capital. For example, a couple of years before (1992), the Banco de Santander acquired the Midland, increasing its assets in one year from 86 billion of English Pound to 170 billion, starting the process that would reach the peak with the fusion with the Banco Central Hispanico giving life to the actual enormous group BSCH. The year before, the ABN (1991), acquired the Amro, becoming the most important Dutch banking group and, after a couple of years, the Banco de Bilbao, after the fusion with the Banco Vizcaya, acquired the Argentaria<sup>12</sup>, defining in that way, a real Spanish duopoly in the banking side.

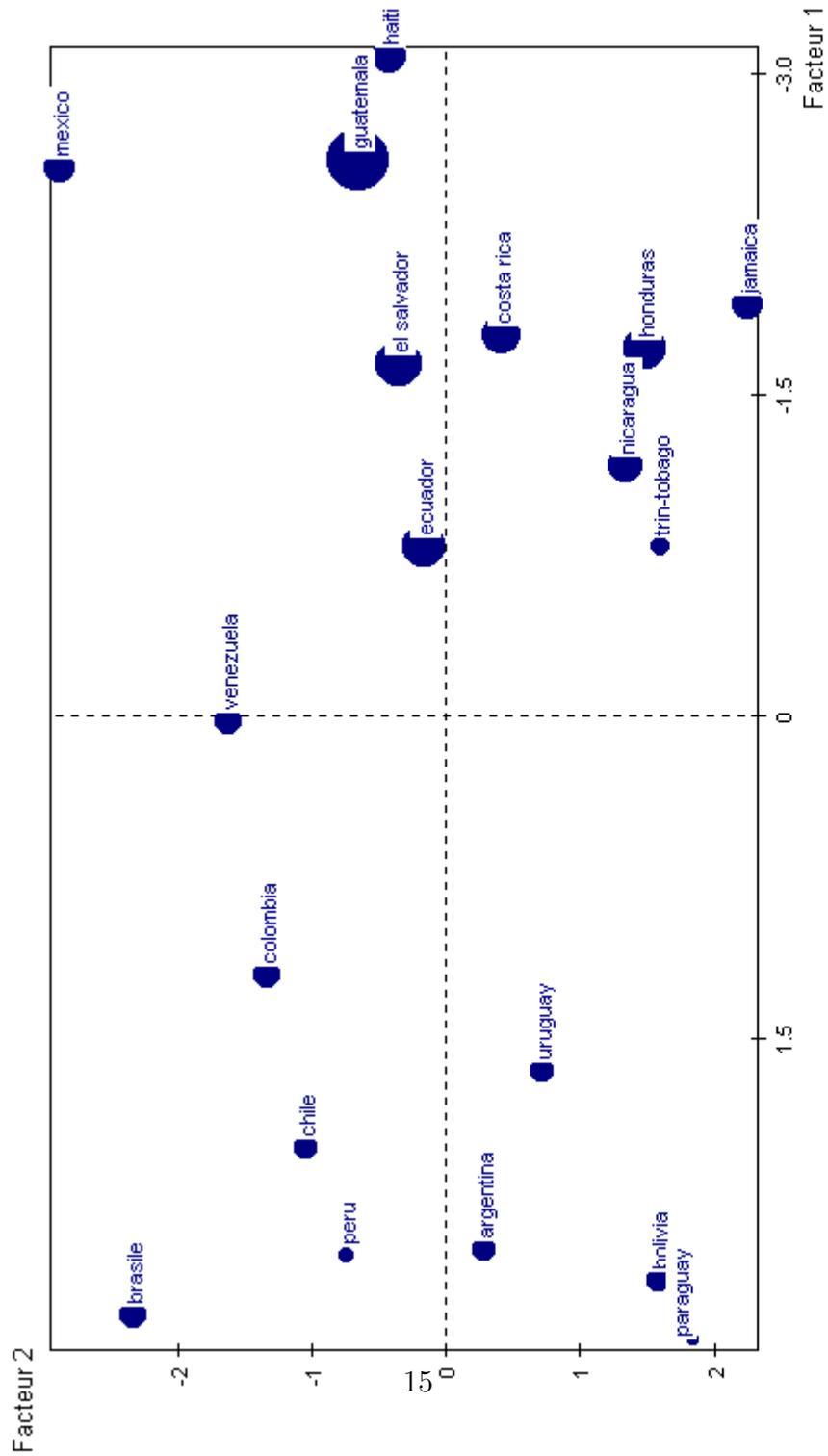
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<sup>10</sup>The situation seems to be sufficiently clear: from the fig.2, in fact, we can understand that the relative weight of the external debt in Usd is more or less the same in all these countries;

<sup>11</sup>cfr. Exposicion de motivos, n.11- Plan Real (Brasil)- 1995;

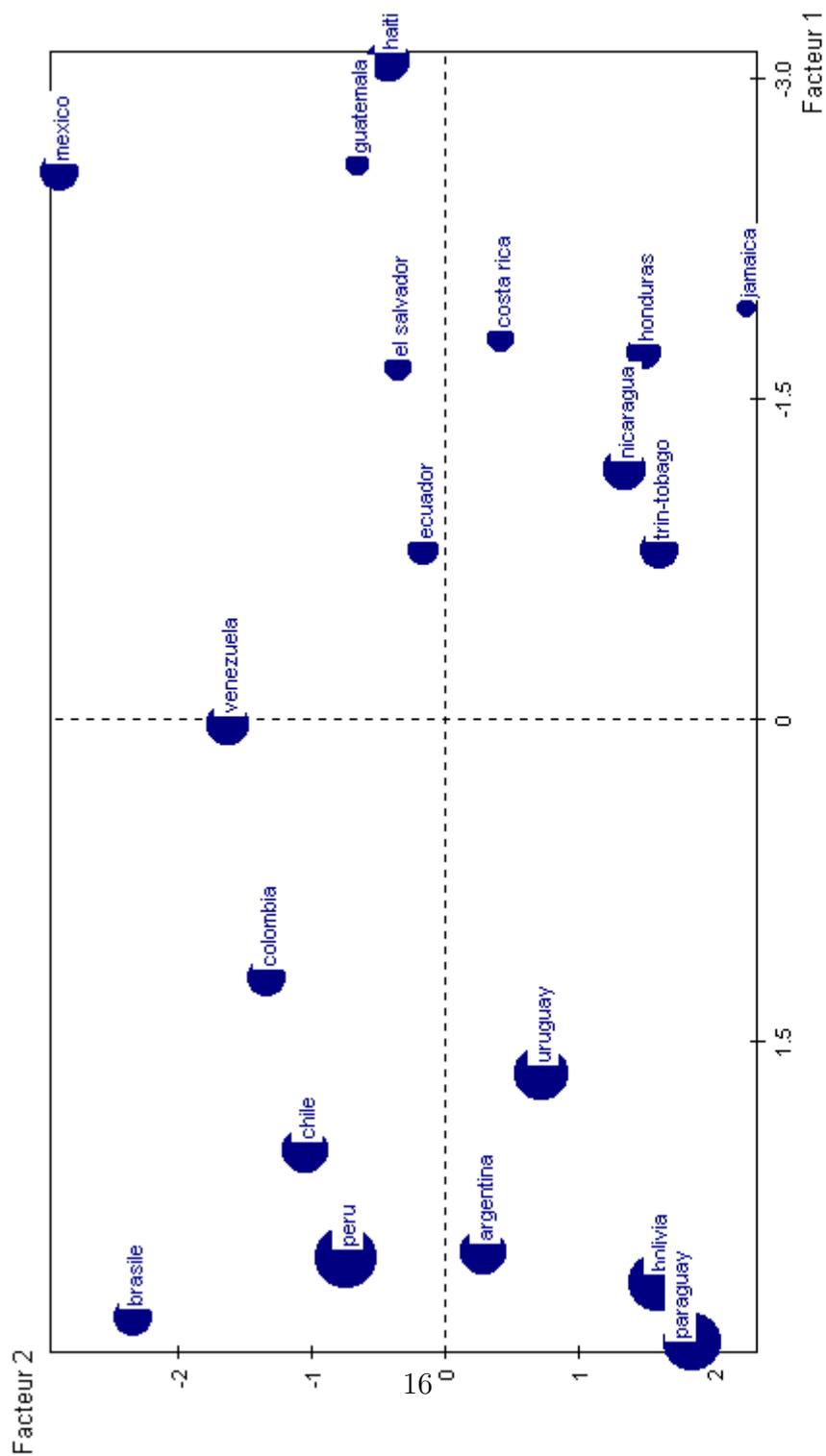
<sup>12</sup>An important Argentinean bank;

Figure 3: The relative weight of the US Bank assets



Source: Elaboration with the software SPAD4.5

Figure 4: The relative weight of the European Bank assets



Source: Elaboration with the software SPAD4.5]

Table 7: Evolution Of The Stranger Banks Assets On The Total bank Assets

	1992	1999	2000	2001
Mexico	1,20%			80%
Brazil	21,70%	48,60%		
Argentina	11%		27,40%	

Source: Correa (2002), Cepal (2003a),(2000b)

The principal acquisitions in the last 15 years of the foreign financial capital in the LAC are notable, drawing the situation that shows table ???. The Latin American banking sector is now clearly characterized by a notable foreign presence that, by 1999, manages the 60% of the total internal loans and the 50% of the total assets of the area (Salomon Smith Barley 1998). This relevant part of the total assets is managed in 34% by the Bsch (Spain), 21,8% by the Citibank (U.S.), 19,6% by the Bbva (Spain), 8,7% by the Bank of Boston(U.S.), 9,15% by the Hsbc (U.K.),6,7% by the Abn-Amro (Holland)<sup>13</sup>.

The assets managed by european banks, that actually issue bonds in Euro, in the LAC countries, are the 70%, against less than the 30% of the Americans. These results become more important when we link this question to the FTAA excluding the Mexico (member of the NAFTA). In fact we observe that the relative weight of the foreign banks that issue bonds in Euro is three times bigger than the U.S. ones. This weight can be felt also in the Latin American bank association, where the absolute majority of the directive places (55%) are occupied by these groups<sup>14</sup>, distributed in each LAC country.

## 6 Conclusions

U.S. and a little group of LAC governments want that the FTAA will start in 2005-2010; this process, unfortunately, is clearly in high contrast with the actual economic condition of Latin America's countries as we have seen in this paper. In fact actually the FTAA could represent only a free trade

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<sup>13</sup>Source: Cepal (2003b)

<sup>14</sup>Minella (2002);

agreement between an area (North American) very developed, and another one (LAC) generally underdeveloped with a high degree of dependence from European economy more than the American.

Until today, as we argued, the European loans to private and public institutions of the LAC countries were made in the ‘*Eurodollar*’ currency. Today, there is no more reasons why the European banks should not have to make loans in Euro; in fact, as we have seen in the previous sessions, nowadays, they issue over the world bonds in Euro and, pointing at the costs minimization, they would prefer to use the same currency for all the transactions. Overall, the numerical presence of the E.U. banks is greater than the U.S. ones. Consequently, a big part of the external debt might follow the recent evolution of the banking sector in terms of currency, increasing the existent gap between the integration of LAC with E.U. and with the U.S.; moreover this condition involves the whole economy because of the economic and political power of these groups. For example the Bsch owned the Respol of Spain that, in the 1999, bought, in the most important privatization of the Latin American history, the YPF, the enormous public firm of petroleum production and extraction.

We conclude that the FTAA process is very difficult. In fact, from the point of view of the American corporations, that prevalently use the USD for their transactions, as it is natural, the process of FTAA and the previous dollarization (of any kind) is a great chance: nevertheless, this hypothetic situation goes against the actual situation that shows that the European capitalists, that largely use the Euro for their transactions, are more integrated in the area; this could give life to a possible collusion between different interests. On the other hand, for what we said in the previous sections, it could appear more reasonable and ‘natural’ for the LAC to use the Euro as the referent currency and, in particular for the Mercosur ones, to increase the integration with E.U, process started some years ago.

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