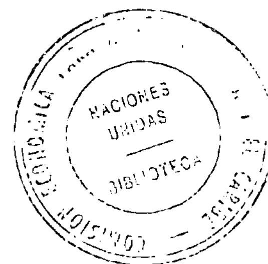
INT-1277

ECLAC-IDRC Workshop II
NEW PRIVATE FLOWS INTO LATIN AMERICA

(Santiago, December 6-7, 1993)
ECLAC's Conference Room N° 1, Second floor



# *THE EUROPEAN CAPITAL MARKETS AND LATIN AMERICAN ACCESS**

Prepared by

Stephany Griffith-Jones

900006293 - BIBLIOTECA CEPAL

# EUROPEAN PRIVATE FLOWS TO LATIN AMERICA; THE FACTS AND THE ISSUES

**Dr Stephany Griffith-Jones**

This paper is prepared for the IDRC funded workshop to be held at CEPAL in Santiago de Chile, on the 6th and 7th December, 1993. Research assistance by Joel Climaco is gratefully acknowledged. Valuable insights and information were gathered during interviews at the BIS, in Basle the Bank of England, the SIB, and in several City of London based private financial institutions.

# I INTRODUCTION

This paper starts (in Section II) by describing briefly recent trends in private markets, at a global level, amongst flows going to developing countries, and those specifically going to Latin America. Then, (in Section III) more detail is provided, where data is available, for EEC flows to Latin America. Section III will also focus on some of the key characteristics of the investors themselves, differentiating where relevant, between countries of origin (within Europe and vis-à-vis the US). The reason to start the statistical analysis at a more global level is that markets are increasingly integrated and globalized, and therefore the trends and forces which operate at a global level are very relevant to understand what happens in specific flows, such as European flows going to Latin America. Indeed, particularly in some markets, it is impossible to establish clearly what a "European" flow is. For example, a US pension fund may buy Latin American bonds in Luxembourg; though the flow is registered as originating in Europe, the actual source of funds comes from the US. Similarly a US pension fund can hire an investment manager in London or Edinburgh to manage money going to emerging markets, mainly destined to Pacific Rim countries.

Then (in Section IV) the paper will explore in more depth the motivations which explain why different types of European investors decide to channel flows to Latin America. Where possible, distinctions will be made between different nationalities within the EEC. Based largely on interview material, the paper will explore the extent to which securities' investors in different types of instruments have different motivations, the factors which encourage such flows to go to Latin America, and the extent to which such flows are likely to be sustainable.

Section V will focus on the regulations which affect different types of European investors, as regards investing in so-called emerging markets.

Section VI concludes the paper, by examining available information on the terms on which such flows come in, and their suitability to the needs of Latin American countries. The risk associated with such flows will also be assessed.

# II RECENT TRENDS IN GLOBAL PRIVATE FINANCIAL MARKETS, IN FLOWS TO LDC's AND TO LATIN AMERICA

Globally, in the first four months of 1993 (January-April), borrowing on international capital markets continued its' rapid increase for the third year in a row; in 1991, there had been an important increase (of 20.7%) in the aggregate volume of

international capital flows; in 1992, there was a further increase of 16.2%; for the period January-April 1993, the overall volume of borrowing facilities exceeded $256 billion, with an even faster rate of growth of 38%, on a year-on-year basis, than in the previous years (see Table 1).

**Table 1**
**Borrowing on International Capital Markets (US$B)**
**(Borrower Composition**

| | | | | | January-April | |
|---|---|---|---|---|---|---|
| | 1989 | 1990 | 1991 | 1992 | 1992 | 1993 |
| OECD COUNTRIES | 426.5 | 384.4 | 457.9 | 535.7 | 160.1 | 228.8 |
| DEVELOPING COUNTRIES | 21.8 | 28.6 | 46.2 | 47.3 | 16.7 | 15.1 |
| CENTRAL EASTERN EUROPE | 4.7 | 4.6 | 1.8 | 1.5 | 0.4 | 2.1 |
| OTHERS | 13.5 | 17.3 | 19.0 | 25.2 | 8.3 | 10.3 |
| TOTAL | 466.5 | 434.9 | 524.9 | 609.7 | 185.5 | 256.3 |
| YEAR-ON YEAR PERCENTAGE CHANGE | +2.8 | -6.8 | +20.7 | +16.2 | - | +38.2 |

Source: OECD, Financial Market Trends; Vols. 54-55, February, 1993 p.7, and June 1993, p.7.

Contrary to the trend in the 1990-1992 period, when borrowing on international capital markets by developing countries increased very significantly (by 31% in 1990, by a massive 62% in 1991 and slowed down to 2% in 1992), the year-on-year evolution of lending for the January-April 1992 reported by the OECD shows a decline of 10% (see Table 2). As a result, the share of LDC borrowing in the total, which had increased from 4.7% in 1989, to 6.6% in 1990, and to about 9% in 1991, declined both in 1992 and early 1993, falling to less than 6% in the first four months of 1993. Reportedly, according to the OECD[1] the slight decline in recourse to international markets by developing countries resulted mainly from a drop in equity issues by Latin American companies (see also Table 3). Indeed. as reported in Table 3, both non-underwritten facilities, as well as particularly equities, raised by Latin

[1] OECD Financial Market Trends, June 1993, op. cit.

American countries declined sharply in early 1993. This is in contrast with issues of bonds which continued their very sharp increase which had started in 1990 (see also discussion below).

It should be mentioned that, according to other sources, such as the 1993 World Bank Study Global Economic Prospects and the Developing Countries, which makes a major effort to have complete coverage of these new flows to LDC's, the figures reported for Latin America are somewhat higher, estimating for example $11.7b of issue of Latin American bonds in 1992 (as opposed to the $8.2b reported by the OECD) and estimating for example $5.5b of equity investment in LA in 1992 (as opposed to the $4.5b reported by the OECD). However, the trends reported are similar for both sources, showing continued rapid growth for bonds throughout (with the OECD also forecasting a further increase in LA bond offerings as several countries approach investment grade ratings), while equity investment is reported to have slowed down in 1992 (according to the World Bank) and in early 1993 (according to the OECD).

**Table 2**
**Borrowing by developing countries (US$B)**

| Instruments | 1989 | 1990 | 1991 | 1992 | January-April 1992- | 1993 |
|---|---|---|---|---|---|---|
| Bonds | 2.6 | 4.5 | 8.3 | 14.0 | 4.3 | 8.2 |
| Equities | 0.1 | 1.0 | 5.0 | 7.2 | 2.9 | 0.3 |
| Syndicated loans | 16.2 | 19.8 | 26.7 | 16.5 | 6.5 | 5.8 |
| Committed borrowing facilities | 0.9 | 2.1 | 4.5 | 1.7 | 0.5 | 0.3 |
| Non-underwritten facilities(1) | 2.0 | 1.2 | 1.7 | 7.9 | 2.5 | 0.5 |
| TOTAL | 21.8 | 28.6 | 46.2 | 47.3 | 16.7 | 15.1 |
| % Increase over previous year | | 31% | 62% | 2% | | -10% |

1. Including Euro-Commercial Paper and Medium-Term Note Programmes

Source: OECD; Financial Market Trends; Vol.54 and 55; February 1993 and June 1993; elaborated on the basis of the statistical Annex.

**Table 3: Borrowing By Latin American Countries (US$B)**

| Instruments | 1989 | 1990 | 1991 | 1992 | January-April 1992 | January-April 1993 |
|---|---|---|---|---|---|---|
| Bonds | - | 1.0 | 4.6 | 8.2 | 2.7 | 4.9 |
| Equities(1) | - | - | 4.4 | 4.5 | 2.4 | 0.2 |
| Syndicated loans | 1.9 | 3.3 | 0.9 | 1.0 | 0.1 | 0.1 |
| Committed Borrowing Facilities | 0.1 | - | 2.8 | 0.3 | 0.3 | - |
| Non-Underwittten Facilities(2) | - | - | 1.2 | 6.1 | 2.5 | 0.5 |
| TOTAL OF LATIN AMERICAN COUNTRIES | 2.0 | 4.3 | 13.9 | 20.1 | 8.0 | 5.7 |
| % OF LATIN AMERICAN COUNTRIES OF TOTAL BORROWING OF DEVELOPING COUNTRIES | 9.2 | 15.0 | 30.1 | 42.5 | 47.9 | 37.7 |

(2) Including Euro-commercial paper and medium-term note programmes
(1) New issues and initial public offerings of common and preferred shares.

**Source:** OECD; Financial Market Trends; Vol. 54 and 55; February 1993 and June 1993; elaborated oon the basis of the statistical Annex.

Returning to global trends, in the early part of 1993, the main dynamism did not come from syndicated credits (which again remained at practically the same level, as can be seen in Table 4), but from securities which on a year-on-year basis increased by 44% in the January-April 1993 period, and from non-underwritten facilities, which in the same period grew by 62%!

As can be seen by comparing Table 2 above , and Table 4 borrowing by developing countries seems to follow overall similar trends to global ones, particularly as regards declining importance of syndicated loans and rapid rise of securities, (both bonds and equities, though with some decline in the importance of equities reported in early 1993).

With the data from Table 5 we can examine the relative importance of different types of private flows to Latin America and the Caribbean, their evolution through time, and a comparison with Asian countries.

**Table 4: Borrowing on the International Capital Markets (US$B; %)**

| | 1989 | 1990 | 1991 | 1992 | January -April 1992 | 1993 |
|---|---|---|---|---|---|---|
| Securities | 263.8 | 237.2 | 321.0 | 357.2 | 122.2 | 176.3 |
| Loans | 121.1 | 124.5 | 116.0 | 117.9 | 31.1 | 31.2 |
| Committed back-up facilities | 8.4 | 7.0 | 7.7 | 6.7 | 2.9 | 1.3 |
| Non-underwritten facilities(1) | 73.2 | 66.2 | 80.2 | 127.9 | 29.3 | 47.5 |
| TOTAL | 466.5 | 434.9 | 524.9 | 609.7 | 185.5 | 256.3 |
| Year-on-year percentage charge | +2.8 | -6.8 | +20.7 | +16.2 | - | +38.2 |

1) Including Euro-Commercial Paper and Medium-Term Note Programmes.

Source: OECD; Financial Market Trends; Vol. 54 and 55; February 1993, p. 87 and June 1993, p. 78.

As can be seen in Table 5, for Latin America and the Caribbean, if the 1977-81 and the 1989-92 periods are compared, we can see a very sharp increase in FDI flows (from 10.6% to 24.0%) of total capital flows, the rapid emergence of portfolio equity (from 0 to 6.3%), some increase in the share of bonds (from 4.5% to 6.3%), and a sharp decline in commercial bank lending (from 66.9% to 14.7%). Similar, but somewhat less dramatic, changes occur for the Asian countries. For example, for the Asian countries the share of commercial bank loans declines, but far less drastically than for the LAC region, and the share of portfolio equity increases from 0 but only to 3.6% of total capital flows; where, according to the IMF data, there are more drastic changes in the Asian countries than in the LAC countries is in the very rapid increase in the share of FDI and in the increase in the share of bonds.

## III EUROPEAN PRIVATE FLOWS TO LATIN AMERICA

### i) FOREIGN DIRECT INVESTMENT

As we can see from Table 6, in the 1987-90 period, direct investment originating in Europe represented 25% of total world investment in Latin America. It is noteworthy that the European country from which the highest flow came was the United Kingdom (with $2.5 billion), followed by Germany (with $1.4 billion), Spain

**Table 5**
**Developing Countries: Capital Flows (a)**
**(as a % of total, unless otherwise stated)**

| | 1971-76 | 1977-81 | 1982-88 | 1989-92 |
|---|---|---|---|---|
| Western Hemisphere | | | | |
| Foreign Direct Investment | 11.8 | 10.6 | 14.2 | 24.0 |
| Portfolio Equity | - | - | - | 6.3 |
| Bonds | 2.6 | 4.5 | 2.3 | 6.3 |
| Commercial Bank Loans | 60.0 | 66.9 | 36.2 | 14.7 |
| Suppliers and Export Credits | 8.9 | 6.2 | 8.8 | 7.7 |
| Official Loans | 15.9 | 11.2 | 35.1 | 35.9 |
| Grants | 0.8 | 0.6 | 3.4 | 5.1 |
| Total in Billions of US Dollars | 17.5 | 49.5 | 36.8 | 42.8 |
| Total in Billions of Constant Dollars (b) | 36.2 | 57.8 | 35.8 | 34.8 |
| Asia | | | | |
| Foreign Direct Investment | 7.1 | 6.1 | 9.8 | 18.4 |
| Portfolio Equity | - | - | - | 3.6 |
| Bonds | 0.8 | 1.4 | 5.6 | 4.4 |
| Commercial Bank Loans | 23.5 | 32.1 | 32.5 | 23.5 |
| Supplies and Export Credits | 12.5 | 14.8 | 11.8 | 13.3 |
| Official Loans | 44.8 | 35.5 | 33.3 | 30.9 |
| Grants | 11.4 | 10.1 | 7.0 | 5.9 |
| Total in Billions of US Dollars | 9.6 | 23.2 | 39.8 | 66.5 |
| Total in Billions of Constant Dollars (b) | 17.8 | 24.3 | 37.5 | 53.4 |

**Source:** IMF World Economic Outlook. October 1993.

(a) Gross long-term flows.
(b) Deflated using unit value of total imports in US dollars (1985 = 100).

($0.7 billion) and France (with $0.6 billion). This European country of origin distribution differs from that in earlier periods, as in 1979-82, Germany was the largest source, followed by France, with the UK in the third place (see again Table 6).

**Table 6**
**FDI Flows from Europe, The US and Japan to Latin America and the Caribbean**
**(in millions of US$)**

| | 1979-1982 | 1983-1986 | 1987-1990 | 1987 | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|---|---|---|---|
| Belgium | 89 | 24 | 136 | 26 | 57 | -5 | 58 | 34 |
| France | 1,161 | 394 | 588 | 84 | 111 | 112 | 281 | -12 |
| Germany | 1,458 | 721 | 1,366 | 377 | 398 | 302 | 289 | 373 |
| Italy | 322 | 473 | 477 | 97 | 210 | 114 | 56 | 123 |
| Netherlands | 204 | 350 | 480 | 48 | 17 | 122 | 293 | 314 |
| Spain | 722 | 303 | 706 | 89 | 148 | 187 | 282 | 580 |
| Switzerland | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| United Kingdom | 1,141 | 1,241 | 2,561 | 805 | 842 | 437 | 477 | n.a. |
| Europe Total | 5,097 | 3,506 | 6,314 | 1,526 | 1,783 | 1,269 | 1,736 | n.a. |
| U.S. | 8,524 | -415 | 8,412 | 708 | 943 | 3,544 | 3,217 | n.a. |
| Japan | 2,058 | 555 | 1,364 | -23 | 471 | 343 | 573 | 560 |
| Total World | 23,870 | 13,259 | 25,652 | 5,356 | 7,553 | 6,266 | 6,477 | 10,939 |

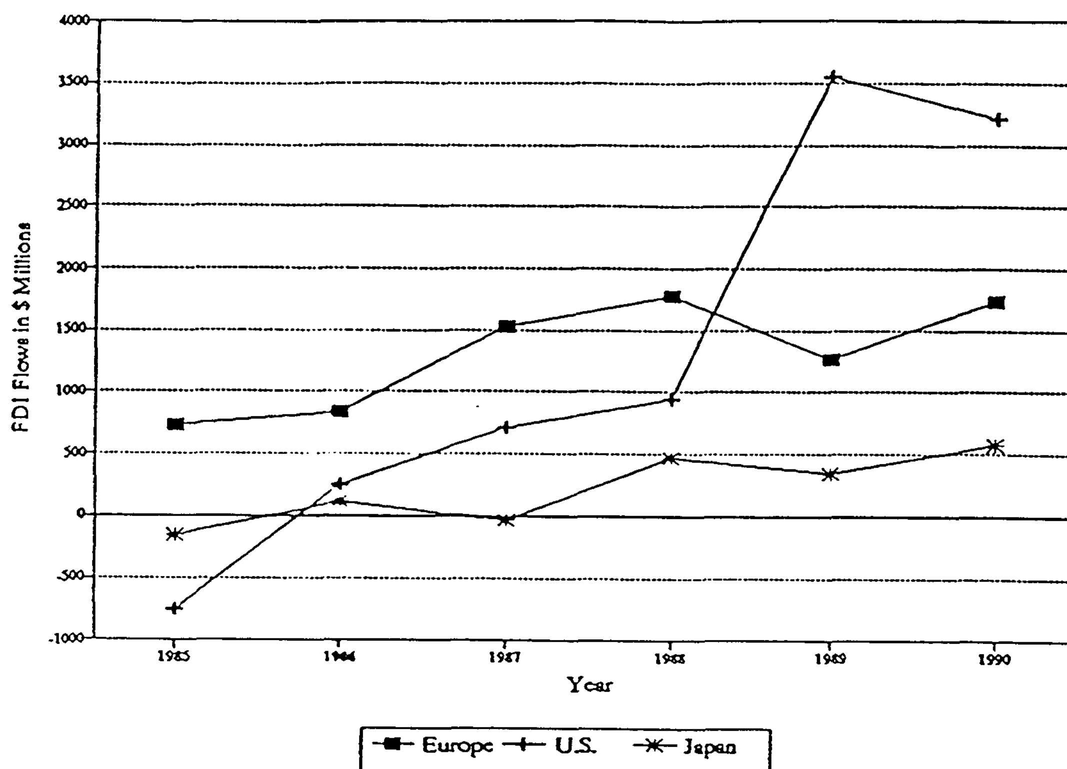
**Notes:** Spanish FDI figures are not strictly comparable with FDI data published by the OECD. The IMF (source of total world data) reports FDI outflow and inflow data while the OECD (source of the country breakdowns) reports only outflows. IMF and OECD coverage and reporting practices also differ. For further information see IDB/IRELA, 1992.

**Source:** Table (except for world total) is reproduced from IDB/IRELA, 1992. Data sources: OECD, Paris; Overseas Development Administration, Statistics Department, (unpublished data), London; and Secretaria de Estado de Comercio, Ministerio de Industria, Comercio y Turismo, Sector exterior 1990, Madrid; IMF, Balance of Payments tapes.

Comparing the European share of FDI going to LAC with that originating in other regions, Figure 1 shows that since 1985, and particularly since 1988, the share originating in the US has increased sharply, and the share of flows originating in Europe has declined somewhat. Indeed, in 1989 the nominal value (in US$) of European FDI to LAC actually fell, although in 1990 it recovered its' 1988 level. It is interesting to note that European investors were "bad weather friends"; in 1983-88,

when FDI flows from Japan fell sharply, and US ones became negative, due to the Latin American economic and debt crisis, European FDI to the region fell far less than Japan, and became the largest source of FDI flows to LAC.

**Figure 1**
**FDI Flows from Europe US, and Japan to Latin America and the Caribbean**




Source: C. Beetz and W. van Ryckeghem "Trade and Investment Flows between Europe and Latin America and the Caribbean", March 1993, Inter-American Development Bank

The increase share of FDI investment in LAC originating in the US in 1987-90 can be attributed to closer integration within the Americas, with the prospect of NAFTA playing an important role. On the other hand, the decline in the share of European FDI going to LAC in the 1987-90 period can partly be attributed to the effects of the 1992 Single European Market, as its' prospects have tended to increase intra-EEC investment flows.[2]

---

2 See, IRELA El Mercado Unico Europco Y Su Impacto En America Latina, Madrid, 1993.

The sectoral distribution of FDI flows varies according to regions of origin. It is reported[3] that European FDI in Latin America is particularly active in the manufacturing sector, in contrast with the US and Japan which are reported to be particularly active in primary sectors. More specifically, European FDI is concentrated in the following sectors: automotives, chemicals, minerals, petrochemicals, electronics, aircraft and food product.[4]

Finally, in Table 7 we can see the inter-country distribution of European FDI flows to Latin America for the 1987-90 period; Brazil is by far the largest recipient of European flows ($3.2 billion) with Argentina coming second ($0.9 billion) Mexico third ($0.8 billion) and Chile fourth ($0.6 billion). In the case of Brazil, Argentina and Chile, the main European source was the UK; for Mexico, the main European source was Germany.

## ii) BONDS

As regards bonds, as pointed out above, it is practically impossible to distinguish sources by geographical region, as international and Euro bonds are traded globally, and as information is not available on who purchases them. However, valuable hints can be extracted from available information.

Indeed, as can be see in Table 8, when Latin America returned in a significant way to the bond market, in 1989, the bonds it issued were only denominated in US$; the share in US$ fell somewhat (to 87% in 1991), but rose again (to 91%) in the first half of 1992. As there are no Latin American bonds issued in yen, the rest are all issued in European currencies, and especially in DM, in Ecu. and other European currencies. The concentration of bond issues in dollars also exists for the total of developing countries, but is significantly less marked than for Latin America (see again Table 8); globally, for all borrowers, the distribution of currencies is quite different, with the US dollar accounting for around 30% in the 18 months starting in January 1991, the DM around 8%, the Ecu around 10% and other currencies (mainly European) around 37%.[5]

---

3 IRELA, op. cit.

4 See C. Beetz and W. van Ryckeghem, op. cit.

5 Source: Collyns, et al.

## Table 7
## FDI Flows from European Countries to Latin America and the Caribbean, 1987-1990
## (in millions of US$)

| | Belgium | France | Germany | Italy | Nether-lands | Spain | Switzer land | United Kingdom | Europe |
|---|---|---|---|---|---|---|---|---|---|
| Argentina | -35 | 97 | 338 | 61 | 51 | 162 | n.a. | 204 | 878 |
| Barbados | 0 | 1 | 0 | 2 | 1 | - | n.a. | -10 | -6 |
| Bolivia | -1 | 0 | -3 | - | 1 | - | n.a. | - | -3 |
| Brazil | 143 | 102 | 482 | 337 | 410 | 73 | n.a. | 1,706 | 3,253 |
| Chile | 5 | 62 | 16 | 5 | 39 | 215 | n.a. | 285 | 626 |
| Colombia | 0 | 29 | 17 | 4 | 31 | 14 | n.a. | 81 | 175 |
| Costa Rica | -1 | 0 | 3 | 6 | 3 | 2 | n.a. | - | 13 |
| Dominican Rep. | 0 | 0 | 1 | 1 | 2 | 23 | n.a. | - | 27 |
| Ecuador | 12 | 36 | -2 | 0 | 3 | 4 | n.a. | 0 | 53 |
| El Salvador | 0 | - | -6 | 0 | - | - | n.a. | - | -6 |
| Guatemala | -1 | - | -17 | 1 | 0 | 3 | n.a. | - | -15 |
| Guyana | 0 | 8 | 0 | - | 1 | - | n.a. | 4 | 13 |
| Haiti | 0 | 0 | 0 | - | - | - | n.a. | - | 0 |
| Honduras | 2 | - | - | 0 | 0 | - | n.a. | - | 2 |
| Jamaica | 0 | 3 | 1 | 1 | 1 | - | n.a. | 53 | 59 |
| Mexico | -20 | 113 | 431 | 30 | 14 | 109 | n.a. | 74 | 752 |
| Nicaragua | 1 | 0 | -6 | 0 | 2 | - | n.a. | - | -3 |
| Paraguay | 1 | 1 | 5 | 4 | - | 7 | n.a. | - | 18 |
| Peru | 5 | 0 | 30 | 8 | 1 | 11 | n.a. | 13 | 68 |
| Suriname | 2 | 1 | - | 0 | -81 | - | n.a. | - | -78 |
| Trinidad & Tobago | - | 4 | 0 | -17 | 1 | - | n.a. | 9 | -3 |
| Uruguay | -1 | 73 | 12 | 1 | 1 | 34 | n.a. | 8 | 127 |
| Venezuela | 24 | 58 | 64 | 33 | -1 | 51 | n.a. | 134 | 363 |
| Total | 136 | 588 | 1,366 | 477 | 480 | 706 | n.a. | 2,561 | 6,314 |

**Note:** Spanish FDI figures are included into the table, but are not strictly comparable with FDI data published by the OECD. For further information see IDB/IRELA, 1992.

**Source:** Table reproduced from IDB/IRELA, 1992. Data sources: OECD, Paris, Overseas Development Administration, Statistical Department, (unpublished data), London; Secretaria de Estado de Comercio, Ministerio de Industria, Comercio y Turismo. Sector exterior 1990, Madrid.

**Table 8**
**International Bond Issues by Currency of Denomination**
**(% share)**

| | 1989 | 1991 | 1992 (First Half) |
|---|---|---|---|
| Latin American Borrowers | | | |
| US Dollar | 100% | 87% | 91% |
| DM | - | 5% | 2% |
| Yen | - | - | - |
| Ecu | - | 2% | 2% |
| Other Currencies | - | 5% | 5% |
| TOTAL | 100% | 100% | 100% |
| All Developing Countries | | | |
| US Dollar | 56% | 65% | 66% |
| DM | 22% | 17% | 11% |
| Yen | 17% | 9% | 12% |
| Ecu | 2% | 5% | 7% |
| Other Currencies | 3% | 5% | 4% |
| TOTAL | 100% | 100% | 100% |

**Source:** Own calculations and data, originating from C. Collyns et al. "Private market financing for Developing Countries", World Economic and Financial Survey. IMF. December 1992. Washington DC.

The high share of dollar denominated bonds reflected both currency preference of investors (for example, much of Latin American flight capital is believed to be in US$) and the currency composition of Latin American companies' receipts. Furthermore, the sharp fall in US short-term interest rates made US based investors more willing to purchase Latin American securities. In this context, Latin American borrowers have been able to tap also the rapidly growing "Yankee" market, whereas they have not tapped the equivalent market in European currencies, such as sterling.[6]

It is noteworthy that although Latin American international bonds are denominated mainly in US$, they are practically all listed in Europe, with a very heavy concentration of listing in Luxembourg. It is also important to stress that within European currencies, it is the DM bonds which are by far the largest ones (and their volume has reportedly increased in the last 12 months). This is because European

---

6 Interview material.

investor interest in Latin American bonds is mainly still restricted to the DM sector; in Germany, banks (and particularly savings banks, many of which operate at a municipal level) play a key role in distributing bond issues to domestic retail customers. Thus, retail customers in Germany rely on their banks to apply quality control, and banks try to maintain the confidence of their customers by avoiding bond defaults. As a consequence, German banks tend to avoid issuing or marketing bonds from countries where bank debt packages have not yet been finalized. It is reported that there is also beginning to be some interest from German institutional investors in Latin American bonds.[7]

In the United Kingdom, both institutional and retail investors are not very keen on bonds, in general, partly because they made severe losses on fixed-income instruments in the high inflation years of the 1970's. Indeed, it is interesting to note the sharp contrast between the general preferences for bonds vs. equities in different European countries. This is illustrated in Table 9, for pension fund investors, for different European countries for which comparative data is available. There is a particularly sharp contrast between the UK, where pension funds distribute their foreign assets, by putting only 6% into foreign bonds and as much as 94% into foreign equities and Germany, where pension funds distribute their foreign assets by putting as much as 93% into foreign bonds and as little as 7% into foreign equities. The other European country where there is a strong preference for bonds is Switzerland (see again Table 9). This is consistent with reports that a growing (though still small) share of Latin American Euro-bonds is being placed via Switzerland. It is also interesting that Dutch pension funds have a fairly high share of their foreign assets as bonds. The preferences of Dutch, Swiss and British pension funds are particularly relevant, in the short-term given their high level of foreign assets. However, for the medium-term, it is particularly important to understand the preferences of those institutions - like particularly the German pension funds - which have a very small share of total assets in foreign investments, and who are therefore very likely to increase them substantially. We will return to this subject below.

---

7 Interview material and Collyas et al.

**Table 9**
**Foreign Assets of Pension Funds, end-1988**

| | Foreign Assets ($ b) | Percent of Total Assets | Foreign Bonds as Percentage of Foreign Assets | Foreign Equities as Percentage of Foreign Assets |
|---|---|---|---|---|
| UK | 53.8 | 14.0% | 6% | 94% |
| Germany | 0.2 | 0.4% | 93% | 7% |
| Netherlands | 15.0 | 14.0% | 41% | 59% |
| Switzerland | 9.0 | 4.0% | 70% | 30% |
| France | 1.2 | 4.0% | 15% | 85% |
| Memo: US | 62.8 | 4.0% | 14% | 86% |

Source: E.P. Davies, "The structure, regulation and performance of pension funds in nine industrial countries", forthcoming as PRE Working Paper, the World Bank. Mimeo. 1992. Bank of England.

## iii) EQUITIES

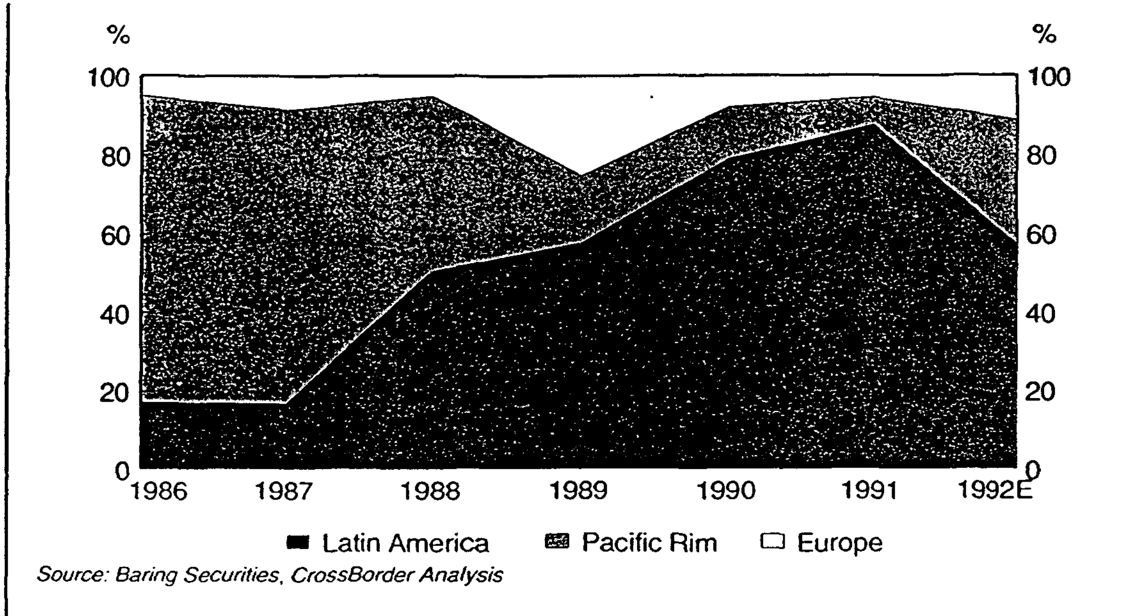
Comparative estimates of global secondary flows into emerging stock markets of Latin America, the Pacific Rim and Europe show that investors have diverted a very rapidly increasing portion of their total allocation to Latin America through the late 1980's and early 1990's, (see Figure 2), though there seems to be some decline in the share going to Latin America since the middle of 1992 and through 1993.[8] Indeed, as can be in Figure 3, the level of secondary flows to Latin America is also estimated to have fallen in 1992, after having increased sharply before. As can be seen in Figure 2, the bulk of net inflows to emerging markets went into the Pacific Rim, with only 17% going into Latin America, this share increased systematically and rapidly till 1991, when over 85% of flows were going into Latin America; in 1992, the share declined somewhat, but was still reportedly very high, at almost 60%. Very preliminary estimates for the first six months in 1993[9] show that around 25% of secondary flows will go to Latin America, with a major share (around 60%) going to the Pacific Rim; there may be a trend towards some increase in the LAC share in late 1993.

---

8 See Figure 2, Figure 3 and Table 3 above; also, interview material.

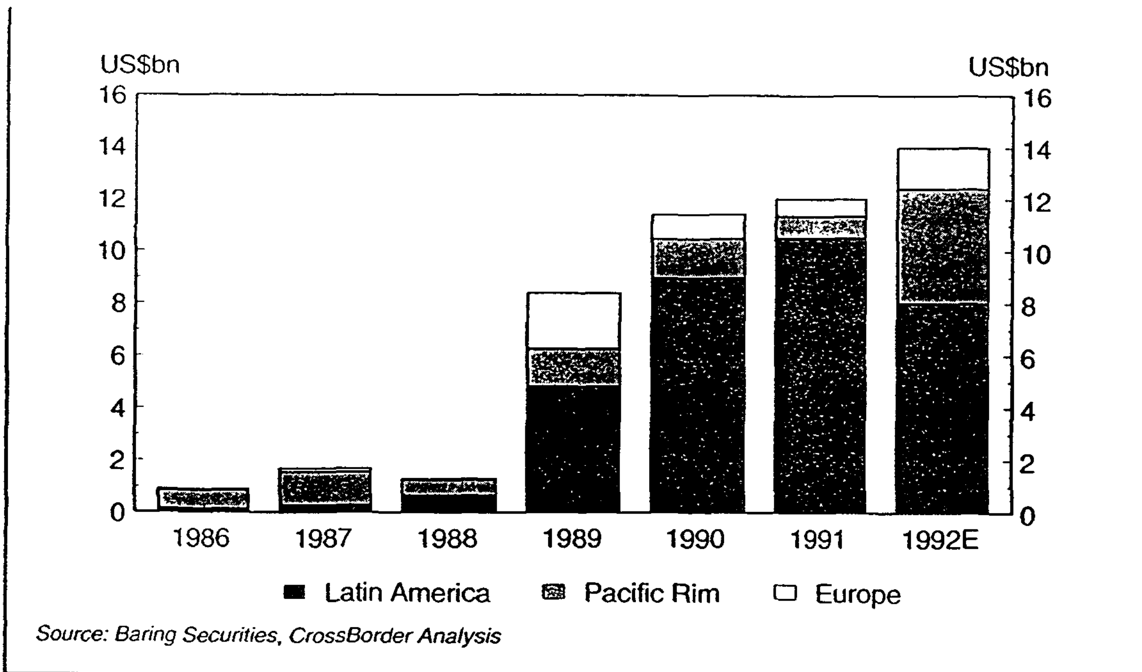
9 Interview material.

**Figure 2**
**Secondary Market Net Flows to Emerging Markets -**
**Flows to each region as a Share of Total Flows, 1986-92E**




*Source: Baring Securities, CrossBorder Analysis*

**Figure 3**
**The Value of Secondary Market Flows to emerging Markets, 1986-92E**




*Source: Baring Securities, CrossBorder Analysis*

It should however be emphasised that as regards primary issues, it is estimated[10] that in 1993, Latin America was dominant within emerging markets, with around 50% of total issues in emerging markets coming from Latin America, of which around half (30% of the total) estimated to have originated in Mexico. These figures would seem to indicate that there is no problem of saturation of Latin American equities, and that investor appetite for Latin American paper continues high at present.

As regards European flows going to invest in Latin American equities, there are no published data available.

However, as shown in Table 10, it is estimated that European purchases of Latin American equities started at very low levels in 1986, 1987 and 1988 (though gradually rising), increased substantially in 1989, continued growing in 1990 and 1991, but declined somewhat in 1992. In this respect European flows reflect a similar pattern to total flows going to Latin American equities (see again Figure 3), with, however, a certain lag. Indeed, it seems that interest in purchasing Latin American equities originated initially more from US based sources (including returning Latin American flight capital; European investors and particularly UK ones) focused first far more on the emerging markets of the Pacific Basin and therefore started to invest somewhat later in the emerging markets of Latin America than their US counterparts.[11] However, by 1991, European investors are estimated to reach a peak of 40% of total secondary flows going to Latin American emerging markets (see Table 10 and Figure 3), with their share however declining somewhat in 1992, to around 30%.

**Table 10:**
**Estimated European Secondary Market Flows to Latin America (U.S.$)**

| | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 | 1992E |
|---|---|---|---|---|---|---|---|
| Amount | $40m. | $170m. | $330m. | $1.7b. | $3.3b. | $4.5b. | $2-3b. |

**Source:** Estimates prepared by Angela Cozzini, on the basis of Baring Securities data base. Ms. Cozzini's efforts at estimates are especially gratefully acknowledged, given the lack of available information.

10 Interview material.

11 Interview material.

It can be argued that this type of behaviour is to an important extent dictated by geographical proximity. Thus, US investors have in general shown a preference for Latin America, whilst Japanese investors have tended towards South-East Asian markets. The European (and particularly the UK) have straddled both, preferring South East Asia in the early stages and then more recently diverting funds to Latin America.[12]

As pointed out above, there are no detailed published figures that show the sources of funds for different regions in emerging markets. However, there is information, by investor, going to the total of emerging markets (excluding Pacific Rim), that is including Latin America, Indian Sub-continent, Middle East, Eastern Europe and others (the bulk of these are likely to go to Latin America). As can be seen in Table 11, for the 1989-92 period, flows originating from Europe represented 40% of flows going to emerging markets, with the largest portion of European flows (23%) originating in the UK, and the second most important European source being Switzerland, (which represents 9% of total flows to emerging markets).

**Table 11:**
**Net Cross-Border Equity Flows (Secondary Purchases).**
**Into the Emerging Markets by Investor**
**(Cumulative 1986-92E)**

| | US$b. | % |
|---|---|---|
| Sources: | | |
| North America | 10.21 | 23 |
| Europe | 17.85 | 40 |
| (U.K.) | (10.35) | (23) |
| (Switzerland) | (4.26) | (9) |
| Pacific Rim | 13.57 | 30 |
| Emerging Markets | 1.55 | 3 |
| Other | 2.70 | 6 |
| Total | 45.88 | 100.00 |

**Source:** Calculations, based on Howell, op. cit.

---

12 Interview material; see, also, M. Howell "Institutional Investors as a source of Portfolio Investment in Developing Countries", paper presented to World Bank Symposium on Portfolio Investment in Developing Countries, September 9-10, 1993.

Clearly the main source for European investment in emerging markets (including mainly those of Latin America) originate in the UK.

UK foreign equity assets are concentrated in the hands of pension funds, life insurance companies and unit trusts.

As regards UK pension funds, the accumulation of foreign assets has been a key feature in their development. In 1975, foreign assets (all equity) represented only 5% of total portfolios. After the abolition of foreign exchange controls in 1979, there was a sharp increase in foreign assets held by UK pension funds, whose share more than tripled, to 18%, by 1990! As can be seen in Table 12, this is the highest share of foreign assets held by pension funds in any developed country. According to data provided by Baring Securities,[13] by end 1991, 26% of overall UK pension funds were held in foreign assets.

**Table 12: Foreign Assets (as a % of assets) of European Pension Funds**

| | 1975 | 1980 | 1985 | 1990 |
|---|---|---|---|---|
| UK | 5 | 9 | 15 | 18 |
| Germany | 0 | 0 | 1 | 1 |
| Netherlands | 8 | 4 | 9 | 15 |
| Switzerland | - | - | 3 | 5 |
| | | | | |
| Memo Item: | | | | |
| US | 0 | 1 | 2 | 4 |
| Japan | 0 | 1 | 5 | 7 |

**Source:** Davies, op. cit., based on national flow-of-funds tables.

The increasing exposure by UK pension funds to foreign stock is particularly striking. These accounted for only 6% of total assets in 1979, but are estimated by Baring Securities to have increased to over 20% in 1991. This is consistent with the information provided in Table 9 (and with interview material) which show that by the late 80's, a very high share of UK pension funds foreign assets was held in foreign equities. This trend is confirmed clearly in the early 1990's.

---

[13] Baring Securities Cross Border Capital Flows. A Study of Foreign Equity Investment, 1991/1992 Review, London 1993.

This may have important implications for future trends. Indeed, in the UK, because pension funds already have such a high proportion of their assets in foreign equities, they probably will not wish to increase this share much further. As a result investments into emerging markets' shares (e.g. in Latin America) will tend to come mainly from a re-allocation of those UK pension funds' international assets, to emerging markets, and not so much from an increase in the share of their investment in foreign equities. However, the re-allocation of funds from developed to developing markets should not be under estimated. However, growth of investment in emerging markets by UK pension funds can be expected to be somewhat more limited than for example that of US pension funds, where only around 4% of total assets were in foreign assets (see again Table 12) and within this only around 3.5% of total assets were in foreign equities.[14] The experts advising US pension funds (called consultants) are as a result suggesting that these US funds rapidly increase their share of foreign equities in total assets to around 15%, of which around 10% (that is, 1.5%) should go to emerging markets.[15] Should these trends materialize, then US pension funds investment in emerging markets' equities would increase both because the share of foreign equities in their total assets is rising sharply, and because of re-allocation of assets to emerging markets.

The situation in Holland is somewhat in-between, though closer to that of the UK. The share of foreign assets held by private pension funds is already quite high, though that of public funds' foreign holdings is fairly low (at only around 3%). As a result, there is some (though not as much as in the US), space for a further expansion in the share of foreign assets in Dutch pension funds' assets, which could be reflected in a potentially fairly large increase in investment in equities in emerging markets (particularly because the Dutch pension funds have a strong preference for equities as a form of foreign asset investment, see above).

Pension funds and life insurers have been "in the vanguard" of foreign equity investment in the UK and Netherlands, within Europe. Both countries share a high ratio of institutional assets to GDP. In both countries, there is a relatively low level of pension benefits provided by governments; this forces individuals to save for their old age.

---

14 See Baring Securities, op. cit., also, interview material.

15 Interview material.

Within Europe, the UK and Netherlands are the exception rather than the rule. For example, more generous State pensions are found in France, Italy and Switzerland; in Germany there is a special retirement system. These countries have as a consequence low institutional assets to GDP. However, informed observers[16] believe that this is set to change as generous government pension benefits become unviable in those countries, due both to ageing population structure and the need to reduce budget deficits. As a result of these and other trends, an important increase in the pension fund assets of France, Germany, Italy and Switzerland is estimated for the coming years. Indeed, Baring Securities[17] estimates that such assets will grow 50% from 1991 to 1996, and reach almost $500 billion in the latter year. Furthermore, the currently low proportion of their assets held in foreign assets is projected to also increase quite significantly in the next years. As a result, there is a large potential for higher investment by French, German, Italian and Swiss pension funds in equities (and bonds) issued by Latin American borrowers. It may therefore be worth while for LA borrowers to make special efforts to attract the interest of these potentially large investors, as well as that of the more established pension funds, such as the UK and Dutch ones.

We will return now to examine the UK pension funds, by far the most important European investors in emerging markets' equities (see again Table 11). What is the proportion of their emerging market investment going to Latin America, and how has it evolved? This is an important question, because it can be argued that investment from institutions such as pension funds implies a more long-term commitment and is therefore potentially less volatile than investment from other sources.

It is at present impossible to obtain data separating only Latin America, but information was obtained that separates Pacific Rim emerging markets from other emerging markets (which are mainly Latin America, but also include Indian Sub-Continent and Middle East). Table 13 provides data, referring to £185 billion of UK pension fund total investment, made by 3,000 different investors. The information provided in Table 13 shows that: a) Latin American equities still (in September 1993) represent an extremely low share of UK total assets (at something below 0.6%), though there has been a systematic and sustained increase since December 1990; b)

---

16 Interview material; see also Baring Securities, op. cit.

17 Based on estimates by Intersec Research.

Pacific Rim (exc. Japan) equities represented a ten times higher share of UK total assets than Latin American equities in December 1990. Their level continued to increase in the last three years, though at a somewhat lower pace than that of Latin American equities. Indeed, Pacific Rim (exc. Japan) equities reportedly represented as high a share of UK pension funds' assets by late 1993 as Japanese equities or as US equities!

**Table 13: % Shares of Investment, in UK Total Pension Fund Investment, Excluding Property[a]**

| | Dec 1990 | Mar 1991 | Jun 1991 | Sep 1991 | Dec. 1991 | Mar 1992 | Jun 1992 | Sept 1992 | Dec 1992 | Mar 1993 | Jun 1993 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Other (including Latin American) equities | 0.2 | 0.3 | 0.4 | 0.4 | 0.4 | 0.5 | 0.5 | 0.6 | 0.6 | 0.6 | 0.6 |
| Pacific Basin (exc. Japan) equities | 2.1 | 2.6 | 3.0 | 2.8 | 2.9 | 3.3 | 3.5 | 3.4 | 3.7 | 4.2 | 4.6 |

**Source:** CAPS Ltd. Several issues Quarterly Bulletin - London

(a) Refers to £185 billion of total assets (excluding property) of 3,000 portfolios of UK pension funds.

The above figures would seem to confirm that there may be a very large potential for the share of Latin American equities in UK pension funds to rise.

This was confirmed in interviews with pension fund representative and fund investment managers. For example, a representative of Mercury, the largest pension fund manager in Europe, expressed the view that UK pension funds (as well as retail investors) will further increase their share going to Latin America, but will not reach as high a level as that going to the Pacific Rim. A representative of another very large investment manager, Robert Fleming, confirmed a similar trend, and emphasized that there is increased interest in Latin America by UK institutional investors in late 1993; this is reflected in the fact that many UK brokers are now creating separate "expertise" and "desks" for Latin American securities, whereas till recently Latin American securities were covered by the US analyst. This trend was further confirmed by a representative from the largest UK pension fund, British Rail

Pension Fund (BRPF). It is interesting that this important pension fund has its' assets totally externally managed by five managers on global remit, who work in an approved list of countries. It is interesting that all five managers had asked BRPF particularly strongly in the last year (and more informally in the previous two years) to let them invest BRPF money in Latin America, as well as Eastern Europe. Reportedly, a decision to allow some small investment in Latin America has been taken.

The interviews also showed a reported interesting difference between UK and US investment in Latin American equities. In the US, most brokers dealing in Latin American shares trade large volumes, so they can make enough money on commission on secondary business. In the UK, the scale of Latin American business is still smaller, so brokers prefer to focus more on primary business, where far higher fees can be earned (reportedly up to 6% of 7%). This requires them to have good relations with primary borrowers.

As regards the country distribution (within Latin America) of UK investors, an important distinction needs to be made between general investors (such as pension funds) and more specialized investors (such as those investing in regional funds). For example, general investment managers offered their general investors what they called a "conservative portfolio" in Latin America, with around 60% in Mexico, and around 15% each in Brazil, Chile and Argentina. This same investment manager, in its' specialized Latin American fund offered a mix with 50% exposure in Mexico, over 20% in Brazil, around 10% in Argentina and Chile each, and included some exposure in the less well known and/or "riskier" markets of Peru, Colombia and Venezuela. Furthermore, Foreign and Colonial, reportedly the largest portfolio investor in Europe in Latin America, had even a more diversified portfolio in its' Latin American fund, with only 32% of it in Mexico, a similar proportion in Brazil, 14% in Argentina, around 5% each in Columbia, Venezuela, Chile and Peru and even with small amounts (less than 1%) in countries like Ecuador and Bolivia.[18] As regards comparing US and European (particularly UK) investors, it was reported[19] that the latter have a broader understanding of Latin America, and are therefore

---

[18] Interview material.

[19] Interview material.

more willing to have a wider range of exposure in terms of countries within Latin America than the more "conservative" US based investors, which concentrate far more on investment in Mexican equities.

As regards very recent (1993) trends, the increased attractiveness of Brazilian equities for UK investors needs to be highlighted, encouraged by large increases of the prices in the Brazilian stock exchange.

The process of increasing country diversification within Latin America is not restricted to investment in equities in the region. Indeed, it was reported[20] that there has recently been significant geographical diversification in the number of Latin American countries accessing the international bond market with the entry of Uruguay and Trinidad in 1992, and with that of Chile, Colombia and Guatemala in 1993. It is interesting that the Guatemalan bond is collateralized by coffee export receivables; this follows a pattern first set by Mexican borrowers on the bond markets whereby the initial bond offerings made were collateralized by export receivables, with later issues often not having that characteristic, as the market got to know those countries and borrowers better.

## iv) BANK LENDING

In contrast to the buoyant activity in the international bond and equity market, total bank lending commitments to Latin American countries declined quite sharply in the 1987-1991 period. This was both because, as discussed above, there was a global fall in international bank lending and because access to such lending remained severely restricted for Latin American and other developing countries that had recently experienced debt-servicing difficulties. However, it is interesting that during 1992 net aggregate bank lending to non-OPEC Latin America was positive for the first time in six years, at $12.1 billion - a level not seen for a decade (see Table 14). Furthermore, in the first quarter of 1993, lending to that region was again positive, (at $0.8 billion) though smaller than in the previous four quarters.[21] There is therefore possibly a new important trend emerging, of increased bank lending to Latin America.

---

[20] West Merchant Bank, Investment Review, October 1993, London.

[21] BIS, "International banking and financial market developments", Basle, August 1993.

**Table 14**
**BIS Reporting Banks' lending to different categories of countries (outside the reporting area)**

| Borrowing from Reporting Banks | Changes, exc. exchange rate effects ($ billions) | | | | | | | Stocks at end-1992 |
|---|---|---|---|---|---|---|---|---|
| | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 | |
| Non-OPEC Latin America | 1.5 | -3.7 | -5.0 | -16.7 | -23.0 | -0.3 | 12.1 | 200.1 |
| Non-OPEC LDC's | 3.1 | 2.2 | -2.4 | -19.6 | -5.7 | 13.8 | 30.3 | 410.1 |
| Total Borrowing | 14.4 | 11.6 | 13.5 | -1.7 | -11.9 | 8.1 | 63.7 | 813.2 |

**Source:** BIS 63rd Annual Report, Basle, June 1993.

As regards the geographical sources of such bank lending, to Latin America, there is no published information available. However, according to estimates provided by the BIS,[22] around a third of the stock of international bank lending to Latin America in the last three years originates in flows from Europe.

An important and potentially problematic recent feature of international bank lending, both to Latin America and more generally, is a fairly significant shortening of the average maturity of such lending. Thus, for non-OPEC Latin American countries, the share of loans up to one year maturity, in total bank loans, rose from 42.5% at end 1991 to 45.1% in mid 1992 and to 47.4% at end 1992; for all developing countries this share went up in a similar proportion, from 49.4% at the end of 1991 to 54.1% at the end of 1992, though at a somewhat higher level of share of short-term loans. Within Latin America, particularly rapid increases in the share of loans up to one year maturity occurred during 1992 in Argentina, Chile and Colombia.

This trend, for Latin America and for the rest of the developing world (as well as for all bank lending) reflects banks' increased preference for short-term lending, shown by the non-renewal of maturing long-term loans and increased emphasis on trade-related credit.

---

22 Interview material.

# IV MOTIVATIONS OF EUROPEAN SECURITIES' INVESTORS

This section will examine the motivations which encourage European investors to put their money into Latin American securities, the extent to which motivations differ for investments in different types of securities and the factors which will determine whether such flows are likely to continue at present levels.

A first noteworthy point that emerged from the interviews was the general impression that specific European investors (e.g. pension funds) seem to decide first whether they like a particular country or region. Once they have decided to go into a particular region or country, they will tend to invest in the whole range of instruments in that particular country, including equity, bonds, short-term instruments. The extent to which they will prefer one set of instruments to another will depend mainly on their general preferences; thus, UK investors tend to prefer in general to invest in equities; this same preference is reflected in their general international assets and in their investments in Latin America. Similarly, German investors have a strong preference for fixed-income instruments (especially bonds), preferences which are reflected in the distribution of their international and Latin American assets.

Another important feature was that investors seem to think mainly in regional terms. Thus, they express strong views about the Latin American region in general, though within it they may also have some preferences for individual countries. This "regionalisation" of preferences works both for positive and negative trends. Thus, reportedly an anti-NAFTA speech delivered by the then US Presidential candidate, Ross Perot, caused both foreign and domestic investors to sell shares in countries as far from Mexico as Argentina, with a resulting large fall in share prices in Argentina, even though the objective connection between Argentina economic performance and the Perot speech was very tenuous indeed.

As regards the factors which encourage European investors into investment into developing country bonds, clearly an important factor is yield. To the extent that European interest rates are now consistently falling, and US interest rates remain very low, the attraction of higher yields are clearly an important incentive, increasingly also for European investors.

**Figure 4**
**Four Key Fundamentals**

MORGAN GRENFELL

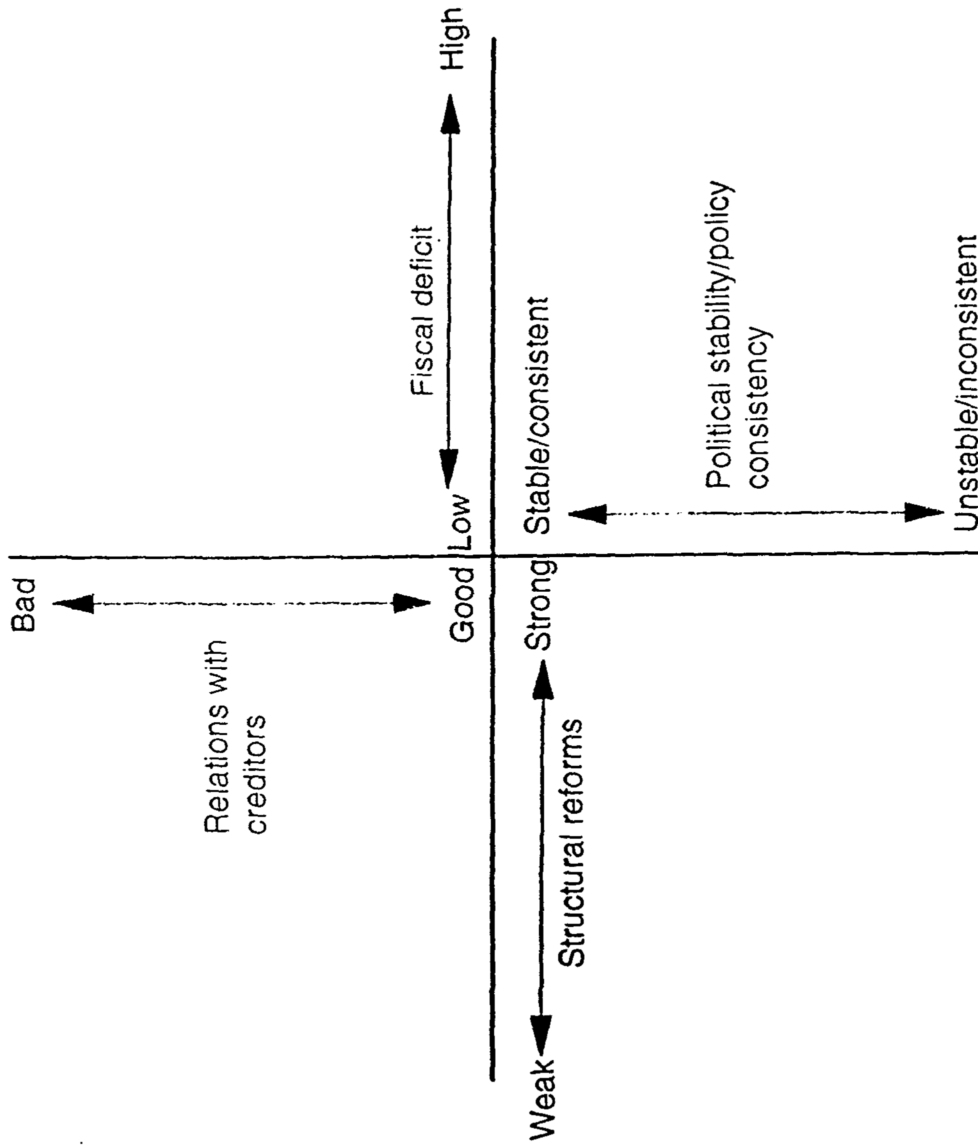
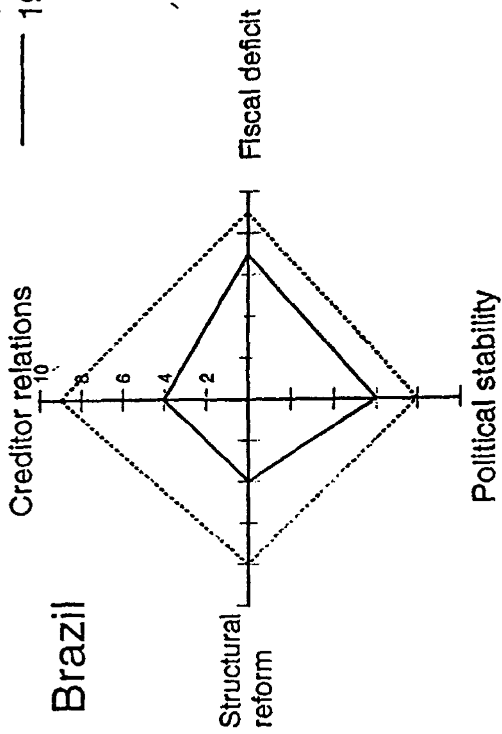
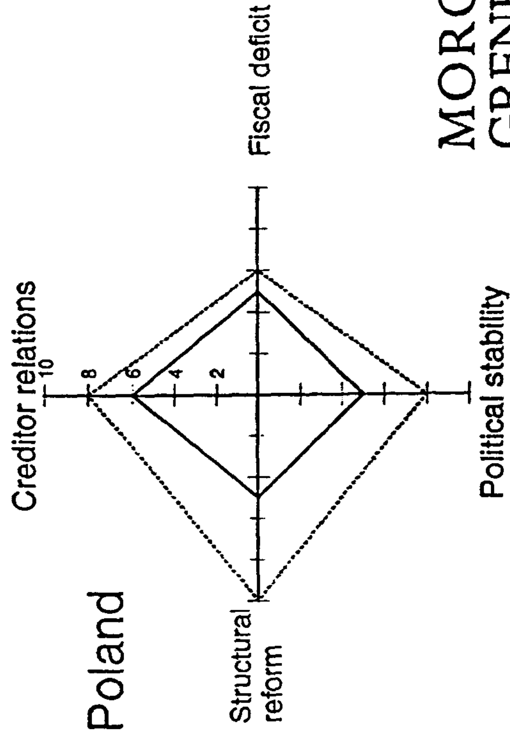
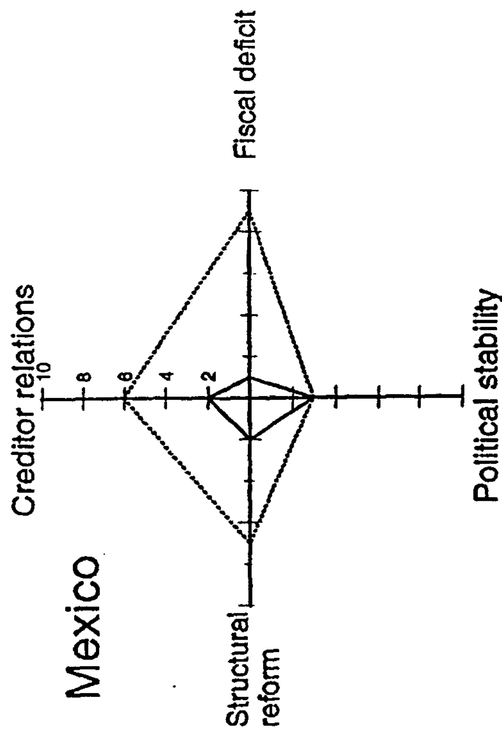
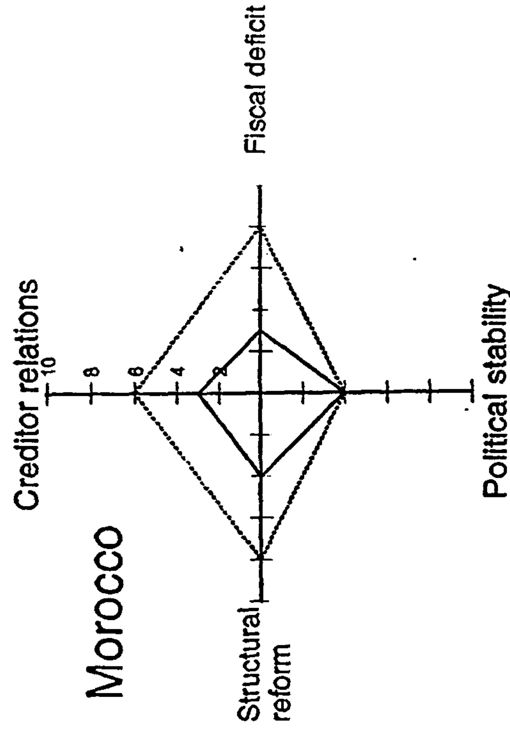


**Figure 5**
**How Four Countries Measue**



As regards specific country factors, one of the most active investment banks in the City of London, in selling Latin American bonds, Morgan Grenfell, summarized them as presented in Figure 4. The key fundamentals detected are: 1) Relations with creditors, 2) Fiscal policy, 3) Consistency of policy and political stability and 4) Progress in structural reforms, such as privatization.

In Figure 5, these four criteria are applied for two different years and for four countries (Mexico, Brazil, Morocco and Poland). For 1992, Mexico emerges as the most attractive country, and with a large improvement over its' 1988 "performance". Interestingly, Mexico's deteriorating current account in 1992 is not detected by the variables analyzed here.

The exponential growth of research on Latin American economies by large investment houses was given as an indication that there will be a likely growth in business from UK investors, both into bonds and equities.

As regards motivations of UK based investors in Latin American equities, it is important to understand first the complex institutional arrangements behind such decisions. Thus, institutional investors (such as pension funds and insurance companies), are the source of the funds, but are only very indirectly and somewhat partially involved in the decision-making process. They hire pension fund consultants, who advise them on a general strategy. They also hire investment managers, to whom they tend to give fairly broad guidelines; the investment managers make suggestions within those guidelines or suggest changes in guidelines. Finally, brokers are involved in directly purchasing the shares. Decisions are somewhat disseminated. Knowledge is also unevenly distributed, as pension fund managers would have far less specialist knowledge on for example Latin American markets, than investment managers. It may indeed be desirable for Latin American borrowers to establish also stronger links and communication channels with pension fund managers directly.

As regards the factors determining investment in Latin American equities, some of them are global in origin. For example, as deposit rates come down, resources are transferred on a large scale from banks into the securities' markets. Furthermore, to fears that returns on European equities could become very low or negative, and investing in emerging markets (including in Latin American ones) is seen both to offer possibilities of better returns and of reducing systematic risk. The latter reason is supported by research which shows that as national trade cycles are not

correlated, (especially in non-crisis times) the investment of part of the portfolio in other markets can reduce systematic risk for the same return.[23] Furthermore, a strong reason for investing in Latin American equities is that in recent years the prices of Latin American stocks (as well as several Far East stocks) have increased far faster than that of stocks in developed countries. Indeed, in 1992 the top six best-performing markets were emerging ones.

As regards more specific factors, most fund managers seem to take a top-down approach to the selection of stocks in developing countries. Thus, they first assess the country's overall economic prospects (with some putting 4-6% growth as a minimum threshold), then moving down to sectoral and company level. Investment managers report a generally inadequate quality of financial information available at a company level, for Latin American countries.

As pointed out above, UK institutional investors are only now beginning to invest in Latin American equities, and are increasing their participation rather prudently. The reluctance to move faster is due to the fact that Latin America is still seen as potentially somewhat volatile, both economically and politically.

The recent performance of Latin America (both in the economies and in the stock markets) is seen as good and as improving; this is reflected in the significantly improved ranking of Latin American economies since 1989 in the country risk ratings published for example by Institutional Investor and Euromoney. However, amongst some UK based institutional investors there are lingering (though diminishing) concerns about the sustainability of Latin America's improved economic performance.[24]

Amongst the criteria attracting UK investors, both institutional and retail, to Latin America are:[25] i) Major change in economic philosophy, towards more free-market economics, which is broadly seen as permanent, ii) Increased growth and growth prospects, iii) Prudent macro-economic management, iv) Increased political stability.

---

[23] For a review of the literature see, E.P. Davies, "International diversification ..., op. cit."; See also, World Bank, Global Economic Prospects ... op. cit.

[24] Interview material.

[25] Based on interview material.

Other factors mentioned which influence decision to invest in Latin American market are: size of the market (with clear preference for larger markets) and domestic regulations. As regards the latter, UK based investors attach quite a lot of importance to appropriate regulation in Latin American markets, which is seen to have improved significantly; however, further improvements are seen as desirable in key aspects, such as liquidity of local markets, systematic information and clearing and settlements procedures. One aspect of Latin American countries' regulations seen as problematic by UK based investors is the continuing holding period requirement in Chile; it is argued that - though this is not a problem for large companies that can raise foreign equity via ADR's - it restricts access to foreign equity by small and medium companies.

As regards expected/required return targets set before investing, these vary widely. Some more aggressive investment managers argue that a less than 20% annual return is considered "disappointing"! On the other hand, some institutional investors said that fairly low returns can be tolerated as their investment in Latin American or other emerging markets produce a valuable diversification effect.

As regards holding periods for emerging markets, it is important to stress that foreign fund managers tend to "hold" their investment in emerging equities far longer (on average for the 1986-92 period they turned their emerging market portfolio over <u>0.8 times</u> a year) than in the developed country markets (where on average for the 1986-92 period global investors turn over foreign equity portfolios <u>2.6 times</u> each year). This leads Howell, op. cit. to conclude that while foreign fund managers are "trading" the developed markets (increasingly with derivative instruments), searching for ever more elusive arbitrage opportunities, they are "investing" in the emerging markets, where they are steadily building up their exposure. However, average holding periods for LDC stocks are still rather short.

It would seem that holding periods are somewhat longer for UK based global investors, as they are more interested in longer-term capital appreciation. There is also some evidence that for UK based global investors the time horizon tends to be longer for investments in Asian markets, where transactions are driven more by fundamental factors; reportedly, the average holding period is generally shorter for

investments in Latin America markets, that tend to be more trading-oriented; one reason for this are high inflation rates in some countries (e.g. in Brazil), which complicate longer-term investment strategy.[26]

As regards the factors that could potentially cause a large outflow of funds from Latin American equity markets, the investment managers interviewed argued that this could occur if there was a major relevant change in the international economy, (for example if US interest rates rose rapidly and significantly, or if there was a sharp increase in protectionism in the industrial world) or if there was major political unrest in one of the larger Latin American countries.

## V RELEVANT REGULATIONS IN EUROPE

A fairly important factor influencing European flows into Latin American investments are source country regulations.

As regards investments by European institutional investors, two general trends can be detected. One is that in most European countries pension funds are less restricted than life insurers as regards their ability to carry out international investments. The second is that there is quite a sharp contrast between some European countries with fairly liberal regulations (in particular the UK, but also to an important extent Holland) and countries with fairly restrictive regulations (e.g. Germany, France and Italy).

As regards UK life insurance regulations, these stipulate that liabilities in any currency that exceeds 5% of the total must be matched at least 80% by assets in the same currency. Since most liabilities are in sterling, this means up to 80% of assets must also be in sterling. Furthermore, firms have to prove to the supervisory authorities at regular intervals that they meet statutory solvency requirements.

In other European countries, life insurers are constrained by regulations from holding sizeable proportions of foreign assets, that is firms are not free to expand foreign asset holdings.

Thus, in Germany the Law on Insurance Supervision specifies that assets held to meet contractual insurance liabilities (which represent more than 90% of the total) must be one of 12 specified types, and foreign assets are excluded from the list.

---

26 I thank Kwang Jun for providing this information, based on interview material.

Technically, 100% matching of domestic currency life insurance liabilities with domestic assets is required. Foreign assets may also not exceed 5% of other assets (i.e. those reserves allocated for future bonuses). Reportedly, an EC directive would raise this ceiling on foreign investment, but regulators would still impose other relevant restrictions.

In France, 100% matching of life insurance liabilities to assets is required, as in Germany; also 34% must be in Public bonds.

Several other European countries have restrictions on life insurance assets similar to those in Germany and France. In Italy, foreign currency assets are limited to the size of foreign currency liabilities.

In contrast, Netherlands has a liberal regime. There are no restrictions on asset holdings or solvency requirements, though account must be made regularly of firms' asset/liability positions.

The regulations passed in the context of 1992 and the single market (including the Life Insurance Directive, ensuring cross-border competition) may either directly - or indirectly as a result of competition - reduce the differentials in portfolio restrictions. The latter will particularly be the case as EC firms will be able to operate under "home" country regulations, allowing foreign firms to compete under less stringent regulations.

In Germany, profitability is also regulated and product design is restricted. With the new EC directives, even if the products remain the same, incentives to invest overseas may increase; however, if - as is more likely - the nature of the product changes, as a result of EC directives, then there will be more offshore German investment.

As regards pension funds, in the UK these (like in the US) are subject to a "prudent man rule", which requires managers to carry out sensible portfolio diversification. UK pension funds are <u>not</u> constrained by regulation in their portfolio holdings, except for limits on self-investment (5%) and concentration. (Trustees may however impose limits on portfolio distribution). There is therefore <u>no</u> regulatory limit on the share of foreign assets held by UK pension funds.

German pension funds remain subject to the same panoply of regulations as those for life insurers (including 4% limit on foreign asset holdings).

In France certain pension funds are constrained by fiscal regulations to invest in domestic assets - implying even tighter control than in Germany.

Swiss limits are similar, if slightly less restrictive than German ones; there is a 20% limit on foreign assets and 10% on foreign shares.

Finally, Dutch private funds face no restrictions, except for a 5% limit on self-investment. In contrast, the public service fund (ABP) faces strict limits, being able to invest only 5% abroad.

As regulations for institutional investors in Continental Europe are likely to become more liberal - both as a result of the influence of the Anglo-Saxon model and as a result of EC directives, as briefly described below - there may be quite a large potential for increased investment by those institutions in foreign assets, including those held in Latin America. Such potentially large growth may be particularly important from those institutions whose regulations are at present particularly restrictive and from those countries where institutional assets are likely to grow (see above).

Changes in EC regulations, not just those that regulate institutional investors but also those which regulate financial intermediaries, will influence decision-making on the allocation of funds globally from European sources, and therefore influences the share going to Latin America. It would be somewhat premature to assess the direction of the effects of such changes, as these have just occurred recently or will occur in the future (see below). However, the measures described briefly below will clearly encourage cross-border activity within Europe by financial entities, and may therefore facilitate access by Latin American borrowers to a greater scale and variety of European sources of savings.[27] On the other hand, there could be a danger that focus on European financial integration and investment opportunities, could distract attention and resources from investment abroad; this trend, which is reported to have occurred for FDI, seem however less likely to occur for securities flows.[28]

The creation of a single financial market in the EC is an essential element of the 1992 Single Internal Market. It aims firstly to abolish capital controls within the EC and the removal of al barriers to cross-border provision of financial services. The latter

---

27 Interview material.

28 Interview material.

requires two measures: the recognition of a single license permitting an institution to do business anywhere in the EC, and agreement on minimum standards. For banks and other credit institutions, mutual recognition is established in the Second Banking Directive, which came into effect on January 1, 1993. This allows a bank that is lawfully established in any member country to establish branches throughout the EC, without needing special permission from the host country and without needing to hold separate capital. The entire bank, including branches in other countries, is regulated by the home country, except for liquidity and risk in domestic markets. There are complementary directives and bilateral agreements on banking regulation in the EEC context.[29]

Amongst the possible likely effects of these directives is to expose European banks, which currently display elements of monopoly, to heightened competition; some observers also suggest that the single market may result in a shift toward the universal banking model, as the EC Second Banking Directive appears to lean towards universal banking, by allowing universal banks to do business throughout the EC, while confining banks from the "Anglo Saxon" model to the same narrow range of activities in any member country as they already do.

In the securities markets, the single passport is to be provided under the Investment Services Directive, adopted in mid-1992, and which is to come into force in 1996. It allows securities dealers licensed in any member country to do business anywhere in the EC; it is supplemented by capital requirements designed to ensure the safety and soundness of dealers and brokers (specified in the Capital Adequacy Directive), that applies to securities firms and to the securities trading activities of banks.

Another important element of the single market is the sale and advertisement of products rather than the establishment of business operations. In particular, cross-border sale of shares in open-ended mutual funds was authorized in the Directive on Collective Investment, which came into force in most EC countries in 1989. It resulted in a significant increase in the volume of cross-border investment activity, although reportedly much of it apparently consists of "round-tripping". This type of "round-tripping" makes accurate statistical analysis of country origins practically impossible.

---

[29] For more details, see, for example, S. Griffith-Jones, "Globalisation of Financial Markets and Impact on Flows to LDC's: New Challenges for Reputation" in R. Cooper et al. (ed.) In Search of Monetary Reform, FONDAD 1993.

An EC Directive on Pension Funds establishes as a general principle their freedom of investment, for example governments cannot require pension funds to hold only domestic assets.

Similar EC initiatives have been underway for life and non-life insurance companies.

Finally, as regards regulation of investments at a national European level, it is important to note likely changes in the UK currently being discussed. These changes are relevant here, because some investment managers interviewed highlighted existing regulations as an important constraint for investment in Latin American shares, particularly by retail investors.

In the UK, the Securities and Investment Board (SIB) regulates securities and investment activities, mainly through a network of self-regulatory organizations. The SIB currently publishes lists of overseas exchanges, which according to its' criteria provide acceptable levels of investor protection.

These lists are important because investments in approved markets imply a lower capital requirement for the securities firm, and are therefore more profitable for them.

As regards approved markets for authorized unit trusts, the current list only includes Mexico, amongst Latin American securities markets, though it includes several Asian securities markets (Korea, Malaysia, Singapore and Thailand). Reportedly,[30] it is relatively simple for new securities markets to be added to the list, if they request to do so; however, only Mexico, from Latin America, has reportedly made this request.

However, in an October 1993 review of its' policy,[31] the SIB is proposing that the concept of approved markets for authorised Unit Trusts be abolished. The SIB proposes a replacement of the list for Approved Securities Markets by a duty, placed upon the manager of the unit trust, after consultation with the trustees, to invest only in those markets which are: i) regulated, ii) operate regularly, iii) are recognized, and iv) are open to the public.

---

30 Interview material.

31 SIB Discussion Paper on Regulated Collective Investment Schemes, London. October 1993.

It is interesting how the SIB justifies this proposed change. It argues that, provided the manager operates within disclosed parameters, appropriate investor protection could be achieved by placing reliance on the integrity and competence of unit trust managers to make judgements about the relevant market. It therefore considers that "this approach should not result in any material lessening of investor protection". It argues then that given accelerated globalisation of investment, and an increase in the number of markets in which fund managers seek to invest, it is unrealistic to expect UK based regulations to make - and continually review - a judgement on each market without a significant increase in regulatory resources and costs.

If, as seems likely, this regulatory change is approved in the UK, it will firstly imply that it will become easier for Latin American borrowers to raise funds from UK unit trusts. This is a potentially large source of revenues, as total UK unit trust assets reach around $ 100 billion.[32]

Though this effect should be welcome, perhaps some concern should be raised about the apparently drastic process of liberalisation of regulation which this change implies, and reflects, and the fact that apparently the issue of regulatory resources and costs, as well as the difficulties of regulating in an increasingly globalized world, so heavily influences the decision on the extent to which regulation should be actually carried out.

## VI TERMS OF INFLOWS INTO LATIN AMERICA, THEIR SUITABILITY FOR LONG-TERM DEVELOPMENT, RISKS ASSOCIATED WITH THEM

As regards bonds, a very important category of Latin American borrowing, it is often stressed correctly[33] that since 1989 on the whole yield spreads for Latin American borrowers have tended to decline and that maturities have on the whole remained constant or slightly increased. Furthermore, the total cost of bond finance is seen as low by Latin American borrowers as the level of US Treasury bonds' interest rate over which spreads are usually calculated is at present fairly low.

---

32 Interview material.

33 See, for example, Collyns et al., op. cit.; see also, for recent data, West Merchant Bank Investment Review. October 1993, op. cit.

However, it should be emphasized that the average weighted spreads for Latin American bonds in the 1989-92 period are fairly significantly higher than they were in the 1972-80 period.[34]

**Table 15**
**Average Term (in Years) of Latin American International Bonds**

| | Average Term (in years) | Total Value (US$ million) |
|---|---|---|
| 1972 | 15.3 | 470.000 |
| 1973 | 14.6 | 130.000 |
| 1974 | 15.7 | 77.000 |
| 1975 | 14.7 | 408.000 |
| 1976 | 11.2 | 1067.000 |
| 1977 | 7.5 | 3908.000 |
| 1978 | 9.0 | 3211.000 |
| 1979 | 8.7 | 1473.000 |
| 1980 | 8.1 | 1418.000 |
| 1981 | 8.4 | 2583.000 |
| 1982 | 8.4 | 1945.000 |
| 1983-84 | 0.0 | - |
| 1985 | 7.0 | 10.000 |
| 1986 | 6.5 | 56.000 |
| 1987 | 7.0 | 50.000 |
| 1988 | 7.7 | 800.000 |
| 1989 | 4.3 | 513.000 |
| 1990 | 4.5 | 3.348 |
| 1991 | 4.3 | 6.420 |
| 1992 | 3.7 | 9.782 |
| 1993 (a) | 3.9 | 10.708 |
| TOTAL | 6.6 | 48.378 |

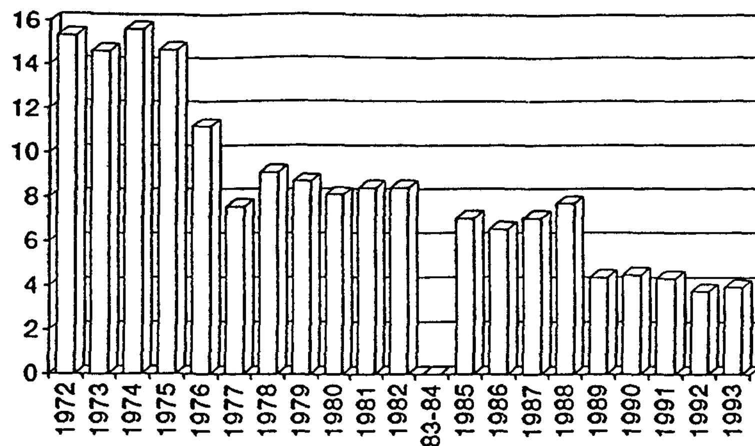
**Source:** BIS. I thank Dr von Kleist for providing this data.

(a) Data up to June. According to West Merchant Bank, op. cit. in the third quarter of 1993 $6.2 b was placed in bonds by Latin America, bringing the first nine months up to $17 b.

---

34 Data provided by Dr Von Kleist at the BIS. The comparability is somewhat limited by the fact that in the later period there is a higher proportion of private sector borrowers, whose spreads tend to be higher than public sector borrowers.

**Figure 6**




More importantly, as can be clearly seen in Table 15, and Figure 6, the maturity at which Latin American borrowers have been raising ever increasing amounts of bond finance are far shorter in the 1989-1993 period than they were in the 1972-82 period. Furthermore, according to Table 15, the average maturity in the 1989-1993 period (at around 4.0) is extremely short. This implies that a high part of the stock of outstanding bonds can be fairly rapidly withdrawn, if bonds are not renewed; this could happen either if the country/region faces internal problems or due to changes in the international economy. If, as a result of this, and other factors a serious Balance of Payments crisis were to emerge, it would be more difficult - then in the case of banks in the 1980's - to organize a concerted response to sustain external financing as claims would be dispersed among numerous bond holders. As Collyns et al. rightly point out, this would complicate the response to a renewed bout of debt-servicing difficulties. This would be further complicated by a lack of any leader of last resort facilities for bond-holders, which is in contrast with such facilities (at least at an implicit level) for international bank lending.

Even though at present the cost of bonds is and is perceived by Latin American borrowers to be relatively cheap,[35] there is excessive risk in borrowing very large amounts, particularly at such short maturities. It would seem preferable for Latin American borrowers to scale down the total level of international flows, and within it to place greater priority on sources such as more long-term loans provided by multilateral banks, as well as foreign direct investment. As regards bonds, perhaps Latin American borrowers should wait to borrow large amounts till they can obtain far longer maturities.

---

35 Interview material.

The same line of argument can be made, but with greater strength, about excessive levels of borrowing via short-term instruments, such as Euro-certificates of deposit and Euro-commercial paper.

As regards bonds, a final point should be made; to the extent that most bonds are and continue to be fixed interest ones, the existing stock of bonds is not subject to debt servicing variations linked to changes in international interest rates. This is positive, especially in contrast to the variable interest bank borrowing undertaken by Latin America in the 1970's. However, this should be qualified in two ways. First, as maturities are so short, there is a risk that on renewal, (if the renewal is possible), the cost of borrowing will increase significantly. Secondly, even if bonds have fixed debt servicing costs, there is no mechanism for this servicing to vary with the borrower's ability to pay.

As regards international equity investment, these have the advantage of a degree of cyclical sensitivity of the dividends paid, thus allowing a better match between debt service and ability to pay. Furthermore, there is no automatic link - as for variable interest rate borrowing - to variations in international interest rates. Secondly, the risks to Latin American borrowers seem at present smaller, because the scale of the flows involved are somewhat more modest.

However, international equity flows also carry important risk for the recipients and recipient countries. If there was a critical, real or perceived situation, large parts of the stock of equities could leave Latin American countries in a very short period. Furthermore, new foreign investments in equities would also cease at that time. To the extent that the shares were sold by foreigners to national residents, this would imply pressure on the balance of payments and on the exchange rate, possibly contributing to a serious balance of payments crisis and/or to a large devaluation. To the extent that the sales are made by foreign residents to other foreign residents, as with an equity instrument like the ADR, then the effect would be more on the prices in the domestic stock exchange. Indeed, even if shares are sold by foreign to national residents, the scale of the foreign exchange outflow could be stemmed somewhat by sharp falls in the prices of shares, as this could reduce the willingness of foreign equity holders to sell, so as to avoid excessive losses. Therefore, the fact that equities have a price correcting mechanism may moderate somewhat the risk of a very large foreign exchange outflow.

However, sharp declines in prices of Latin American shares, caused or accelerated by sales by international investors, would also imply negative effects. Via a wealth effect, it could contribute to a decline in aggregate demand. Equally or more

seriously, it could imply risks for the domestic financial system, and particularly for the banks; this would be particularly the case if there is strong integration between banking and securities activities, and/or if borrowers from banks have large investments in domestic shares and their ability to pay back their loans could be impaired.[36] In this context, regulations that limit direct exposure of banks to volatility in equity markets (and have appropriate risk-based capital requirements for such risks) could help limit the negative effects of volatility. To the extent that an increasing amount of the foreign inflows going into Latin American shares originate in institutional investors, and these allocate their assets using more long-term criteria, based on specific asset allocation and diversification targets, (see discussion above), the risk of massive outflows from Latin American shares in the event of a crisis is somewhat decreased. However, in a very critical situation (or one that is perceived as such), even institutional investors would be likely to sharply revise their aim of greater diversification into foreign, and particularly emerging, markets.

More generally, as the 1980's debt crisis so clearly showed, there are always risks that in critical situations, the problems in foreign flows and in domestic financial markets will perversely magnify each other. A source of concern here is that to the extent that capital flows are intermediated through the domestic banking system, if there is a sudden burst of capital outflow, this can lead to a domestic financial crisis.[37]

Finally, as regards foreign direct investment flows, these seem on the whole far more stable and long-term, and therefore having less problematic effects in the case of a critical situation. However, it has been reported[38] that international companies do play speculative games with some of their funds, for example in anticipation of a devaluation; this "speculative" behaviour can be an additional, though probably a more limited, source of exchange rate instability.

---

36 See S. Griffith-Jones, op. cit., for a more detailed discussion.

37 See G. Calvo, L. Leiderman and C. Reinhart "The Capital Inflows Problem". IMF Paper on Policy Analysis and Assessment. July 1993. Washington DC.

38 Interview material.

More generally,[39] it has been argued that labels on flows (short vs. long-term ones) can maybe be less relevant in practice than has traditionally been believed, this was partly confirmed by some of the interviews described above. Though this argument should not be taken too far, as such distinctions do have validity and important policy implications, it does point to the need for an overall, careful aggregate analysis of individual and countries' exposure to foreign debt and equity.

Finally, it should be stressed that globally regulations of international capital flows have evolved well behind the flows themselves. This is partly due to technical difficulties, the great complexity of the task[40] and lack of political will in the major industrial countries. Though the tide is turning, the regulatory response seems always "too little, too late". This is combined with a situation of large pressures from global liquidity to find profitable investment via mechanisms that have often only recently been de-regulated. Therefore, it may primarily fall to the Latin American governments themselves to carry out any necessary regulation of capital inflows, such that their benefits can be maximized and their potential costs minimized.

Ref: SGJ/LAB/DW/sgjidrc.doc 11.11.93

---

39 S. Claessens, M. Dooley and A. Warner "Portfolio Capital Flows: Hot or Cool?" Paper presented to the September 9-10 1993 World Bank Symposium on Portafolio Investment in LDC's.

40 For a more detailed discussion, see for example S. Griffith-Jones, op. cit.