Latin America Rising

Stock markets in several Latin American countries are worthy of respect. Even local people are buying local securities.

Investors should give Latin American stock markets a careful look. The cycle of presidential elections in the region is almost finished, so there’s less political uncertainty. Also, the markets are rebounding well from a downturn in May and June.

The triggers for the decline were external: interest-rate hikes in the rich countries; rising tensions in the Middle East; fears that commodity prices were peaking. They affected all the emerging markets.

There was a flight to quality, as usual, but the flight did not turn into a general rout in Latin America. In particular, markets in Brazil, Chile, Mexico and Peru have been reformed, so they weathered the May-June decline with little difficulty. The resilience which these stock markets displayed is new.

The region’s stock markets used to be small, chubb}y and wildly volatile—but since 2002, the leading four have become much more solid and transparent. Reforms have remedied many of the defects in design that plagued the region’s national financial systems for generations. They now have better checks and balances, allocate capital better and police the abuses more reliably.

Capital markets in those countries have grown, and now play an increasingly important role in the capital-allocation process. Private pension funds and mutual funds have rapidly taken market share away from classic commercial banks, which allocated capital badly and often collapsed.

Financial reforms also include central bank independence and protection of minority shareholder rights. In Brazil, Mexico, Peru and Chile, the reforms have passed a very stringent test: They have won the confidence of savvy local citizens, who have watched the reforms being enacted and have shown their confidence by putting their money into local financial institutions.

When the current rally in Latin American stock markets slows down, the downturn in prices will be mild in the countries that have modernized their financial systems. In the countries that still have the traditional, opaque, bank-centered financial systems, the downturn may be much sharper.

Meanwhile, although the cycle of presidential elections made investors nervous, election results have been much more encouraging than the “leftward shift” description often repeated in the U.S. news media. Alarmists warned that a new cohort of demagogues and populists was going to take over—yet it is a mistake to attach simplistic labels to the newly elected presidents. Each one is unique and none of them is like Hugo Chavez.

Since 1990, the most effective financial reforms have been undertaken by center-left governments (although Mexican President Vicente Fox of the center-right PAN party also deserves a nod). The U.S. press has paid too much attention to Chavez, Evo Morales of Bolivia, Nestor Kirchner of Argentina and, as always, Fidel Castro of Cuba, while overlooking the steady improvements in the finance sectors of the other important countries in the region.

One of the benefits of the financial reforms is that middle-class savers are more willing to hold local currency. They no longer take the trouble to convert it into dollars and send it to relatives living in the U.S. or Europe. This is a watershed shift. Until as recently as half a decade ago, they distrusted their local financial institutions. Now, they are willingly buying locally issued securities.

Another benefit of the reforms: improving confidence in the private-pension systems in Mexico and Peru. Workers in those countries were skeptical about what would become of the deductions from their paychecks that went into private-pension accounts. Now, as in Chile before them, the accounts have become a large part of their net worth, and they have become believers. They want those accounts to keep growing and will resist any policies that would undermine their value.

The reformed financial systems have built a wall between custody of the money and the power to allocate it. In the reformed financial systems, the opportunities for self-dealing are fewer. The mutual funds and pension funds that have arisen so rapidly in those countries only buy listed securities. The procedure for allocating capital now involves arm’s-length assessment, and has become relatively free of improper influence.

Local bond markets are also functioning, and have made lending criteria more objective. Today, when a company wishes to finance a project, it raises the money by issuing bonds, instead of applying to its principal bank. To place those bonds, it has to convince cold-eyed portfolio managers that its proposal deserves funding. The portfolio managers are representing the beneficiaries and are not taking orders from the patriarch of a local bank. The growth of local bond markets has been rapid. The amount of locally issued corporate bonds in Latin America rose tenfold from 2001 to 2004.

The countries with modernized financial systems have been in a sweet spot since the last quarter of 2002. Chile, which has been the leader in financial reform since it launched its revolutionary pension system in 1981, is the exemplar. Its gross domestic product has grown 6% a year since 2003, its government debt has fallen from 45.4% of GDP in 1990 to 7.7% at the end of 2005, and its foreign-exchange reserves are more than twice its dollar-denominated government debt. Its fiscal accounts showed a surplus for 2006 equivalent to 4.5% of GDP, and are also in surplus this year. Its trade balance is hugely positive, and capital-goods imports grew 32% in 2005.

Financial indicators in Peru, Colombia, Brazil and Mexico are also impressive.

The whole region’s ratio of external debt to GDP has declined, and its central banks have built up a war chest of foreign-exchange reserves. For example, Brazil’s total external debt was $224 billion in 1998 and its foreign-exchange reserves were $36 billion. By July 2006, its external debt had fallen to $178 billion. Its foreign-exchange reserves had risen to $66.5 billion, even after paying the $15 billion it owed the International Monetary Fund.

The financial reforms in the four key countries probably have become irreversible. In those countries, there is a major new constituency in the political equation: A large portion of the electorate owns financial assets and is depending on them. Also important: The easy expedient of printing money is no longer available, because the politicians no longer control the central banks. In those countries, the political cost of inflationary policies is prohibitive.

The traditional signal for foreign investors to withdraw from a developing country is that local investors start sending their money abroad. Now that local investors in Brazil, Mexico, Peru and Chile are bringing their wealth home to work for them, foreign investors could do well to follow their example. ■

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