For release on delivery
11:00 a.m. E.D.T.
May 4, 1992

The Return to Capital Markets

of Selected Latin American Countries

Remarks by

Edward W. Kelley, Jr.

Member, Board of Governors of the Federal Reserve System

before the

XXIX Meeting of

Governors of Central Banks of the American Continent

San Salvador, El Salvador

May 4, 1992

The Return to Capital Markets of Selected Latin American Countries

Latin American countries that experienced serious debt-servicing difficulties in the 1980s have shown a renewed ability of late to attract foreign capital. So far, the resources have been raised mainly through bond and equity offerings and foreign direct investment, and only to a minor extent through loans from commercial banks. These renewed inward capital flows are impressive because they are again being provided voluntarily by foreigners and by domestic residents who had earlier placed capital abroad, in contrast to the concerted flows from banks that were arranged for countries after they began running into debt-servicing difficulties in 1982. Additionally, the flows are mostly going to the private sector or public sector corporations, rather than to governments for general balance of payments financing. In my remarks, I will review the reasons why these countries have achieved varying degrees of increased creditworthiness, describe how the markets have evolved over the last two years, and examine the implications for other countries in the region.

Most of the recorded capital flows so far have gone to five countries--Chile, Mexico, Venezuela, which can be classified as early reentrants into capital markets, and Brazil and Argentina, which can be classified as later reentrants. Smaller economies, e.g., Uruguay, also have reentered. For the three early reentrants, the movement toward improved creditworthiness has been characterized by two main features: (1) an established track record of improved economic policies and (2) the resolution of earlier debt problems with creditors.

Economic Policy Reform

The first feature is fundamental. The early reentrants have all managed the implementation of substantially improved macroeconomic and structural policies for a sustained period. They have made substantial fiscal adjustments, conducted more restrained monetary policies, and have established more credible exchange rate policies. The fiscal adjustments, in particular, have been huge. For example, in Mexico, the public sector borrowing requirement, was reduced from 16 percent of GDP in 1986 and 1987, to just over 1 percent last year.

Fundamental structural adjustments also have been implemented in these three countries over time. Governments have made it clear that they are interested in freeing their economies from a host of government regulations and interferences. Trade regimes have been liberalized--tariffs have been reduced and made more uniform, and many quantitative restrictions have been eliminated. There have been important moves toward the privatization of state-owned companies, which represent a clear shift by policymakers toward the view that the private sector can manage industries more efficiently than governments. Privatization of large telephone companies, airlines, banks, and other industries have become commonplace, often with the participation of foreign firms.

These policy changes are ultimately the choice of the governments involved, but the IMF, the World Bank, and the IDB have played important roles in providing some of the financing and in the formulation and development of policies. The involvement of these organizations also provides some comfort to creditors and others that appropriate policies will be sustained.

Central bankers, too, deserve to take a share of the credit for improved economic policies. Central bankers have been important, often behind the scenes, in advising on the long-term benefits of macrostabilization and structural reforms. Fiscal adjustment, in particular, makes pursuit of price stability by the central bank much easier.

Few of the macroeconomic and structural changes came easily, and more remains to be done. But the track records of the early reentrants are impressive enough that domestic residents and foreigners alike have come to believe that the changes in economic policy have a good chance of being durable. Moreover, these countries are pursuing policy agendas that are supportive of further steps toward macroeconomic stabilization and structural reform. For example, Mexico and Chile have clearly demonstrated their interest in expanding trade. They have established a free trade area with each other. Mexico is also pursuing a North American Free Trade Area, while Chile has expressed similar interests.

With regard to the later reentrants, Argentina has also made significant progress in implementing improved policies, but its track record is shorter. Brazil has made less progress in implementation, but the government endorses these types of policies in principle.

Settlements on Commercial Bank Debt

The second feature that has characterized increased creditworthiness in the cases of Mexico, Venezuela, and Chile has been the achievement of negotiated settlements with their bank creditors. The settlements increase the likelihood that past debt-servicing problems have been resolved and that future debt-servicing obligations will be met. Chile's method of settlement relied on large debt to equity conversion programs implemented since the mid-1980s. The settlements of Mexico and Venezuela have taken place over the last couple of years under the auspices of the debt initiative proposed by Secretary Brady in 1989, which relied heavily on the exchange of bank debt for partially collateralized bonds and much less on concerted new money packages from banks that characterized most debt restructurings during the 1980s. Markets anticipate that Argentina and Brazil will follow suit; in fact, Argentina reached preliminary agreement on a Brady package in early April.

Costa Rica and Uruguay have also benefited from debt reduction under the Brady initiative, and have thereby lowered their debt burdens, and improved their creditworthiness. Other countries, too, may still avail themselves of the benefits available.

The negotiated debt deals with banks reduced the net present value of the countries contracted obligations and largely resolved market uncertainties regarding the overhang of debt. The reduction of these uncertainties reinforced confidence that the governments would continue with reasonable economic policies.

Since the debt servicing under the agreements looked broadly compatible with the governments' fiscal situation, it reduced the probability that the governments' would need to raise extraordinary revenues to service old debt, thereby reducing disincentives to potential investors, both foreign and domestic.

The creation of easily tradable securities through Brady-debt deals further expanded the secondary market for developing country debt, which developed in the mid-1980s as banks tried to swap or reduce loan exposures. The volume of trading on the secondary market surged from well under $20 billion per year in the 1985-87 period to about $100 billion in 1991, fueled importantly by the trading of Brady bonds. As the market expanded and became increasingly liquid, it became easier for the market to price country risk. The yields provided market benchmarks so that new securities could be priced appropriately and accepted in the marketplace.

The secondary market prices for the debt of Chile, Mexico, and Venezuela have improved substantially since the end of 1989, reflecting the improved economic performance and the increasing perception that significant progress has been made in resolving their debt problems. It is also interesting that Colombia's debt prices have achieved relatively high levels without resorting to debt reduction operations but through negotiations with banks on new loans, and, of course, the implementation of sound policies. Colombia's experience illustrates that increased creditworthiness can be achieved in various ways.

In recent months, prices for the debt of Argentina and Brazil have been rising, but trade at considerably lower levels.

The price of debt can retreat as well as advance. Prices have typically retreated in countries when the market has judged that the economic or political situation has deteriorated.

New Flows

Improved economic policies and the resolution of earlier debt problems laid the foundation to attract new capital flows from abroad over the last couple of years. Important sources of the new flows for all reentrants have been bond and equity markets, as well as foreign direct investment. Voluntary medium and long-term loans from banks have not yet played an important role in providing new finance.

The increase in bond placements over the last two years has been impressive. According to OECD data, reentering borrowers from Latin America raised $1.2 billion in 1990 and $4.6 billion in 1991 in public bond offerings. There were no such placements in 1989, and only occasional issues recorded in the OECD data in the preceding few years. These data represent a lower bound on the amounts raised since they exclude private placements. IMF data suggest that there has also been a large increase in private placements, beginning as early as mid-1989.

For the countries reentering capital markets, most of the borrowing in bond markets has been done by large public sector corporations and well known private firms, as well as by governments. More recently, smaller firms too have become successful.

The perceived risk in these bonds has tended to drop over time, as reflected in the changes of borrowing terms. For example, PEMEX, Mexico's state-owned oil company, in October 1990 issued a $150 million three-year bond at 370 basis points over a comparable U.S. Treasury security. In September 1991, PEMEX issued a $150 million seven-year bond at only 245 basis points over the comparable U.S. Treasury. Similarly CEMEX, a private sector cement company in Mexico privately placed in May 1991 $425 million for five years at a 680 basis points spread; in September it placed $150 million for three years at a spread of 450 basis points.

Many of the bonds placed by public and private sector firms have special features to reduce the risk to lenders and to lower interest costs for borrowers. Telefonos de Mexico made several offerings, both before and after it was privatized, which included collateralization with AT & T receivables, i.e., a pledge of dollar assets in the United States. It is estimated that this collateralization feature cut Telmex's borrowing costs by 250 basis points.

Other features have been added to some of the bonds such as put options, call options, and bonds convertible into equity shares. All of these features are designed to meet the varying preferences of different borrowers and lenders.

Another important source of external finance for countries that have regained access to international capital markets over the last two years has been the issuance of equity in foreign markets. It is often preferable for firms to seek equity rather than debt financing since in addition to the absence of pressure to repay principal, there is more scope to vary dividend payments according to profitability, while interest must be paid regardless of conditions.

There are no good comprehensive data on equity issues available on a timely basis, but market reports and available data indicate that equity issues have picked up enormously over the last two years. The privately owned Compania de Telefonos de Chile was reported to have made the first international equity offering by a Latin American borrower in 25 years in July 1990. That offering raised about $90 million in ADRs (American Depository Receipts). A U.S. investment bank recently calculated that Mexico issued over $4 billion in ADRs in the United States in 1991, including about $2 billion by Telmex, which was privatized at the end of 1990. These new issues have taken place in an atmosphere of generally rising stock markets in Latin America. Country or region specific stock market funds, marketed in foreign countries, have attracted capital inflows into these markets. The IFC calculates that country funds of Argentina, Brazil, Chile, and Mexico have been launched over the last few years at an aggregate initial size of about $1 billion.

There have also been significant increases in direct foreign investment flows to market reentrants over the past few years. These flows, which never completely dried up in the 1980s, amounted to an estimated $9.3 billion in 1991 for the five countries, an increase of about 50 percent compared with average

1989-1990 levels. Investment has been in a wide range of industries. Investment in Argentina and Venezuela, in particular, has been heavily influenced by the government's decision to privatize state-owned enterprises like telephone companies and airlines.

Foreign direct investment also usually brings with it benefits other than financing. Often foreign management expertise is provided and technology transfer occurs. These attributes may well add to the growth potential of an economy.

In addition to bond, equity, and foreign direct investment flows, there are some signs that banks are willing to make moderate increases in exposures in selected cases. Chile, whose restructured bank debt sells at 90 cents, has been successful in raising limited amounts of voluntary medium-term financing from banks. Mexican banks have been issuing significant amounts of CDs in the Euromarket, reportedly in excess of $5 billion over the past two years. Mexican banks, in turn, use these deposits to lend to Mexican entities. In fact, recently the Bank of Mexico has become concerned at the size of flows raised in this fashion and has encouraged more prudent behavior by banks. Mexican entities, too, are increasingly issuing commercial paper in Euromarkets, estimated at over $500 million in 1991.

The sources of these resumed flows to Latin American countries have been diverse. Reports indicate that they include insurance companies and individuals, as well as intermediaries such as money managers, pension fund managers, and mutual fund managers. Funds have been raised mostly in European, including Spanish, and U.S. markets and in a mix of currencies including dollar, DM, and pesetas. The fact that Moody's applied just below investment grade ratings to the bonds of Mexico and Venezuela within the last 18 months increased the base of interested investors. There also are clear indications that these investments are attracting the interest of Latin American investors who had previously placed their funds abroad. These and other signs that flight capital is returning home are particularly encouraging since significant resources had been placed outside of Latin America during the 1970s and 1980s.

Implications for Other Countries

These remarks have been focussed on the early reentrants. But as noted, other countries, Argentina and Brazil, in particular, also have regained limited access to capital markets, perhaps in anticipation of Brady packages, and in the case of Argentina, a sustained period of improved policies and a significant privatization program. Experience suggests that market access will be maintained only if macroeconomic stabilization continues to be pursued and is sustained, structural reforms are solidified, and outstanding debt issues with creditors are resolved. The fact that capital is flowing to Brazil partly in anticipation of sustained implementation of improved policies, of better economic performance, and of settlements with commercial banks illustrates that capital is anxious to enter the region in pursuit of profitable opportunities.

Experience also would suggest that individual countries, including those countries that have made the most progress to date, run the risk of easily losing market access and being subjected to capital outflows if the markets should lose confidence in economic policies and performance. Any retrenchment from reforms would be more costly over time, even though at times such rollbacks appear politically attractive in the short run.

The recent coup attempt in Venezuela exemplifies that markets can react rapidly if it is perceived that reforms and liberalization are threatened by lack of internal support. In very difficult political circumstances, the Venezuelan leadership faces the challenge of sticking with the basics of its economic program. Continued policies of macrostabilization and structural reform will provide the basis for future growth. The continued fiscal adjustments that are required in Venezuela will have to take due account of the impact on the neediest segments of the population. More generally, policymakers in the region must try to insure that the benefits of economic growth spread widely among the population. Otherwise, support for necessary policy changes will evaporate.

Other countries in the Western Hemisphere are undoubtedly being affected by the experience of the countries that have regained access to international capital markets. Investors are looking for additional outlets for their investments after rediscovering the opportunities in these countries. A number of other countries in the region have made strides toward improved policies and performance, and participants in international capital markets will notice. In most countries there is ample opportunity to attract the return of flight capital. Domestic residents who have placed funds abroad are often in a good position to appreciate the implications of policy developments in their home countries. They are likely to seize the opportunity to make profitable investments in stable environments. At the same time, countries that lag in implementation of sound policies are likely to suffer, since investors have alternative investment opportunities both inside and outside the region.

Will Latin America Be Constrained by a World Capital Shortage?

Concerns have arisen in recent years that a world capital shortage might develop because of increased demand for capital resulting from the restructuring of Eastern Europe, including eastern Germany and the former Soviet Union, the rebuilding required as a result of the invasion of Kuwait, the ongoing need for foreign investment in developing countries, including Latin America, and the anticipated cyclical recovery in industrial countries. These increased demands for capital are occurring at a time of persistent large structural fiscal deficits in some industrial countries, including my own, which drain the supply of savings.

All countries in the Western Hemisphere desire higher levels of investment that will support higher levels of income and economic welfare. If prudent policies are continued, there is no reason why Latin American countries cannot continue to attract a portion, indeed an increasing portion of world savings, albeit perhaps at higher world real interest rates. If confidence continues to increase, the reduced risk premium paid by Latin borrowers may more than offset any increase in world real interest rates. Moreover, there is strong evidence that there are significant opportunities for countries in the region to benefit from the return of flight capital.

All countries have the ability to augment domestic savings through appropriate policies, most readily through increased public savings. Many countries in Latin America have had success in reducing budget deficits--a record the United States should emulate. But given the desirability of higher levels of domestic investment, further increases in domestic savings would be appropriate, especially if there are concerns that savings from abroad may not be available at the levels or terms desired. Private savings can also be encouraged. Private savings will flourish in an environment where policymakers have established credibility. People are more inclined to save when they have confidence that their savings will not be taxed indirectly through inflation or through arbitrary taxes and freezes on assets, and that positive after tax real rates of return will be earned. The structural reforms, implemented by countries in the region, directed at prudent financial market deregulation, including the removal of interest rate controls, will be supportive of increased financial savings.

Conclusion

Working our way out of the debt problems of the 1980s has been a difficult and complicated challenge. But evidence from the past couple of years strongly suggests that the worst of the debt-servicing problems is over for those countries that have implemented sound macroeconomic and structural policies while resolving their old debt problems. Not only have the early reentrants demonstrated their capacity to regain access to international capital markets, but these countries also have recorded impressive gains in economic growth, trade, and investment. Other countries like Colombia and Bolivia, which have implemented sound macroeconomic policies and structural reforms, have also recorded sustained records of growth. With continued pursuit of appropriate policies, I have every reason to believe that other countries represented at these meetings that follow the example of the more successful adjusters will grow and prosper in the years ahead, and will have the opportunity to draw on foreign capital markets as appropriate.