

Competing for Financing in World Capital Markets

by John C. Edmunds

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For the past sixteen months Latin American countries have successfully attracted inflows of capital. For the five years before that, the region attracted little capital, and in some cases repaid foreign capital that it had attracted previously. The region can continue to attract inflows of foreign capital, or can choose to slide back into the pattern of 1997- 2002, using only small amounts of foreign capital.

The crises of 1997 and 1998 forced Latin American countries to reduce their reliance on inflows of foreign portfolio investment. The countries responded by trying harder to gather internal savings and to improve the functioning of their internal capital markets. Aggregate statistics show what happened: total outstanding foreign debt of the Latin American and Caribbean countries peaked in 1999 and then declined slightly, from \$795 billion to \$765 billion two years later. Short-term debt declined sharply, from \$127 billion in 1997 to \$96 billion in 2001.

There are several possible views of the 1998-2002 decline in foreign borrowing. The decline might be the liquidation phase of a classic credit cycle, with the expansion phase having begun in the fourth quarter of 2002. The decline might be the *dénouement* of the era of volatile inflows and outflows, which was plagued by financial crises and contagion. The most constructive view of the decline is that it was a pause while the region's capital markets retooled themselves to compete successfully in the modern financial economy of the world. For the past year and a quarter, the bonds and stocks issued in the region have been better designed, and now offer adequate protection against the risks that in previous eras deterred investors from buying Latin American securities.

The decline in foreign debt was in stark contrast to what was happening in the U. S. during the same time period. While Latin America was paying back foreign lenders, US households and corporations were increasing their borrowings enormously. Households increased their installment debt and

mortgage borrowings by almost \$1.5 trillion and corporations increased their borrowings by about \$1 trillion.

The data indicate that during 1997-2002 lenders gave a vote of no confidence to Latin American borrowers, and instead lent to US borrowers. The average yield on debt securities in Latin America was consistently higher than in the U.S., but was not high enough to induce many lenders to take the risk of lending in Latin America. Evidently lenders preferred to lend to spendthrift North American consumers, who borrow to support their profligate lifestyles, than to lend to Latin American businesses, despite the high real returns those businesses offer.

The data also show that the vote of no confidence applied to the national financial systems and not to the goods-producing sectors of the economies. Direct investment, which bypasses the national financial systems and is less affected by financial shocks, rose steadily from 1997 on, pausing only for the Argentine crisis. Foreign investors did not stop investing in Latin American countries; they shifted their mode of operations to direct investing. Through the recession and stagnation of 2000 – 2002, foreign direct investment continued to flow into the region, while portfolio investment slowed to a trickle. The steady inflows of foreign direct investment show that opportunities have consistently been good.

The most striking fact that the data show is that the total amount of new financing that businesses in Latin America obtain from all sources is miniscule compared to the amount of new financing that U.S. borrowers obtain. Why do U.S. borrowers enjoy such lavish amounts of foreign financing, while Latin American borrowers obtain such small amounts? The U.S. has many advantages in attracting funds, and has always been adept at burnishing its appeal to investors abroad. Latin America has not been as focused on attracting funds, and has sometimes put other priorities higher. The result has been that funds have flowed into the U.S. capital markets, while the small amounts flowing into Latin America have by-passed Latin American capital markets and have gone directly into goods-producing investments.

This extreme difference in access to capital is a key determinant of the wealth gap that exists between the U.S. and Latin America. Latin America repaid foreign debt and became more self-reliant, but that is not the recipe for future growth. Wariness about using borrowed money shackles the

region's growth. With the improvements in the region's national financial systems, the policy of using debt to finance growth is no longer as risky as it used to be.

Since the fourth quarter of 2002 Latin American capital markets have again attracted money from abroad, and have improved the savings products they offer to local savers. The improvement in performance has fueled a jump in the region's real economic growth rates. The outlook is promising, as Latin America issuers successfully upgrade the quality of the securities they offer to investors.