Prosperity for Latin America by the Direct Route

By John C. Edmunds

The market prices of most of the capital assets in Latin America can be much higher then they currently are. Capital assets including land, buildings, machinery, intellectual property, going concerns, trademarks, and electromagnetic spectrum are priced lower than their productive capacity would justify. Those same assets, if they were in Europe or the U.S., would be worth more, and in some cases as much as ten times more. This point may seem of little importance because conventional economic analysis pays scant attention to the market prices of capital assets; instead the normal approach is to focus exclusively on output, technology, exports, and international competitiveness to explain the prosperity of Latin American countries.

There is good reason to spend a minute thinking what the effect would be of raising the market values of capital assets in Latin America. In most countries the market value of the capital stock is between 2 and 5 times the country's annual GDP. For countries that have mineral resources, oil, or extensive forests the value of the capital stock can be higher, for example as high as 10 times the GDP. Now suppose that in a short time the market value of a country's capital stock rises from 2 times GDP to 3 times GDP. The increase in value of capital assets would be a windfall gain equal to a year's GDP of the whole country. This gain would accrue to the owners of the assets. Those owners would quite quickly find themselves richer than they previously were. They would increase their spending, and they might also take steps to increase output at the businesses they control, and invest in improving the assets they own. These increases in spending and investment could lead to a virtuous circle of growing GDP, and further increases in the market values of capital assets in the country.

For the value of a country's capital stock to increase does not require many transactions. It might seem that a massive wave of buying would be required to raise market prices, but in reality only a few transactions at higher prices suffice to raise the prices; the marginal buyer is the one who sets the price. So any change in the outlook, or any change in new buyers' legal standing, may trigger a virtuous circle of asset price increases.

Latin American asset prices are low for two reasons that are easy to remedy. One is that there are large assets including farms and family businesses that are unsecuritized – that is, there is a single owner who is also the manager. A buyer has to buy the whole asset and also has to manage it. If these large assets were organized as corporations with millions of shares and professional management, the number of potential buyers would be greater because each buyer could buy just a tiny fraction of the whole, and would not have to manage the asset. The more potential buyers there are for an asset the higher the price. Also when the shareholders are independent of the managers they bring pressure for performance, and demand adequate returns, so securitizing assets brings accountability and puts an end to idleness and underperformance. To see how much potential securitization alone can offer, consider figures from Chile, the country with the strongest credit rating and the most successful financial system in the region. Chile's PIB is approximately US$100 billion, but its total stock market capitalization has fallen as low as US$50 billion because large buyouts have removed companies from the stock exchange, more than offsetting new issues of shares in recent years. Trading volume has also dried up and only a few of the approximately 300 listed shares have enough liquidity to attract new buyers. Consider now that if more Chilean companies listed on the local stock exchange, so that the value of listed shares went up to US$70 billion, and then the Chilean stock market rose 20%, the gain would be worth US$14 billion. That gain would be equal to 14% of GDP, much larger than the current forecasted growth of 4.3% for Chilean GDP for 2001. A paper profit is not the same as growth of the real economy, but in terms of order of magnitude the paper profit is three times larger, and the people with the paper profits would know gained them, and would act accordingly.

Second, most Latin American companies cannot optimize their capital structures. Most of them do not have continuous access to capital and when they can get it the financing tends to be debt instead of equity; furthermore the debt is short-term, floating-rate and the costs are onerous. So in the aggregate they get too little financing, and the maturity structure of their assets does not match the maturity structure of their liabilities. The biggest reasons for their chronic inability to fine-tune their financial structure are country risk and incomplete risk and maturity intermediation. Country risk premiums have to be high because of contagion. That fact of life, however, does not have to condemn all Latin American companies to a high cost of capital; issuers can circumvent part of the country risk penalty by designing deal structures that shield cash flows from contagion, and can lay off another part of the country risk by purchasing credit enhancements from international insurance companies. Insurance companies do not have to fear contagion as much as portfolio investors do and consequently do not have to charge so much for bearing that risk. The other fact of life is that capital markets in Latin American countries are not as complete as they are in the rich countries. Classic commercial banks, with their conservative, risk-averse underwriting standards, still dominate and more risk-tolerant channels still do not move enough money to meet the needs of the young, unseasoned borrowers. Consequently fast-growing companies often outstrip their lines of credit and have to brake their growth because the securities they would place are too risky for local appetites. Startup companies often do not get as far as they should, or grow slower than their merits justify because local suppliers of capital demand guarantees or dole out fresh capital too slowly. This sort of risk aversion slows the country's growth rate and keeps new job creation below the level that it would reach if Latin American capital markets included a full complement of risk-tolerant providers of capital. That is regrettable but not the key point of this argument. By far more important is the point that low rates of securitization and incomplete capital markets, that do not adequately intermediate risks and maturites, keep Latin American capital assets from having higher market prices.

To see how much difference it could make if capital assets in Latin America had higher prices, consider the following approximate figures for Chile. At this time the market value of all capital assets in Chile is probably no higher than US$200 billion, or US$300 billion including mineral resources. The high country risk premium for Argentina probably depresses prices of Chilean assets, but even without that cloud on the horizon Chilean assets would still be worth much less than the prices they can easily attract. To attract consistently higher valuations Chilean asset owners would have to assign high priority to overcoming and circumventing barriers to higher valuations. Some of these barriers are outside their control but others are clearly within their control. The approximate magnitudes of the wealth increase that Chilean owners can achieve are in the range of US$50 billion to US$200 billion. They could probably achieve the lower figure in a short time and without changing their ownership structures or their day-to-day affairs very much. To reach the larger figure would require more profound changes and more time. The increase in value is worth pursuing because it amounts to a windfall gain between US$3000 and US$12000 per capita.