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Recent Capital Inflows to Latin America: Too Good to Last?

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Recent Capital Inflows to Latin America: Too Good to Last?

Think of how much impact Japanese, German, British and American bondholders have on Canada's currency and interest rates. Imagine the impact stock or bond investors could have on a country with a fragile economy and underdeveloped financial markets a tenth the size of ours.[1]

Although the LDC debt crisis has long faded from public memory, it was not that long ago that most economists believed that it could take decades for the commercial bank debtors of Latin America to be welcomed back into international capital markets. But recent net flows of financial capital to Latin America have recovered from their decline throughout the 1980s. Net transfers to the countries of Latin America are again positive. While the composition of these capital inflows has changed from commercial bank credit, to bond and portfolio equity financing, along with significant amounts of foreign direct investment (FDI), it is still possible that these flows could reverse themselves sometime in the future. A number of economists fear that the advent of a second debt crisis, albeit with different consequences, could be on the horizon. To understand how this could occur, it is important to understand the magnitude of these flows in recent years, as well as why international capital has once again been attracted to Latin America.

Magnitude of Recent Capital Inflows

Net resource flows to Latin America have been restored to their pre-debt crisis nominal levels and net transfers to the region have again become positive in the 1990s after being negative throughout the better part of the previous decade (Table 1). The composition of these flows, however, has changed. Whereas it was commercial bank credits that comprised the majority of resource flows in the years preceding the debt crisis, it has been portfolio equity, FDI and international bond issues that have increased since the beginning of the decade.

Just as commercial bank lending once was concentrated in just a few Latin American countries (Mexico, Argentina and Brazil), so too are the new capital flows. Argentina, Brazil, Chile and Mexico, for example, accounted for 86% of all FDI flows to Latin America in 1992.[2] The reason for the flows has changed, however, as debt-equity swaps have given way to the inflow of capital for

[1]Douglas Goold, "Mutual funds in the Third World," *Globe and Mail*, July 25, 1994, p. B9.

[2]*World Debt Tables, 1993-94, Vol. 1* (Washington: World Bank, 1993), p. 57.

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privatization of state enterprises. Between 1985 and 1989, FDI through debt-equity conversions in Argentina, Brazil, Chile and Mexico amounted to US $11.5 billion. Between 1990 and 1992, the same countries attracted US $5.1 billion through privatization offerings.[3]

Table 1: Net Resource Flows and Net Transfers to Latin America and the Caribbean, 1980 and 1986-93
(millions of U.S. dollars)

	1980	1986	1987	1988	1989	1990	1991	1992	1993
Net Resource Flows	**30,159**	**11,402**	**13,846**	**15,438**	**5,908**	**19,272**	**28,782**	**30,796**	**37,545**
Net flow of long-term debt (ex. IMF)	23,355	6,113	5,871	4,998	(3,910)	8,012	6,205	5,317	11,062
Foreign direct investment (net)	6,183	3,553	5,777	7,999	7,083	7,669	12,375	14,506	17,510
Portfolio equity flows	0	0	78	176	434	1,099	6,228	7,883	6,030
Grants (excluding technical co-op.)	621	1,735	2,119	2,265	2,301	2,492	3,975	3,089	2,943
Net Transfers	**7,488**	**(18,931)**	**(16,231)**	**(19,589)**	**(22,369)**	**(5,998)**	**4,198**	**5,433**	**9,494**
Interest on long-term debt	17,531	25,559	25,228	29,160	21,071	18,929	18,433	18,742	19,733
Profit remittances on FDI	5,140	5,140	4,773	4,848	5,867	7,207	6,341	6,151	8,318

Notes: (1) Long-term debt includes loans (commerical and official) and bonds.
(2) Net transfers are equal to net resource flows, less interest on long-term debt and profit remittances on FDI.
(3) Data for 1993 are preliminary.

Source: World Bank, op. cit., p. 186.

As in the case of FDI, international bond issues by Latin American countries have also been concentrated. Mexico has led the pack issuing US $4.4 billion in 1992 with a further US $7.5 billion projected for 1993. Brazil was second (US $3.5 billion in 1992 and a projected US $4.7 billion for 1993), followed by Argentina (US$1.7 billion and US $3.5 billion, respectively).[4]

Stock market capitalization in the major Latin American markets has also increased dramatically in the past few year, further fuelling the increase in capital flows. As of June 1993, total capitalization of the Mexican stock market stood at US $130 billion. Brazil had a total market capitalization of US $76 billion, while

[3]World Bank, *op. cit.*, p. 57.

[4]World Bank, *op. cit.*, p. 9.

Argentina stood at US $27 billion.[5] Total portfolio equity inflows also increased from next to nothing at the end of the 1980s, to almost US $8 billion in 1992 (Table 1). Commercial bank lending, however, has not been as buoyant; new commercial bank credit commitments to the region averaged just over US $1.5 billion between 1989 and 1993.[6]

Factors Behind the Resurgence of Capital Inflows

Why has money flowed back into these countries? Several factors have converged which have allowed a number of countries in Latin America to attract large amounts of international capital flows.

First, domestic changes in the countries themselves have made them attractive destinations for foreign capital. Countries in Latin America, which once viewed foreign investment as a threat to sovereignty, began to welcome foreign investment by changing regulations which discriminated against foreign investors. Furthermore, inflation began to be tamed and most governments throughout the region became fiscally responsible in controlling government deficits. Trade regimes were liberalized and exchange rates began to reflect their true market values. In addition, the sale of state-owned firms, through debt-equity swaps or privatization programs, provided investors with good investment opportunities. The Brady Plan, the only effective concerted effort to address the debt overhang, has reduced the debt-servicing burdens of a number of Latin American countries. It has further acted as a signal to global investors that the unmanageable debt overhang is gone and that these countries once again present acceptable risks.[7] The return of flight capital, which left in the tens of billions of dollars during the crisis of the 1980s, has further bolstered the activity in these markets.

Second, sluggish growth rates, low interest rates and balance of payments problems in countries such as the United States have resulted in large amounts of

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[5]World Bank, *op. cit.*, p. 26. For a good review of the factors behind the growth and internationalization of emerging stock markets, see Peter K. Cornelius, "The Internationalization of Emerging Stock Markets," *Intereconomics*, Vol. 29, No. 3 (May/June 1994), pp. 131-8.

[6]World Bank, *op. cit.*, p. 18.

[7]For a fuller discussion of related issues, see Richard E. Mueller, *Still an Albatross? The LDC Debt Crisis Revisited*, Policy Staff Paper No. 94/09 (Ottawa: Department of Foreign Affairs and International Trade, May 1994).

capital (both portfolio and FDI) searching for higher rates of return.[8] Still, a recent International Monetary Fund (IMF) study notes that external factors could not be the primary cause of the inflows in the six countries under study since changes in external factors did not precede capital inflows.[9] Nonetheless, while changes in external economic conditions may have not started the capital inflows, there is little doubt that they contributed to its persistence.

Third, financial market regulation changes in developed countries increased the popularity of new financial instruments (i.e., mutual funds and derivatives), and the dramatic growth in pensions as a result of an aging population has increased the pool of investible international capital.[10] In a number of OECD countries, for example, there has also been a move towards advanced-funded pension systems over "pay-as-you-go" pensions which has increased contributions to these funds.[11] The growth in these instruments, along with the limited opportunities in traditional markets, the rise in the philosophy of international portfolio diversification and increasing information about emerging markets, has led to capital looking for the highest rate of return in non-traditional markets. A 1992 survey notes that institutional fund managers have quadrupled the amount of their international portfolio allocated to Latin American and Asian markets, with Latin America accounting for 39% of emerging market portfolios.[12]

Fourth, the passage of the North American Free Trade Agreement (NAFTA) by its member states, along with talks regarding accession to the agreement, has resulted in an increased interest in the region, mainly Mexico at the moment. It has been argued that the economies of Latin America which have not reformed as

[8]For an explanation of changes in the U.S. economy which caused capital inflows into Latin America, see Guillermo A. Calvo, et al., "Capital Inflows and Real Exchange Rate Appreciation in Latin America," *IMF Staff Papers*, Vol. 40, No. 1 (March 1993), pp. 108-51.

[9]Susan Schadler, et al., *Recent Experiences with Surges in Capital Inflows* (Washington: IMF, December 1993), p. 5. The countries included in this study were Chile, Colombia, Egypt, Mexico, Spain and Thailand.

[10]For a review of the changes in U.S. capital markets, the largest source of foreign capital in Latin America, see Roy Culpeper, "Resurgence of Private Flows to Latin America: The Role of American Investors," North-South Institute, February 1994.

[11]Organisation for Economic Co-Operation and Development, *Financial Market Trends 56* (Paris: OECD, October 1993), pp. 37-38. Generally, "pay-as-you-go" pensions are a transfer from the cohort of people currently employed to beneficiaries in the cohort who have retired. Advanced-funded pensions are funded by the cohort of people currently employed and invested for the future retirement benefits of the same cohort.

[12]Kleiman International Consultants, "1992 Emerging Stock Market Survey," (Washington: 1992), cited in, International Monetary Fund, *International Capital Markets Part II: Systemic Issues in International Finance* (Washington: IMF, August 1993), p. 58.

much as countries such as Mexico and Chile have also benefitted from this boom as a result of the bandwagon effect in markets.[13]

Too Much, Too Fast?

The problem for the governments of Latin America today is not how to address negative foreign resource transfers, as it was throughout the 1980s, but rather how to manage the large increase in positive resource flows. Increasing foreign currency flows has led to a number of problems such as the appreciation of the domestic currency, large current account deficits and high domestic interest rates. Still, countries which have been subjected to large inflows have largely been successful in managing them.[14] These problems, moreover, are comparatively minor to the consequences of the massive outflow of capital during the 1980s.

If there is one thing that we learned from the debt crisis of the early 1980s, it was that financial capital is highly mobile internationally. This is even more true today. Although the region has recently been successful at re-attracting much of the capital flight that left during the 1980s, this could quickly be reversed. According to Loxley: "The fear is that these 'surges' in capital repatriation might just as rapidly be reversed, should either the external or internal climate change abruptly."[15] This could easily occur in equity markets, since financial liberalization has largely reduced restrictions on the inflows (and outflows) of foreign capital. In addition, bond maturities for most heavily indebted countries are short-term and, even where maturities are longer, bonds often have an early redemption option as a form of credit enhancement. Thus, the short-term nature of these inflows makes them very volatile and inconsistent with the longer-term financing necessary for investment in development projects.

Despite the surge in capital inflows, there has not been a significant improvement in the rate of investment for heavily indebted countries. Investment rates remain below their pre-debt crisis levels, likely the result of higher real rates

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[13]Culpeper, *op. cit.*, p. 24. Culpeper argues that investors may not have the information necessary to differentiate between a country such as Mexico (which continues to reform its economy) and a country like Brazil, which has not. For this reason, investors will invest in the region through such instruments as mutual funds. This does not reflect irrationality of the part of investors, only the fact that information is costly. Of course, this lack of information is reflected in the yield spreads of international bond issues as Brazil generally must pay higher spreads than Mexico. See International Monetary Fund, *Private Market Financing for Developing Countries* (Washington: IMF, December 1992), pp. 62-65.

[14]See Schadler, et al., *op. cit.*, and World Bank, *op. cit.*, pp. 26-8.

[15]John Loxley, "International Capital Markets, the Debt Crisis and Development," paper presented at *Global Development 50 Years After Bretton Woods: A Colloquium in Honour of Gerald K. Helleiner*, Ottawa, June 22-24, 1994, p. 16.

of interest which promote rent-seeking activities in favour of fixed investment. In Chile, Mexico and Argentina, for example, investment as a percentage of gross domestic product (GDP) has not yet reached its levels of the late 1970s and early 1980s. In addition, domestic savings have decreased, implying that foreign savings have had to make up for the gap between domestic savings and investment.[16] Furthermore, a significant proportion of new inflows have been the result of debt-equity swaps or privatization offerings, rather than new investment, with the United States being the main source of foreign investment in Latin America.[17] Therefore, dealing with the debt overhang has not had the impact on investment that many thought it might have had in Latin America.[18]

The financial system in Latin America is still fragile and investors in (primarily) OECD countries are still not comfortable with these markets. The recent assassination of Mexican presidential candidate Luis Donaldo Colosio is a case in point; only extraordinary efforts by Mexican officials stopped the political event from causing a drastic reversal in the recent surge of capital inflows.[19] The political uncertainty in the lead-up to the August presidential elections has also taken its toll on capital flows. Recently, at least US $100 million has reportedly been leaving Mexico each week.[20]

In addition, there is concern that the world capital market is still very concentrated, lacks adequate flows of information and is subject to inadequate regulation, problems which plagued international financial markets at the beginning of the debt crisis, although these problems do not appear to be as threatening to the international financial system as they were in the late 1970s.[21] In addition, fund managers face intense competition and are under increasing pressure to increase returns, much as the commercial banks were under to pressure to perform

[16]Investment as a percentage of GDP was estimated to be 19.9% of GDP in 1990-93, up from 18.1% in 1986-89, but down from 20.6% and 21.6% in 1971-78 and 1979-85, respectively. Domestic savings have also not recovered, amounting to 15.5% of GDP over 1990-93 down from 17.0% ,18.4% and 16.2%, respectively, in previous three periods. Meanwhile, foreign savings have increased to cover this investment gap. See International Monetary Fund, *World Economic Outlook* (Washington: IMF, October 1993), p. 82.

[17]IMF (Oct. 1993). *op. cit.*, p. 75.

[18]Loxley, *op. cit.*, p. 18.

[19]See Craig Torres, "How Mexico Averted Panic," *Globe and Mail*, March 29, 1994, p. B9, for a good hour-by-hour account of the period immediately following the assassination of Colosio.

[20]*Wall Street Journal*, July 19, 1994, p. A10.

[21]Loxley, *op. cit.*, p. 17.

in the 1970s and 1980s. This may cause money managers to ignore larger risks in the search for higher returns.[22]

The recent increase in international interest rates has caused a great deal of concern in investments circles and can harm emerging markets in a number of ways. First, and most directly, increases in international interest rates will cause investors in these markets to shift their asset allocation into fixed income instruments (i.e., guaranteed income certificates (GICs), savings bonds, etc.) and away from equity portfolio and non-investment grade bonds in these countries. With the exception of Chile, none of the countries of Latin America have had their bonds receive an investment grade rating by both of the major U.S. bond rating services. This means that higher interest rates must be offered for investors to accept the higher risk involved in holding these bonds; as much as 500 basis points above those of industrial country bonds.[23] Second, a number of these countries still have sizeable outstanding debts to international commercial banks. Higher interest rates increase payments to these commercial banks, increasing the burden on these countries and possibly limiting growth rates as larger proportions of public funds are earmarked for debt servicing. Furthermore, the emerging private sector is also faced with higher interest rates, limiting the number of cost-effective projects they will be willing to undertake. The result will be an exodus in portfolio capital as the once-sound investments lose their attractiveness and international investors seek higher rates of return elsewhere.

It is unlikely that the large capital flows to the countries of Latin America will continue at the same rate experienced over the early part of the decade. The amount of capital flight returning is a finite amount and debt-equity swaps and privatization programs are nearly exhausted in countries such as Mexico and Argentina. The World Bank estimates that 16% of all FDI flows to Latin America over the 1988-92 period were the direct result of privatization programs.[24] As the number of enterprises being privatized diminishes, so too does the amount of capital inflow. In addition, capital inflows have been concentrated in countries such as Mexico, Argentina and Chile, the economies that have implemented massive structural reforms. Future capital inflows may be directed at countries such as Brazil which is just beginning to reform its economy. Rather than how to cope with the large inflows in capital, it is argued that Latin America may be forced

[22]Organisation for Economic Co-Operation and Development, *Financial Market Trends* 57 (Paris: OECD, February 1994), p. 22.

[23]Loxley, *op. cit.*, pp. 15-6.

[24]World Bank, *op. cit.*, p. 61.

to deal with large outflows of capital, especially as economic factors external to these countries favour capital outflows (e.g., an increase in real interest and real growth rates in OECD countries). According to a recent IMF study:

> When surges in inflows are generated principally by changes in external macroeconomic conditions or bandwagon effects, it is less certain that the inflows will be channelled into productive investments: the threats of inflows feeding consumption and speculative investments, unsustainable real appreciation, and reversal of the inflows are greater.[25]

If this is in fact the case, then some of the economies that are least reformed in the region (Brazil and Venezuela, for example) could face significant capital outflows unless domestic economic reforms occur soon.

The Advent of a Second Debt Crisis?

Unlike the problems of the early-1980s, however, a number of factors make large capital outflows unlikely to occur and any outflows are not likely to result in severe consequences for the international financial system. First, bank lending was the norm in the 1970s after the first oil shock. The normally conservative banks were flush with petrodollars and needed an outlet for the increase in deposits. They largely relaxed their normal lending practices, and changed or circumvented banking regulations in the U.S., which relied on collateralized debt holdings (i.e., project lending), and began lending for balance of payments support with no collateral. Today, a larger proportion of the capital inflows are in the form of foreign direct investment, inherently a longer-term type of investment than the extensive reliance on short-term commercial credit at the beginning of the 1980s. Also, although bank lending is only slowly beginning to trickle back into Latin America after a conspicuous absence throughout the 1980s, it will likely increase in the future. Increased regulatory requirements and a more cautious attitude on the part of commercial banks, coupled with better information and the channelling of lending into projects (rather than balance of payments support based on sovereign risk) means that new lending will be more secure.[26]

Second, foreign holders of equity and debt instruments are less concentrated today. Unlike the early 1980s when international commercial banking syndicates

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[25]Schadler, et al., *op. cit.*, p. 29.

[26]OECD (Feb. 1994), *op. cit.*, pp. 13-4.

held most of the debt instruments of a small number of countries, it is individuals and institutional investors which hold the bulk of the bond and portfolio equity financing in these countries. While this helps to diversify risk, and trading of these securities helps give investors price signals about possible future difficulties, it also makes a concerted response more difficult since the debt instruments are so widely held.[27] Foreign direct investment is also diversified amongst a number of different companies, reducing the risk of systemic failure if problems should arise. This means that the international financial system will not be threatened if these countries again have debt-servicing problems. Furthermore, previous commercial bank lending put all the risk on the borrowing countries since they had to assume all interest rate and exchange rate risk. Today, this risk is assumed by foreign debt and bond holders.

Third, whereas in the 1980s, commercial debt was held by governments or state-owned enterprises and was used to finance fiscal deficits and consumption, today funds are being channelled into the emerging private sector where they are presumably being used for more productive investments. The World Bank estimates that private-to-private flows now account for 60% of the net inflows to all developing countries.[28]

Fourth, the countries that have been the largest beneficiaries of capital inflows are the ones that have reformed their economies and have been successful at absorbing the massive inflows. One of the mechanisms of coping with the flows have been to increase international reserves. The international reserve position of Mexico, for example, improved from US $4.2 billion in 1980 to over US $19 billion in 1992.[29] This allows debtors to weather a sudden reversal of capital inflows, at least over the short-term, while still maintaining import levels, debt-servicing payments and defending domestic currencies.

Outlook

What will we witness in the near future? Some of the optimism which surrounded commercial bank lending in the previous two decades has now infected

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[27]In the 1970s and the early 1980s, official debt was held by a few countries and international financial institutions. Likewise, commercial bank loans were made by a few large banks (with the participation of a number of smaller banks). When these loan portfolios went bad after 1982, a concerted response through the London and Paris Clubs was manageable because of the relatively small number of debt holders. Today, by contrast, debt and equity instruments are held by thousands of individuals, companies and institutional investors, making such a response logistically more difficult.

[28]World Bank, *op. cit.*, p. 3.

[29]World Bank, *World Debt Tables, 1993-94, Vol. 2* (Washington: World Bank, 1993), p. 298.

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private and institutional investors who are investing tens of billions of dollars in the emerging markets of Latin America. It is likely that we will see a slowing of capital inflows to the region as privatization programs wind down and markets become overheated, although flows will remain positive. Also, as economic reforms progress and economic stability ensues in countries such as Brazil, these countries will attract a larger proportion of the pool of international capital. Higher real interest and growth rates in traditional OECD markets also mean that international capital will have a larger number of attractive destinations.

There have been problems in managing these massive capital inflows, but these pale in comparison to the negative consequences of a massive capital outflow. There is little danger that large outflows of foreign capital will occur and most countries, although still with fragile capital markets, are in a good position to weather temporary bearish attitudes of foreign investors. The diversification of risk will also ensure that the international financial system would not be threatened, as it was in the 1980s, even if a drastic reversal of capital inflows did occur. Domestic savings and investment rates, however, still low by historical standards, will have to improve, enhancing economic growth and ensuring that debt will be repayable and that shareholders will receive a competitive rate of return on their assets.

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