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THE POLICY JOURNAL FOR OUR HEMISPHERE

THE ECONOMIC CRISIS: What's Next?

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The global economic crisis has sent shock waves rippling through the region, but it's also proved that sound fiscal and monetary policies can help governments ride out the worst of the storm.

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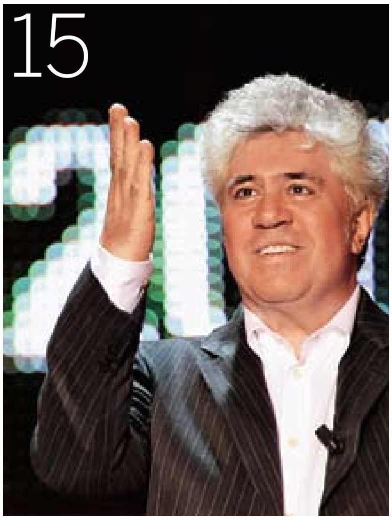
COVER PHOTOGRAPH BY ANTONIO ROSARIO



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in our next issue:

Human Rights Today: The Inter-American Human Rights system turns 50 this year, and *AQ* is dedicating its Summer issue to the topic. Since its creation, the Inter-American system has played a key role in the expansion of human rights, from its support for victims under the military governments of the 1970s and 1980s, to its work on freedom of expression in the late 1990s. Santiago Cantón, Claudio Grossman and Susana Villarán, among others, explore its evolution and challenges.

Latin American capital markets exploded in recent years. Now only a few are well positioned to recover.

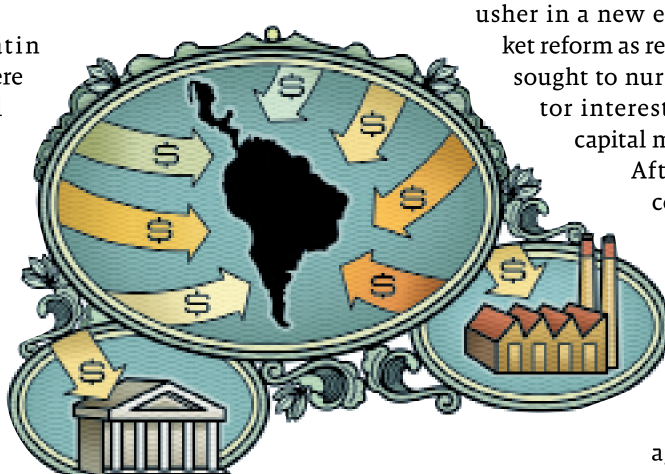
by Benjamin D. Wolf

From Decoupling to Deleveraging and Divergence

The global financial crisis has caused a dramatic disruption in Latin American capital markets. While asset values in mature markets had been diminishing for well over a year prior to the fall 2008 meltdown, the crisis hit Latin American markets abruptly. In a matter of months, major regional stock indices lost nearly half their value, the issuance of corporate securities came to an abrupt and seemingly definitive end, and foreign investors fled the region en masse.

Capital markets in Latin America had been in a period of rejuvenation during the preceding five years. Capital, lured by increased political stability and growth prospects better than those of any advanced economy, flowed to the region's financial markets in unprecedented volume. This period of protracted growth did more to address the principal constraints confronting the region's financial markets than the decade of market reform that preceded it. Yet it also masked an emerging divergence between countries that made prudent policy choices to foster dynamic capital markets and those that merely reaped the rewards of the commodities windfall and global liquidity boom.

The financial crisis has crystallized this divergence. The strength of capital markets not only serves as a rough proxy for overall economic health, it is one of the key determinants of growth. In Latin America's strongest economies, well developed capital markets act as a catalyst. In less dynamic economies, capital market activity is merely an offshoot of growth, rarely one of its principal drivers. This distinction will play a significant role in determining the effects of the financial crisis across the region.



PETER HOEY

Prior to the 1990s, Latin American capital markets were grossly underdeveloped and consisted primarily of sovereign bank lending—in contrast to the prolonged expansion of financial markets in developed economies that began with the demise of the Bretton Woods system in the early 1970s. Local equity and bond markets remained negligible and did not attract the attention of international investors. Latin American governments' disproportionate reliance on commercial bank debt led to the debt crisis that stunted economic growth across much of the region in the late 1970s and early 1980s and limited the development of domestic capital markets for nearly a decade.

By the end of the 1980s, the debt crisis had metastasized. The region's capital markets, consisting almost entirely of sovereign bank loans that debtor nations were unable to pay, had reached a state of paralysis. The Brady Plan, designed to help emerging economies restructure distressed bank loans, largely in the form of discounted sovereign bonds collateralized by U.S. Treasury securities, eased the crisis.

From Debt Relief to the Boom

The advent of the first Brady bonds in 1989 represented a watershed in the modernization of Latin American capital markets. Not only did they allow developing economies in Latin America (and elsewhere) to reduce and restructure their debt, but they created an erstwhile nonexistent market for Latin American sovereign bonds. They also restored a measure of credibility to the region, allowing governments to obtain financing in international capital markets. Perhaps most important, they helped to usher in a new era of vigorous market reform as regional governments sought to nurture renewed investor interest in their domestic capital markets.

After Chile's early success, efforts to attract foreign capital to the region through privatization formed a principal component of most market reform agendas in the early 1990s. According to the World Bank, Latin American privatization proceeds grew from only $2.6 billion in 1988 to $25.4 billion in 1996 and had reached a cumulative total of nearly $200 billion by 2003. Again following the Chilean example, several governments in Latin America adopted reforms to privatize their pension systems during the 1990s, creating institutional investor classes overnight and dramatically increasing local demand for securities. Seeking to emulate the market-friendly conditions of their North American and European counterparts, Latin American governments implemented a host of institutional and regulatory reforms throughout the 1990s, including the creation of supervisory bodies, improvements in

Institutional investors in the United States, Europe and Asia, aggressively seeking growth, began to view Latin American holdings as a "core asset class."

disclosure standards and the establishment of insider trading laws. The resulting legal and regulatory environment was far more hospitable to the development of capital markets than that which existed at the onset of the debt crisis.

Measured strictly in terms of growth, the market reforms of the 1990s were largely successful. Despite two significant crises, total stock market capitalization in Latin America grew from $200 billion in 1990 to almost $600 billion in 2001. During the same period, bond markets in the leading economies of the region underwent a similar expansion, with aggregate bonds outstanding increasing from $160 billion in 1990 to over $500 billion by 2001. As a percentage of GDP, both stock and bond markets nearly tripled.

Nevertheless, despite the success of the reforms in facilitating overall growth, many of the challenges confronting Latin American capital markets were embedded in the region's broader economic landscape, beyond the purview of financial market reforms. Prior to 2003, Latin American capital markets as a whole remained shallow and illiquid.

The number of firms with shares listed in domestic capital markets decreased substantially, from 1,624 public companies in 1990 to only 1,344 in 2001. With the exception of Brazil, Chile, Colombia, and Mexico, liquidity worsened in all Latin American markets during the same period. Financial markets also remained highly concentrated. As recently as 2004, according to the World Federation of Exchanges, the top ten public companies accounted for over 50 percent of total market capitalization in Argentina, Colombia, Mexico, and Peru, and over 50 percent of the shares traded in Argentina, Chile, Mexico, and Peru.

On the supply side, domestic stock market illiquidity was fueled by a longheld preference among Latin American issuers to list their shares abroad. As late as 2001, in Chile, the historical leader in financial market reform and one of the deepest markets in the region, nearly half of the aggregate value of stock was traded in U.S. exchanges. Demand remained limited by a narrow investor base that reflected the economic inequality of the region. By 2000, retail investors in securities in Mexico, then the eleventh largest economy in the world, consisted of approximately 1 percent of the total population.

At the end of the 1990s, bond markets also remained shallow and immature. While Brady bonds shifted the composition of financing from bank credit to bond issuance, sovereign bonds continued to dominate the markets. By 2001, aggregate corporate bonds outstanding represented only 6 percent of GDP and 20 percent of total bonds outstanding in Latin America. Furthermore, firms continued to issue bonds denominated in foreign currencies, increasing exposure to exchange-rate risk. At first blush, the 1990s reform era appears to have fallen short. It nonetheless established the institutional framework necessary for the next period of significant development in Latin American financial markets.

Between 2003 and 2007, Latin American capital markets not only went through an unprecedented expansion, but became deeper, more liquid and more dynamic. Equity and bond issuance reached $55 billion and $85 billion, respectively, in 2007, greatly surpassing their previous highs. Led by the Brazilian IPO market with 89 new listings in 2006 and 2007 combined, the number of publicly traded firms in Latin America increased for the first time in 15 years.

In 2008, Brazil's stock market (Bovespa) merged with its futures exchange (Bolsa de Mercadorias & Futuros), forming the second largest securities exchange in the Western Hemisphere and the third largest in the world. The composition of securities changed as well, with corporate bond issuance

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exceeding sovereign issuance for the first time in 2006 and the long-standing preference for foreign-currency-denominated bonds waning in 2006 and 2007. Institutional investors in the United States, Europe and Asia, aggressively seeking growth, began to view Latin American holdings as a "core asset class," greatly increasing capital flows to the region's financial markets.

This historic expansion can be attributed to a confluence of several factors, including a staggering global liquidity boom, increased political stability throughout much of the region, record commodity prices, and increased trade liberalization. The most significant reason for the unprecedented growth, however, was also the most basic: greatly improved macroeconomic fundamentals led to an unprecedented period of sustained growth across the region. Despite varied economic performance in different countries, aggregate Latin American growth averaged nearly 6 percent for the period from 2002 to 2007. In the period from 2003 to 2005 alone, the economies of Latin America expanded by 53 percent. By almost any meaningful measure, the period from 2003 to 2007 represented the broadest and most significant economic expansion in Latin America in 40 years.

The emergence of a new middle class has expanded a historically narrow investor base and increased demand for local securities.

Decoupling: Just Wishful Thinking?

This period of sustained economic growth, combined with more diversified trade with the rest of the world and, in some cases, more prudent fiscal policy, led to the so-called "decoupling" of Latin America's economies from that of the United States. Having watched foreign capital flee in prior financial crises, many Latin American policymakers worked hard to reduce their dependence on foreign credit and successfully accumulated vast international reserves. Moreover, Latin American banks had virtually no exposure to the subprime crisis through mortgage-backed securities or other complex financial instruments. Though there is great disparity within the region, Latin America as a whole is less dependent on the U.S. economy and better positioned to endure a global downturn than at any time in its history. At the onset of the credit crisis in 2007, this apparent insulation from American and European market turmoil made Latin America an attractive destination for investment in long-term assets.

In September 2008, when asked about the financial crisis, Brazilian President Luiz Inácio Lula da Silva responded, "What crisis? Go ask Bush about that." Until recently, Lula's comment was largely representative of attitudes in the region. As the depth and severity of the global financial crisis has set in, however, decoupling has become an increasingly quaint notion.

By the middle of October, the Bovespa was down nearly 50 percent from its 2008 highs. Stock exchanges elsewhere in Latin America have undergone comparably precipitous declines. Across the region, there has been a sharp increase in exchange rate volatility. Commodities prices are sharply declining, tighter credit terms are constraining exporters, and inflation is becoming increasingly difficult to control, even among the strongest economies. In short, Latin American markets have not proven immune to the contagion of the financial crisis.

The impact on the region's capital markets has been abrupt and severe. Though share prices and bond spreads have recovered somewhat from the lows reached during the trough of the crisis last fall, new issuance of both equity and corporate debt securities has ground virtually to a halt in all Latin American markets. The IPO market, which now seems like a pre-crisis relic, has ceased to exist.

In all of Latin America in 2008, there were only seven companies that listed shares for the first time as dozens of companies postponed or canceled plans to go public. Thus far, the prospects for 2009 are even worse. As foreign investors reallocate capital to cover losses in other markets and global liquidity remains scarce, Latin American issuers have been punished. The financial crisis has exerted substantial downward pressure on asset prices and has curtailed issuance of new corporate securities in the short term. It remains to be seen whether this will cause a wholesale retrenchment of the progress achieved during the five years preceding the crisis.

Who Will Bounce Back?

Not surprisingly, capital continues to gravitate toward growth. While there has been a substantial deceleration of overall economic growth across the region, prospects in the leading economies of Latin America remain strong compared with the negative projections in the mature markets of the United States, Europe and Asia.

Despite months of successive downward revisions, consensus GDP growth estimates for Brazil, Chile and Colombia remain close to 2 percent, and projections for Peru still approach 5 percent. Demand in capital markets serves as a barometer for such growth. Despite very limited global appetite for new securities, Brazil and Colombia issued bonds in January 2009 for $1 billion each, and Chile and Peru both have large issuances planned for the first quarter of this year. Quasi-sovereigns such as Codelco, Petrobras and Pemex have all conducted large bond issuances this year, demonstrating further that Latin American blue-chip debt securities are able to compete with high-grade U.S. corporate issuances for the greatly reduced pool of investor capital available in post-crisis markets. This relatively limited access to international capital markets, however, has not been uniform or widespread throughout the region.

While Latin American markets have never been monolithic, the financial crisis has precipitated, and in some cases revealed, further differentiation among the large economies of the region.

Since the meltdown, the issuance of sovereign bonds has been limited to those countries that have achieved investment-grade status, rewarding those economies that were managed well in the years preceding the crisis. To varying degrees, the countries with the most promising growth prospects—Brazil, Chile, Colombia, and Peru—were all able to reduce the proportion of outstanding foreign-currency-denominated debt, foster domestic demand and diversify sources of growth. Prudent policy decisions alone, of course, were insufficient to shield these markets from the external shocks caused by the depletion of global capital and a steep decline in commodities prices. In the immediate wake of the crisis, the broad issuance of corporate securities is not likely to return

CORRUPTION SHAKEUP

by Danielle Renwick

Protests spread through Colombia last November when thousands of small investors discovered that their life savings had vanished in pyramid schemes. Losses totaled nearly $1 billion, with most concentrated around David Murcia Guzmán's D.M.G. Grupo Holding. The scandal put President Álvaro Uribe under fire for perceived loose regulation, and sparked riots that left at least two dead.

Only weeks later, in a fraud similar in design but much larger in scale, Wall Street investor Bernard Madoff revealed that he had misled investors by investing an estimated $65 billion in the largest Ponzi scheme in history. The scandal had ripple effects throughout Latin America: Spain's Banco Santander, one of the largest banks in the region, lost an estimated $3.1 billion in Madoff investments. Similarly, Chile's Celfin Capital SA and Peru's largest financial-services company, Credicorp Ltd., revealed they too had invested millions with Madoff.

Similar schemes were exposed elsewhere. In south Florida, the Securities and Exchange Commission (SEC) filed suit against Haitian-American investor George Theodule for swindling investors from the area's

Which went up in flames faster? This effigy of David Murcia Guzmán or the alleged profits from D.M.G?

Haitian community out of $23.4 million, and against Andres Pimstein, the Chilean-American owner of The Bottom Line of South Florida, Inc. and Summit Trading LLC, for an alleged $30 million Ponzi scheme. In February, the Antigua-based Stanford Financial became the subject of an SEC investigation for investing as much as $1.6 billion in a Ponzi scheme.

The credit meltdown of financial institutions revealed both a string of corrupt financiers and the lack of financial oversight in many economies. Victims range from the wealthy elite in Madoff's inner circle to working-class Colombians who entrusted their life savings with hopes of big returns. However, what many of these schemes have in common are charismatic perpetrators who gulled investors, and loose regulatory environments that allowed such schemes to proliferate.

"These schemes often rely on a type of social network and connections to those networks to create trust and credibility," says Daniel Kaufmann, senior fellow of global economy and development at the Brookings Institution in Washington DC. Madoff served on the boards of several nonprofit organizations and New York security commissions; Theodule cultivated many of his investor relationships through Haitian church communities.

Many are left wondering how this could have gone on for so long. Kaufmann argues that regulatory laws were largely similar throughout the region, but "it's a question as to whether the oversight and regulating institutions do their jobs." As for the SEC, Kaufmann says its laissez-faire mentality harks back "to an era when less oversight was considered better for business growth." He points to Canada and his native Chile as two countries with relatively strong regulatory oversight that, as a result, were relatively unscathed by financial corruption.

"This was an era when all financial institutions—with few exceptions—took huge financial risk," says Kaufmann. "Some took them with leveraged derivatives. Others with Madoff." Those, he notes, were just part of the "palette of risky products," that took investors for a ride.

in earnest. In the meantime, the leading markets are likely to continue to attract the vast majority of foreign capital allocated to Latin America.

Mexico occupies a middle ground among large Latin American capital markets. Though its sovereign debt earned investment-grade status nearly a decade ago and it was able to access international capital markets as recently as February 2009, its growth prospects remain limited in 2009 due to its strong ties to the U.S. economy. Despite having the second largest stock market in Latin America, even during the peak of market activity in 2006 and 2007, liquidity lagged behind Brazil and the IPO market never flourished.

In Argentina and Venezuela, growth projections for 2009 are at or below zero, and inflation is becoming unmanageable. All capital markets activity, including the issuance of sovereign debt, is likely to remain extremely limited in both countries in the medium term, as poor management of macroeconomic policies and the steep decline in commodities prices will continue to hinder growth. Increased political risk, whether actual or perceived, will further constrain Argentina and Venezuela's access to international capital markets. With smaller economies such as Bolivia, Ecuador and Paraguay barely registering any capital markets activity, the financial crisis has brought about even greater divergence between leading and lagging capital markets in their

AP PHOTO/SKY GILBAR

ability to attract capital and facilitate growth.

Following the crisis, the breadth of such growth may be a more relevant determinant of capital markets activity in Latin America than its depth. The emergence of a much-touted new middle class across the region in recent years has expanded a historically narrow investor base and increased demand for local securities. According to Banco Santander, approximately 15 million people entered this burgeoning middle class between 2002 and 2006. During the same period, official unemployment fell from 11 percent to under 8 percent.

Though the proportion of retail investors remains low in Latin America, much of this new middle class is participating in the formal sector for the first time, buoying institutional demand for domestic securities through pension contributions. Particularly in Brazil, Chile, Colombia, Mexico, and Peru, these new consumers have increased demand for improved infrastructure, credit card and banking services, private education services, and retail goods, reducing reliance on external demand to generate growth. Though such progress has already begun to recede in the downturn, based on current economic forecasts, it is not likely to erode entirely. In other words, in the leading economies of the region, the new middle class will not fall back into poverty en masse—as happened in prior crises—and the corresponding newfound domestic demand will remain.

Chile, Brazil, Colombia, and Mexico are able to implement policies that stimulate their economies.

Though Latin America is hardly a refuge from the current global economic turmoil, the old axiom "if the U.S. sneezes, Latin America catches a cold" has not applied to this crisis. Decoupling may have been overstated by some, but after two decades of reform, Latin America as a whole has become more fully integrated with the global economy and less dependent on the United States. Relative to the anemic state of global growth, the leading markets in the region still offer attractive investment opportunities.

Latin American capital markets were hit hard by the financial crisis, despite these financial developments. Across the region, economic growth has slowed considerably and stock markets have fallen precipitously. The issuance of new securities has slowed to a trickle.

Ironically, some of the strongest capital markets in the region were hit hardest, principally because of their increased integration into the global economy. But in the wake of the crisis, markets that were well managed during the boom years—particularly Chile, but also Brazil, Colombia and Mexico—are able to implement policies to stimulate their economies. They are cutting interest rates, cutting taxes and increasing spending on infrastructure. In addition, they can cover any shortfall by issuing sovereign debt in international capital markets, while still maintaining very low ratios of debt to GDP. As a result, better positioned markets are still able to attract foreign capital and maintain domestic demand for local securities.

Weaker markets, on the other hand, are languishing. Among the region's large economies, Argentina and Venezuela are at particular risk. In Venezuela, inflation is above 30 percent and the economy is wholly dependent on oil prices. In Argentina, the recent nationalization of private pensions further diminished already wavering investor confidence. Amidst the downturn, it is unlikely that these struggling economies will transform their capital markets. Instead, policies should be aimed at mitigating damage and stabilizing markets by focusing on basics: controlling inflation, increasing transparency, diversifying growth and encouraging domestic savings.

The continued development of all capital markets in Latin America is contingent upon external factors such as commodities prices and global liquidity. But it is the economies that have fostered broad and diverse growth that are likely to benefit as the post-crisis landscape takes shape. Those that fail to do so are at risk of falling further behind. AQ