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Case study: business inclusion – the experience on access to financial services in Cajamarca

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|---------------|---|
| Item Type | Preprint |
| Authors | Sulzer, Marianne |
| Rights | With permission of the license/copyright holder |
| Download date | 2026-07-02 00:34:04 |
| Link to Item | http://hdl.handle.net/20.500.12424/173940 |

CASE STUDY:

Business inclusion – the experience on access to financial services in Cajamarca

Abstract

“When I began the study of economics ..., I was struck by the incongruity between the models that I was taught and the world that I had seen growing up, in Gary Indiana, a city whose rise and fall paralleled the rise and fall of the industrial economy”¹.

2002 was an inflexion year for Cajamarca’s entrepreneurial environment. Minera Yanacocha, a subsidiary of Newmont Mining Corporation and the main purchasing institution in the region, gained a positive experience by strengthening and developing local supplies by local small businesses. The starting point was a study that focused on the potential of Cajamarcan enterprises to be incorporated in the supply chain of Minera Yanacocha and that illustrated how the purchasing system is able to generate a virtuous and sustainable cycle of reinvestment, employment and productivity improvement.

Based on this study, the International Finance Corporation (IFC) and Minera Yanacocha (MI) identified a set of projects in order to strengthen and develop local businesses as suppliers of the mine. One of those projects had the purpose to provide financial advice to small businesses to improve their access to finance. Other projects focused on the improvement of local suppliers’ production standards to meet the mine’s requirements, on the inclusion of local rural suppliers, on market rules and their transparency and on the local enabling environment to do business as a local supplier.

The results of these projects illustrate the positive effect of corporate social responsibility in the adoption of good practices by other local purchase institutions, and the generation of market mechanisms to face commercial opportunities. The impact of the projects for small business development goes beyond the direct linkages between MI and its suppliers and triggered economic development in the entire region and in additional industrial and economic sectors.

The following case focuses on the results achieved in improving local small businesses’ access to finance based on three success factors: parallel accounting and the importance of truthful information, implementation of financial tools and access to information; decision making on optimal financial structure.

The case shows that in developing countries, even though financial institutions disseminate information, the lack of experience and knowledge is a hurdle for small businesses and their access to financial services.

Yanacocha and Corporate Social Responsibility

In the 90’s when the Minera Yanacocha (MI) started its operations, the economic environment within the region Cajamarca started to change essentially: national and international service

¹ Joseph E. Stiglitz, “Information and the change in the paradigm in economics”, Nobel Prize Lecture, Stockholm, December 2001.

providers and suppliers to Yanacocha started to penetrate the local markets and to crowd out local enterprises in Cajamarca. The reason for this was the fact that the local enterprises, especially the small businesses, were not able to deliver to Yanacocha the required quality and quantities within the demanded deadlines.

Although some bigger local enterprises were able to find themselves a niche in delivering to MI, the big majority of local businesses experienced a big threat to their businesses for a variety of reasons: there were no opportunities for local businesses to bid for tenders by MI, the businesses had no access to market information, depended mainly on only one buyer like MI, lacked access to finance and were not able to comply with minimal quality standards. These deficiencies caused MI to look for national and international suppliers. However, this shift away from the local market created an unfavourable social environment for MI: local businesses and individuals started to demonstrate against the mining company and blocked some of the daily operations.

Within this context, and in order to improve the relationships between MI and the local community, in 2002, the mining company did a study to identify the potential of local enterprises. The study was conducted together with International Finance Corporation (IFC), a body of the World Bank. Based on IFC's and MI's study, a program to support small businesses in the region of Cajamarca was launched that was co-financed by the IFC and MI. Swisscontact, the Swiss Foundation for Technical Cooperation, became responsible for the coordination and management of this program. Within this program, there were 5 activity lines:

- ✓ Strengthening of local suppliers
- ✓ Strengthening of the local construction sectors
- ✓ Modernisation and diversification of local agri businesses
- ✓ Strengthening of local handcrafts
- ✓ Access to Financial Services for small enterprises

The following case illustrates practical experiences and results within the activity line Access to Financial Services for small businesses.

A Practical Case on Business Inclusion: Access to Financial Services for small businesses

The parallel accounting and the importance of truthful information

The project "Financial advisory to facilitate the access of small and medium sized business² to financial services"³ started on March 1st, 2004. The purpose was to promote an enhancement in the local financial culture in order to increase the demand for official services.

At the beginning, the project worked with forty businesses as a pilot intervention, many of them where related to Minera Yanacocha's supply chain, directly or indirectly; and other ones were representative of the local economic activity.

The intervention started with the application of an entrepreneurial diagnosis under the methodology Gestiona 3.0, developed by Recursos SAC, which consisted in evaluating the

² According to the classification used by Recursos SAC - one of the think tank companies that executed the Project - to determine the entrepreneurial universe, a small business generates a net income per year between US\$ 140 thousand and US\$ 750 thousand, and a medium business generates a net income per year between US\$ 750 thousand to US\$ 28 million.

³ The project was executed by the association Instituto de Formación Bancaria – Recursos SAC, with the financial assistance of the International Finance Corporation and the monitoring of Swisscontact. The period of execution was one and a half year and the total budget was 2 Mio. Nuevos Soles or approx. 674'000 USD.

enterprises in four areas: finance, management, market and production, with a set of forty one indicators. Table No. 1 shows the indicators per area⁴.

Table No. 1
Entrepreneurial diagnosis: Indicator management scheme per area⁵

| FINACE | MANAGEMENT | MARKET | PRODUCTION |
|--|---|---|---|
| Liquidity (L) + Liquidity rate (L1) + Acidic test (L2) | Mission y vision + Existence of a mission (D1) + Entrepreneur vision (D2) + Intangible (HRG) | Product + Sales contribution (M1) + Product description: essential, formal and added values (M2) | Production + Production process (P1) + Production evolution (P2) |
| Management (G) + Inventory rotation (G1) + Assets rotation (G2) + Recovery rate (G3) | Human resources + Education level ranking (HRG) + Development and training of human resources (D3) | Price + Price establishment (M3) | Productivity + Human resources productivity (P3) + Added value generated (P4) + Profit generated (P5) |
| Solvency (S) + Indebted equity (S1) + Coverage of assets (S2) + Coverage of interests (S3) | Information management + Accounting registration (D4) + General information management (D5) | Promotion + Promotion strategy (M4) | Efficiency + On productive process (P6) + On working environment (P7) + On general environment (P8) |

⁴ The extensive information on the entrepreneurial diagnosis developed by Recursos SAC is available in a Spanish edition. More information can be requested from recursos@recursososa.com.

⁵ Translated from "Gestiona 3.0: System of entrepreneurial diagnosis and enhancement plan", German Technological Cooperation - Recursos SAC, Edition 2003.

| | | | |
|---|---|--|---|
| Return (R) + ROS (R1) + ROI (R2) + ROE (R3) | Competitiveness + Development of cooperation networks (D6) + Development of continuous enhancement processes (D7) + Family and business (HRG) | Distribution + Distribution strategy (M5) + Marketplace distribution (M6) + Sales cycle (M7) | Quality + Product quality qualification (P9): - Materials and inputs - Human resources - Machinery and equipment - Method |
| Accumulation + Evolution of equity (HRG) | | | |
| Gender + Gender indicator (D8) | | | |
| Environment + Environmental policy (HRG) | | | |

The information obtained from the diagnosis was contradictory: In general terms, as shown in Table No. 2, the financial performance was acceptable if looked at from a common financial perspective: Businesses generated returns to shareholders and investors without losing cash. Nevertheless, the symptoms expressed by the managers consisted in:

- Little profit generation in terms of return on equity.
- Illiquidity situation.
- Insufficiency of collaterals.

Table No. 2
Entrepreneurial diagnosis: Main financial indicator⁶

| No. | BUSINESS DATA | | | | | | | | |
|-----|---------------|--------------|---------------------------------------|-----|-------|--------|-------|-----------|-----------|
| | CIUU | SECTOR | MAIN ACTIVITY | AGE | ROS | ROI | ROE | LIQUIDITY | ACID TEST |
| 1 | 2925 | Manufacture | Bakery | 5 | 22.7 | 52.7 | 87.6 | 0.4 | 0.1 |
| 2 | 2925 | Manufacture | Beverage industry | 7 | 4.7 | 9.0 | 12.6 | 0.9 | 0.9 |
| 3 | 1554 | Manufacture | Beverage industry | 6 | 1.4 | 2.9 | 20.6 | 0.7 | 0.6 |
| 4 | 2924 | Services | Blowing-up services | 6 | 2.1 | 15.6 | 15.0 | 1.3 | 1.3 |
| 5 | 4520 | Manufacture | Carpentry | 7 | 7.7 | 16.6 | 19.9 | 2.6 | 1.7 |
| 6 | 4520 | Construction | Construction | 8 | 5.2 | 17.7 | 28.7 | 1.0 | 0.5 |
| 7 | 7122 | Services | Construction machinery rent | 5 | 6.4 | 38.6 | 91.9 | 1.8 | 1.5 |
| 8 | 8090 | Education | Education services | 11 | 13.5 | 117.5 | 117.5 | 0.2 | 0.2 |
| 9 | 3190 | Services | Electric services | 4 | 4.4 | 14.5 | 10.7 | 3.7 | 3.7 |
| 10 | 6599 | Finance | Financial entity | 10 | 3.2 | 12.6 | 14.3 | 28.0 | 24.9 |
| 11 | 5122 | Manufacture | Food industry | 7 | 1.7 | 17.0 | 19.4 | 1.6 | 1.1 |
| 12 | 2925 | Manufacture | Food industry | 9 | 4.8 | 24.8 | 44.3 | 1.2 | 0.0 |
| 13 | 5050 | Commerce | Fuel sale | 4 | 2.6 | 12.3 | 19.7 | 0.5 | 0.4 |
| 14 | 5141 | Manufacture | Gas bottling and commercialisation | 12 | 11.6 | 28.8 | 55.0 | 1.3 | 1.0 |
| 15 | 4530 | Services | General Services | 7 | -25.8 | -227.0 | -3.9 | 102.5 | 102.5 |
| 16 | 2430 | Services | Geo-synthetic instalation services | 8 | -2.2 | 0.9 | -7.5 | 0.9 | 0.9 |
| 17 | 7512 | Services | Giant equipment washing | 6 | 6.9 | 77.3 | 56.6 | - | - |
| 18 | 5143 | Commerce | Hardware store | 9 | 5.5 | 14.3 | 11.7 | 15.7 | 4.1 |
| 19 | 3692 | Manufacture | Hose production and commercialisation | 5 | 7.5 | 26.5 | 12.1 | 1.3 | 0.9 |
| 20 | 6304 | Services | Hotel | 7 | 7.3 | 54.2 | 55.3 | 39.3 | 39.3 |
| 21 | 5510 | Services | Hotel | 7 | 20.2 | 27.2 | 18.9 | 3.5 | 3.5 |
| 22 | 1820 | Manufacture | Industrial apparel making | 2 | -13.7 | -2.3 | -5.7 | 1.0 | 0.7 |
| 23 | 1721 | Manufacture | Industrial apparel making | 4 | 9.1 | 61.1 | 56.3 | 2.0 | 1.8 |
| 24 | 7111 | Services | Light equipment rent | 4 | 6.4 | 10.0 | 30.0 | 0.9 | 0.9 |
| 25 | 5030 | Commerce | Lubricant and spare parts sale | 8 | 3.7 | 14.6 | 10.9 | 15.6 | 1.2 |
| 26 | 2892 | Services | Mechanis and maintenace services | 2 | 19.7 | 39.6 | 60.2 | 2.3 | 2.0 |
| 27 | 1520 | Manufacture | Milk industry | 11 | 16.4 | 14.6 | 20.0 | 3.8 | 1.6 |
| 28 | 2924 | Mining | Mining exploration | 3 | 15.7 | 27.3 | 41.2 | 2.9 | 2.9 |
| 29 | 6599 | Finance | NGO | 6 | 1.7 | 4.8 | 4.7 | 2.9 | 2.9 |
| 30 | 6599 | Finance | NGO | 17 | 11.5 | 9.5 | 11.9 | 32.6 | 32.6 |
| 31 | 2222 | Services | Printing | 12 | 5.2 | 16.6 | 36.2 | 1.0 | 0.6 |
| 32 | 2222 | Services | Printing | 10 | 8.3 | 4.3 | 20.0 | 0.6 | 0.2 |
| 33 | 7414 | Services | Project formulation services | 4 | -3.2 | -7.9 | -41.4 | 0.8 | 81.0 |
| 34 | 2925 | Services | Restaurant | 6 | 5.8 | 81.9 | 77.9 | 1.7 | 1.0 |
| 35 | 3699 | Commerce | Security equipment sale | 5 | 5.8 | 14.3 | 21.6 | 2.3 | 1.3 |
| 36 | 6021 | Services | Taxi services | 8 | 2.3 | 4.6 | 18.4 | 1.0 | 1.0 |
| 37 | 6420 | Services | Telecommunication services | 14 | -77.9 | -60.0 | -76.8 | 1.4 | 1.4 |
| 38 | 5122 | Commerce | Wholesale business | 3 | -0.6 | 0.6 | -20.3 | 1.1 | 0.4 |
| 39 | 5139 | Commerce | Wholesale business | 8 | 2.3 | 5.8 | 68.7 | 1.0 | 0.3 |
| 40 | 5122 | Commerce | Wholesale business | 6 | 1.0 | 10.4 | 31.8 | 1.4 | 0.1 |

Looking a bit more in-depth and checking other indicators – by applying a survey to the same group of businesses –the following problems were found⁷:

- 61% had a double accounting system or were faking financial information.
- 40% had collaterals in an informal situation or not registered officially.

⁶ Taken from "Final report: Project of Financial advisory to facilitate the access of small and medium sized business to financial services", Association Instituto de Formación Bancaria – Recursos SAC, Cajamarca, November of 2005.

⁷ *Idem.*

- 30% were in a kind of informal situation, in other words, they were avoiding certain official regulations.
- 18% were not registering financial information.
- 9% had inadequate accounting advice.

In other words, the project' representatives were facing a transparency problem to do parallel accounting. That situation was perfectly known by financial institutions. Consequently, the intervention was re-oriented to emphasize the importance of truthful information:

- An instrument was developed to quantify the amount of money that had been traded in the parallel system.
- Secondly, the project team held meetings with managers, shareholder and accountants in order to demonstrate how a parallel system was damaging the businesses' competitive situation in terms of restricted growth, paying excessive taxes, affecting the real liquidity; and in some cases having real losses.
- Finally, the project team proposed plans to sincere the situation gradually, according to the characteristics of each business; and had conversations with representatives of financial institutions to follow up on the processes.

The assumption of the project was that if the last step described would be successful, the incorporation of those businesses to a formal financial system would become possible.

Implementation of financial tools and information access

Based on information provided by the businesses that participated in the diagnosis phase, the project's representatives worked with thirty businesses in a second phase that consisted of the transfer of a set of financial tools to these businesses as part of their financial re-organisation and the implementation of transparent practices.

The main tools transferred and their principle contents were the following:

Cost – volume – profit analysis

To have a strong and successful business, it is essential to have a clear understanding of the financial impact that basic business decisions may have on financial statements. As a consequence, the first step taken consisted of:

- Determine the components of the cost structure, organised in fixed and variable costs. Additionally, bargain margins with providers.
- Establish the relationship between the fixed and variable costs with the commercialisation volumes, in terms of units and monetary units.

Three kind of analysis were applied to businesses, according to their needs:

- Breakeven analysis, which tells where the sales volume needs to break even, under different price or cost scenarios.
- Contribution margin analysis, which compares the profitability of different products, product lines, or services offered.
- Operating leverage, which examines the degree to which a business uses fixed costs, which magnifies profits as sales increase, but also magnifies losses as sales drop.

Cash flow planning

Cash Flow is a financial statement that shows a company's incoming and outgoing money; in other words, the sources and uses of cash during a specific period of time (often quarterly or annually). The statement shows how changes in balance sheet and income accounts affected cash and cash equivalents, and breaks the analysis down according to **operating**, **investing**, and **financing** activities. As an analytical tool the statement of cash flows is useful in determining the short-term viability of a company, particularly its ability to pay bills.

The concepts of incoming and outgoing money not necessarily have to stand in past terms; otherwise, they can be perfectly applicable to future terms as a planning tool for a responsible use of money⁸.

As a planning financial tool, the cash flow responds to the following questions:

- What kind of product will be sold? To whom? What volumes? Which prices? What terms and delivery conditions?
- How much will cost to produce the different kinds of products? Raw materials, direct personnel, inputs and services?
- What kind of basic structure is needed to fulfil what the planned sale? What kind of fixed cost demand such structure?
- What kind of investments is required? How will be the finance structure of the operation? What opportunity cost the company has?
- In case of loans, what is the interest rate and commissions for each alternative? What are the repayment conditions?
- What kind of taxes the company's operations is imposed? What is the frequency of payment for such taxes? The operations will generate any fiscal shield? What are the conditions to apply to such fiscal shields?

Customer and providers portfolio analysis

Customer and providers analysis was implemented as a complement to cash flow analysis. The tool consisted in:

- Systematisation of customer and providers information in a single database.
- Assessment and classification of customers and providers according to criteria like: volumes, credit conditions, quality requirements, and other.
- Bargaining and projection of credit from providers and customers.

Accounting control

Everyone agrees on the importance to sincere accounting information. For that reason, it was necessary to implement good practice through accounting procedures, in order to prevent the return to the beginning situation.

Three kinds of procedures were implemented:

- Internal auditory process and plan.

⁸ Business managers and owners are responsible for an adequate use of money, which means the obligation to plan, organise and control de use of money. A company without enough money will have serious difficulties to survive in competitive markets.

- Financial contingency prevention process, include periodical emission of financial statements, periods and sort of information required.
- Accounts management process, which implies standardised practices.

Financial statements analysis

The lack of understanding of financial information expresses a main limitation in management of small and medium sized business. Managers and owners generally use financial statements for tributary purposes, rather than as a decision making instrument. For that reason, they used to be interested in paying less taxes as possible and in knowing how much the firm earns without taking on account the wide kinds of financial situations they must face.

Financial statements analysis provides information and explanation to the firm's financial circumstances in a specific point of time or during a period of time. Through the calculation of financial ratios is able to determine the financial health of the business and provides de basis for decision making.

The implementation of this analysis consisted in transferring:

- Management and interpretation of accounting information, including financial statements annexes.
- Estimation and interpretation of financial ratios.
- Future scenario drawing from financial statements.
- Decision making process from the interpretation of financial statements.

Financial guide

The transfer of financial tools as just described implied hours of technical assistance dedicated directly to firms participating in the second phase. On the other hand, the project developed another tool based on the demand of market information.

The financial guide was a document resulted from the effort of Cajamarcan financial institutions and the project in order to systematise and consolidate the information on financial services oriented to small and medium sized businesses, which was organised with the following criteria:

- Financial services offered per institution.
- Description per financial service.
- Requirements need to apply for any of the financial services and per institution.
- Levels of amount of money that were offered per services and per institution.

The dissemination of such information was a first effort to provide transparent information to firms in a simple language that was able to be understood. As a consequence, financial institutions recognised that there was an increase in the interest manifested by local firms for financial services and in the amounts of lending money.

As a conclusion from the transfer of financial tools, eighteen firms were able to obtain loans from financial institutions. The total amount accessed was US\$ 350,667. Due to the project's limited period of time it was not possible to continue with the escorting of the other twelve firms. Nevertheless, the experience demonstrates that the intervention was appropriately oriented to fulfil the project goal and to demonstrate the business case for all other local small businesses to adopt the tools and processes.

Decision making on optimal financial structure

In January 2006, the project “Project of Competitive Development of Local Suppliers”⁹, known as PDP Cajamarca, started – with the purpose to contribute to the development of a competitive situation for local firms through the provision of entrepreneurial services and the implementation of supply chain policies of from the big contractors like MI that operate in Cajamarca Region.

One kind of entrepreneurial services provided by PDP Cajamarca is the financial technical assistance that builds on the experience of the project of Financial Advice to facilitate access to finance of small and medium business. This time, the situation was very different: Almost all firms in the supply chain of big purchasing companies had access to finance. However, the matter was to optimise such access.

Figure No. 1 shows decision making from a financial point of view developed by Aswath Damodaran, Professor at the Stern School of Business of the New York University. According to his point of view, entrepreneurial finance preserves internal consistency and coherence and develops powerful models and theory about the right way to make investment, financing, and dividend decisions¹⁰. All of these objectives are geared to the main purpose of maximising the value of a firm.

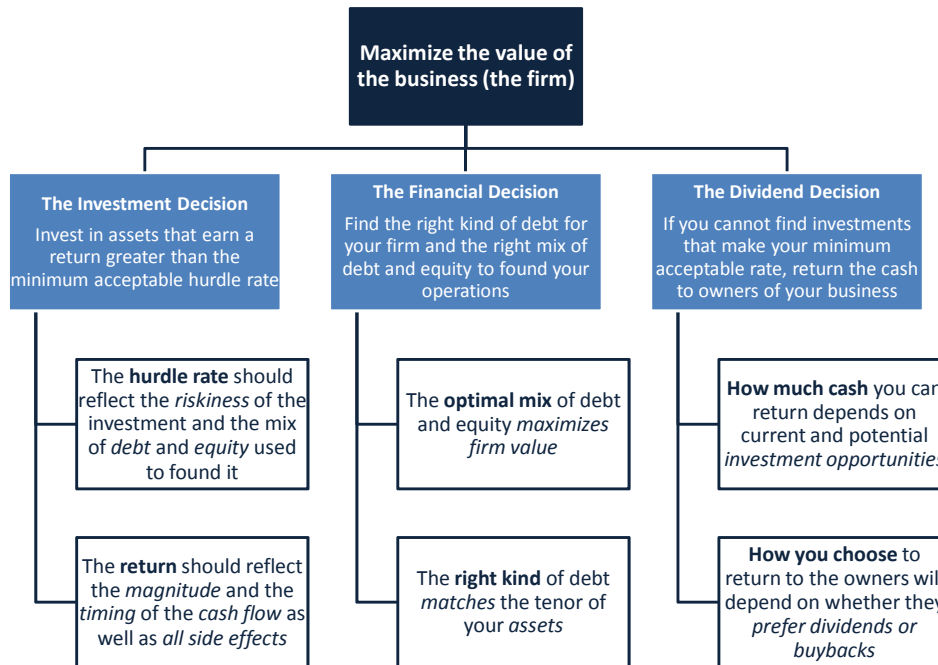
Firms that have worked with PDP Cajamarca were facing situations related to what Prof. Damodaran calls financial decision:

- Some firms had experienced a quick growth, which implies the need for long term investment in operating funds, but which are at the moment funded by short term funds.
- Requirement of letter of credits which implies immobile assets.
- Over-indebted, due to a lack of analysis on financial structure.
- A lack of matches of debt and the tenor of assets, which has as consequence illiquidity situations and in some cases insolvency.

⁹ An institutional effort made by Fondo Empleo (the Peruvian employment fund), the International Finance Corporation, Asociación Los Andes de Cajamarca (Minera Yanacocha’s foundation), Commerce and Production Chamber of Cajamarca, Swisscontact and Recursos SAC. PDP Cajamarca works with the supply chain of six big purchasing entities: Aramark Peru (a catering company subsidiary of the American Aramark), Gloria (milk industry), Minera Yanacocha (mining company), Transportes Línea (transport company) Regional Government of Cajamarca and Provincial Municipality of Cajamarca (public entities).

¹⁰ Damodaran, Aswath, “Applied corporate finance: a user’s manual”, John Wiley & Sons, Inc. Second Edition, New York, 2006.

Figure No. 1
The objective in decision making¹¹



As a consequence, PDP Cajamarca provides financial services with the approach of financial decision making, using the same tools described in the previous paragraph in order to:

- Calculate the actual debt ratio of firms.
- Determine the optimal debt ratio of firms, according to its operations and in order to maximize the value.
- Develop a set of criteria for decision making, which implies:
 - Decide whether to move to the optimal or preserve the present situation.
 - If a firm decides to move to the optimal, it is necessary to establish how quickly the change will be done.
 - If the firm decides to move gradually to the optimal, it has to decide whether to use new financing to invest in new projects or to shift its financing mix on existing projects.

At the moment, PDP Cajamarca works with twenty seven firms. All of them have a debt ratio different from its optimal ratio. The average debt rate is four while the optimal point is between one and one and a half. The consequences for the firms are expressed in the following decisions:

- In the first level, 100% of the firms chose to move to the optimal ratio.
- In the second level, 11% made a quick shift to the optimal, due to critical situations. The rest of the firms opted for a gradual change.
- In the third level, 25% - due to their situation of expansion – chose to use new financing by new projects. The rest of them had to shift the financing mix, which implied bargaining with financial institutions and with shareholders.

¹¹ Taken from Damodaran, Aswath, "Applied corporate finance: a user's manual", John Wiley & Sons, Inc. Second Edition, New York, 2006. Pg. 9.

As a result, the actual debt ratio today is two. Still far from the optimal, but the shift started and the firms are able to face more professionally the financing decision making.

Learning lessons

As a summary, it is important to reflect on the following issues:

1. There are ways and possibilities for international companies to integrate their operations within a local environment, providing win win situations for themselves as well as for the local communities. Yanacocha initially hesitated to go this way, but ultimately was rewarded for its investments in Corporate Social Responsibility: it managed to buy from local providers who complied with its standards and could contribute to the development of the local economy through activities like the one on Access to Financial Services for small businesses.
2. The initial impulse that is generated by a big social investment like the one by MI is an opportunity for local firms to enhance their performance, generate employment and enter on the path to sustainable growth.
3. Entrepreneurial growth is necessarily accompanied by the financial system. Its dynamism is crucial to complement the private initiative. Nevertheless, a lack of knowledge and understanding of financial market rules can create hurdles to an optimal access to such services.
4. In some cases, especially in developing economies, it is necessary to complement market functions with interventions that accelerate processes in order to cut down the learning curve. Such interventions vary according to firm situation, market conditions and time.
5. To be successful in the intervention it is important to articulate inter-institutional efforts. Such support is important in terms of promoting transparency and good practices.
6. The future represents a challenge for firms. An adequate system of objective decision making implies a delicate balance of financial decision subjects with other management decision subjects like direction, market and production. All of them are made conditional to the maximisation of the value of the firm.

The case illustrates how common efforts of different stakeholders such as MI, the local government, local businesses, the local financial sector and NGOs lead to sustainable growth of the local economy: The initial boost of economic development by MI could be taken further into more indirect linkages with MI and even other economic sectors of the Cajamarca Region so that growth is broad based and diversified. The activities of MI – originally seen as a big threat to the region's balance – turned out to be a big opportunity for the region and its people.