United Nations
Economic
Commission for
Latin America and
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ECLAC WASHINGTON
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# Capital Flows to Latin America

## First Quarter 2005

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**CAPITAL FLOWS TO LATIN AMERICA**
**First Quarter of 2005***

Latin American markets entered 2005 with impetus, as the favorable environment for capital inflows at the end of 2004 persisted in the beginning of the year. However, investors' sentiment deteriorated as the first quarter progressed, and concerns about economic conditions (including rising interest rates in the United States and lower liquidity in global markets) increased. In February, Fitch, the credit rating agency, released a report warning that a combination of slowing global growth and higher-than-anticipated U.S. interest rates would lead to a less favorable environment for emerging market borrowers, as investors reduce their exposure to borrowers with weak credits. Investors moved into risk aversion territory in March, according to J.P. Morgan's Liquidity, Credit and Volatility index (LCVI), after spending the early part of the year in risk seeking mode. Goldman Sachs' Risk Aversion Index (RAI), after falling to a trough of 3.65 in February 2005, a level last seen in early 2000, rose to 4.32 in March and 4.60 in April[1]. Although two points do not make a trend, many investors believe risk aversion is gaining momentum.

After declining in February, Latin American spreads rose in March (Appendix, Table 2), reflecting the deterioration in investors' sentiment towards the end of the quarter. Despite the increase in March, spreads remained at low levels. There were many more positive credit rating actions than negative in Latin American markets during the quarter (Table 1; Box 1), since the combination of less vulnerability to liquidity shocks (as a result of the structural changes of the past 5 to 10 years) with the favorable global environment in the past few years bolstered solvency in Latin American countries. Latin America new debt issuance in the first quarter was strong, covering more than half of the region's financial needs for 2005.

The Latin American region has performed strongly in the past two years,[2] and continued to perform well in the first quarter of 2005, despite deteriorating external conditions towards the end. The most remarkable fact regarding the region's performance is the fact that the biggest challenges in the near future, according to market analysts, are not of a domestic nature. They are the risk of a hard landing in China, the potential impact of the U.S.'s rising interest rates, weakening dollar and slowing economy, and the effects of increasing oil prices on the global economy. According to the Institute of International Finance (IIF), rising interest rates in the U.S. and the continuing current account imbalances in the global economy point to a more challenging phase ahead for all emerging markets. The IIF has warned of excessive risk-taking by emerging market investors, adding its voice to concerns expressed by the International Monetary Fund and the World Bank about the potential for a disorderly adjustment in global financial markets.

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* This document has been prepared on the basis of market views and developments. All data and information are from market sources, unless otherwise noted.

[1] The RAI ranges between 0 and 10 and measures investors' willingness to invest in risky assets as opposed to risk-free securities. A higher value of the index implies higher risk aversion.

[2] The need for foreign borrowing has been reduced as the growth in exports and remittances from emigrants left the region in 2003 and 2004 with its first current account surpluses since the mid-1950s.

**Table 1:**

**Credit Ratings in Latin America**

| | Moody's | | S&P | | Recent Moody's Action | | Recent S&P Action | |
|---|---|---|---|---|---|---|---|---|
| | Rating | View | Rating | View | Action | Date | Action | Date |
| Argentina | Caa1 | - | SD | - | Upgrade, stable | 20-Aug-03 | Downgrade | 6-Nov-01 |
| Barbados | Baa2 | - | BBB+ | - | Upgrade, stable | 8-Feb-00 | Downgrade, stable | 5-Aug-04 |
| Bolivia | Caa1 | - | B- | - | Downgrade, stable | 16-Apr-03 | O/L changed to stable | 4-Aug-04 |
| **Brazil** | **B1** | **o** | BB- | - | **O/L changed to (+)** | **12-Jan-05** | Upgrade, Stable | 17-Sep-04 |
| **Chile** | **Baa1** | **o** | A | - | **O/L changed to (+)** | **14-Feb-05** | Upgrade, stable | 14-Jan-04 |
| **Colombia** | Ba2 | oo | BB | - | O/L changed to (-) | 27-Mar-02 | **Affirmed, stable** | **11-Feb-05** |
| Costa Rica | Ba1 | oo | BB | oo | O/L changed to (-) | 16-Apr-03 | Affirmed, O/L (-) | 24-Jun-04 |
| Cuba | Caa1 | - | nr | - | | | | |
| **Dominican Republic** | B3 | oo | **SD** | **-** | Downgrade O/L (-) | 30-Jan-04 | **Downgrade, stable** | **1-Feb-05** |
| **Ecuador** | Caa1 | - | **B-** | **-** | Upgrade, stable | 24-Feb-04 | **Upgrade, stable** | **24-Jan-05** |
| El Salvador | Baa3 | | BB+ | - | O/L changed to (-) | 18-Dec-03 | Affirmed, stable | 10-Sep-04 |
| Guatemala | Ba2 | - | BB- | - | Affirmed, stable | 1-Mar-00 | Affirmed, stable | 30-Jul-03 |
| Honduras | B2 | - | nr | - | Affirmed, stable | 3-Feb-00 | | |
| Jamaica | B1 | - | B | - | Downgrade, stable | 27-May-03 | Affirmed, stable | 10-Dec-04 |
| **Mexico** | **Baa1** | **-** | **BBB** | **-** | **Upgrade, stable** | **6-Jan-05** | **Upgrade, stable** | **31-Jan-05** |
| Nicaragua | B2 | - | nr | - | Affirmed, stable | 30-Mar-00 | | |
| **Panama** | Ba1 | - | **BB** | **-** | Affirmed, stable | 7-May-03 | **O/L changed to stable** | **18-Feb-05** |
| Paraguay | Caa1 | - | B- | oo | Downgrade, stable | 28-Apr-03 | Upgrade,O/L to stable | 26-Jul-04 |
| Peru | Ba3 | - | BB | - | Affirmed, stable | 28-Oct-02 | Affirmed, stable | 6-Oct-04 |
| Trinidad & Tobago | Baa3 | - | BBB+ | o | Affirmed, stable | 30-Aug-00 | Upgrade, O/L (+) | 16-Jun-04 |
| Uruguay | B3 | - | B | - | O/L changed to stable | 10-Nov-04 | Upgrade, stable | 21-Jul-04 |
| **Venezuela** | B2 | - | **B** | **-** | Upgrade, stable | 7-Sep-04 | **Upgrade, stable** | **3-Mar-05** |

*- stable outlook ; o positive outlook ; oo negative outlook.* ***Changes for the first quarter of 2005 are highlighted.***

**Note:** Moody's ratings are qualified by outlooks and reviews while S&P ratings are qualified by outlooks and watches.

A review/watch is indicative of a likely short-term development.

An outlook suggests that a review/watch or long/intermediate-term movement is likely.

**Source:** JP Morgan, *Emerging Markets Outlook, April 6, 2005.*

**BOX 1: CREDIT RATING MOVES, Q1 2005**

During the first quarter of 2005, Fitch, Moody's and/or Standard & Poor's announced upgrades or improved outlook changes in foreign currency debt for seven countries in Latin America.

On January 6, Moody's upgraded **Mexico**'s foreign currency debt to Baa1 from Baa2, indicating that the rating upgrade reflected the continued reduction in Mexico's external vulnerability. On January 12, Moody's upgraded **Brazil**'s debt outlook to positive from stable, citing the robust current account performance, the strong fiscal results and the improvement in the domestic public debt profile. On January 24, Standard & Poor's unexpectedly raised **Ecuador**'s long-term foreign currency credit rating to B- (stable outlook) from CCC+, highlighting improvements in prospects for government financing, though it also noted the lack of progress in structural reforms and the continued dependence on the oil-sector. Finally, on January 31, S&P's raised Mexico's long-term foreign currency credit rating to BBB from BBB-, that is, two notches above the lowest investment grade rating. The move placed S&P's rating only one notch below Moody's and one above Fitch. The agency also raised Mexico's local currency long-term sovereign rating to A, from A-, highlighting that the depth of the local debt market has decreased the vulnerabilities coming from the risks of external rollover financing.

In February there was one downgrade, but followed by two improved outlook changes. On February 01, S&P's downgraded Dominican Republic to 'Selective Default', after the government acknowledged arrears on its commercial bank debt in its Letter of Intent with the IMF. On the same day Fitch revised the outlook on its B+ sovereign rating for **El Salvador** to stable from negative, citing a reversal of the fiscal deterioration experienced in the aftermath of the 2001-2002 earthquakes, progress on the reform agenda, and the better political environment. On February 14, Moody's raised the outlook on **Chile**'s credit rating to positive from stable, increasing the possibility of a rating increase. According to the agency, the change in outlook is based on Chile's policy to use the 2004 windfall from higher copper prices to pay down public debt. On February 21, S&P revised the outlook on **Panama** to stable from negative, reflecting the expected improvement in the fiscal stance and debt dynamics after the swift passage of the fiscal reform package.

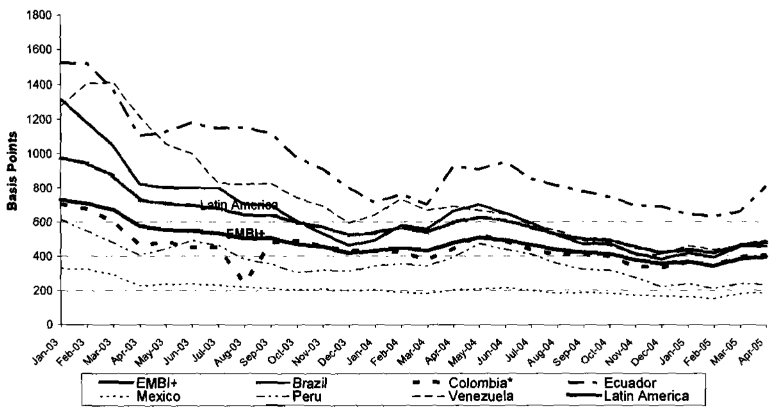
In March there were two positive credit rating actions. On March 7, Fitch raised **Uruguay**'s sovereign rating one notch to B+ (stable outlook) from B, citing expected continued economic recovery and Uruguay's comfortable financial needs. Fitch also upgraded Chile to A from A-, citing improved growth prospects, reductions in government debt and fiscal surpluses.

Finally, on a separate note, S&P's downgraded Venezuela to 'Selective Default' (from B) on January 18, citing the nonpayment of US$35 million in oil warrant payments attached to Venezuelan Brady bonds, which were due in October of 2004. Markets believed the government carried a willingness to pay, so the effect of the SD rating was short-lived. The country was upgraded back to B on March 3, after making a debt payment of US$329,300 on its oil-indexed warrants.

# I. Bond Markets and Debt Management

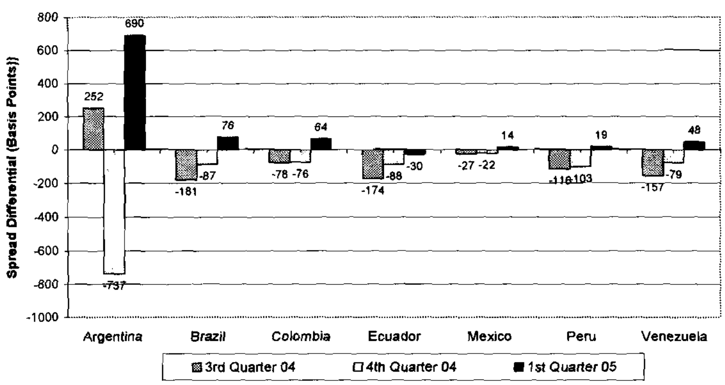
Emerging market spreads, as measured by the J.P. Morgan EMBI+ index, widened 28 basis points in the first quarter of 2005, while the Latin American component widened 46 basis points. Despite the increase, emerging market and Latin American spreads remained at historically low levels (Chart 1)[3].

**Chart 1:**
**Spreads on JP Morgan EMBI+ and Latin American Composites**
**January 2003 to April 2005 (without Argentina)**




Source: ECLAC, on the basis of data from "Emerging Markets Bond Index Monitor", JP Morgan.

**Chart 2:**
**Quarterly Spread Differential**
**Q3 & Q4 2004, Q1 2005**




Source: ECLAC, on the basis of data from JP Morgan.

Following two quarters of spread tightening, Latin American spreads widened for all major Latin American markets in the first quarter of 2005, with the exception of Ecuador. Argentina showed the biggest spread widening in the quarter, followed by Brazil and Colombia (Chart 2).

According to the Emerging Markets Traders Association (EMTA)[4], the emerging markets trade volume stood at US$1.408 trillion in the first quarter of 2005, a 12% increase from the US$1.260 trillion reported in the fourth quarter of 2004, and a 35% increase compared with the first quarter of 2004. The first quarter 2005 volumes represented the highest industry turnover levels since late 1997. The rise in trading activity was focused on high-yielding countries, given the global search for yield, with Brazil gaining at the expense of Mexico.

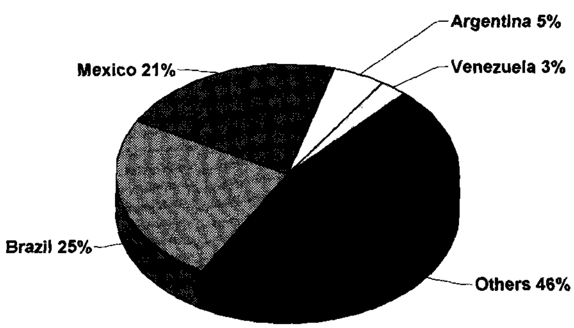
Brazilian debt trading volume increased to US$350 billion, a 12% increase vs. fourth quarter trading (of US$312 billion) and a 17% increase over the first quarter of 2004 total. Brazilian debt instruments accounted for 25% of the total and were the most frequently traded assets in the EMTA survey. Mexican debt instruments were the second most frequently traded instruments, accounting for 21% of the total volume (Chart 3).

[3] See appendix for the evolution of the spreads of the EMBI Global Index, which also includes Chile and Uruguay in addition to the countries included in the EMBI+.

[4] Emerging Markets Traders Association, *EMTA Survey*, May 26, 2005.

**Chart 3:**
**Q1 Emerging Markets Debt Trading Volume: Country Shares**

**Trade Volume in Q1: US$ 1.408 trillion**




Source: EMTA

Mexican debt trading totaled US$301 billion in the first quarter, 23% above first quarter 2004 levels, although 7% less than the US$324 billion reported in the fourth quarter. Other frequently traded Latin American countries included Argentina (US$67 billion) and Venezuela (US$38 billion).

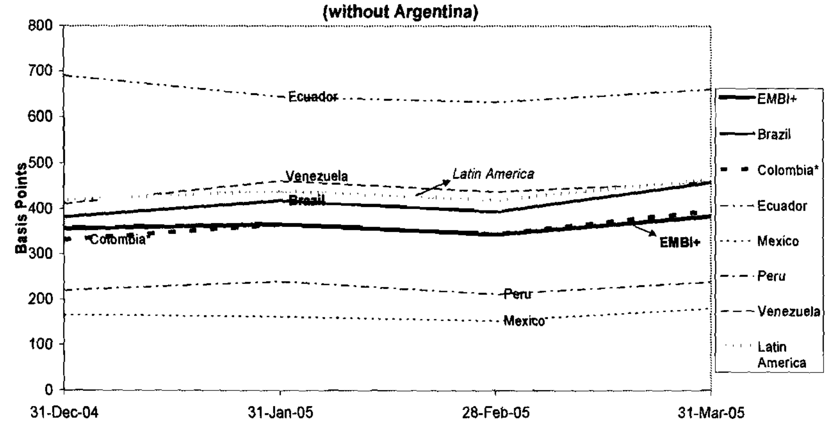
Emerging markets turnover in local markets instruments amounted to US$668 billion, a 55% increase compared to the first quarter of 2004 and a 15% increase compared to US$582 billion in the fourth quarter, reflecting an increase in investor appetite for local market assets. Mexico's local instruments corresponded to US$225 billion of total trade in local instruments, while Brazilian local instruments stood at US$103 billion, a gain of 142% when compared to the first quarter of 2004. As a share of the total, local instruments accounted for 48%, an increase from 41% in the first quarter of 2004.

Eurobond volumes also accounted for 48% of the total, standing at US$674 billion, up 38% vs. first quarter 2004 and 15% compared to the US$587 billion total of the fourth quarter. Brazilian sovereign trades stood at US$199 billion and made up 57% of Brazilian trade volumes, with Brazil's 2040 alone, the industry benchmark, accounting for US$119 billion in trading (34% of Brazilian total volume).

Brady bonds volumes (the majority of which were Brazil C-Bond trades) stood at US$37 billion, or 3% of trading (compared to 4% in the fourth quarter 2004 and 8% in 2004's first half), as they continued their gradual decline through exchanges or early redemptions.

## A. Spreads

**Chart 4:**
**Spreads on JP Morgan EMBI+ and Latin American Composites**
**Q1 2005**
**(without Argentina)**

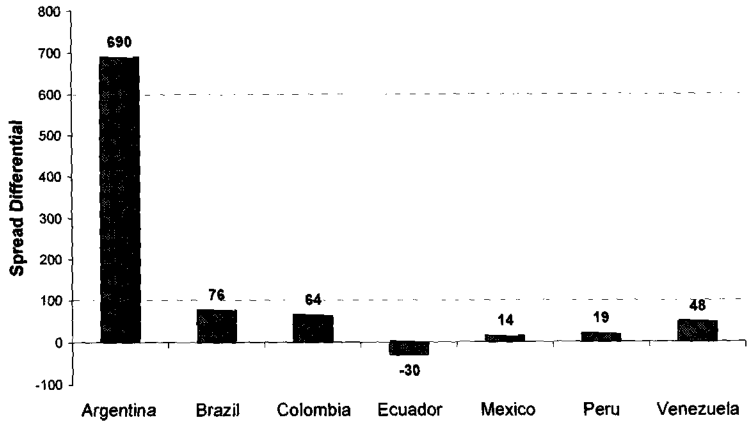



Source: ECLAC, on the basis of data from "Emerging Markets Bond Index Monitor", JP Morgan.

The EMBI+ widened by 28 basis points in the first quarter of 2005, to 384 basis points at the end of March, from 356 bps at the end of December 2004. The Latin American component of the EMBI+ widened by 46 bps in the first quarter, to 466 bps at the end of March, from 420 bps at the end of December (Chart 4). Spreads increased for all Latin American countries in our sample, with the exception of Ecuador (Chart 5).

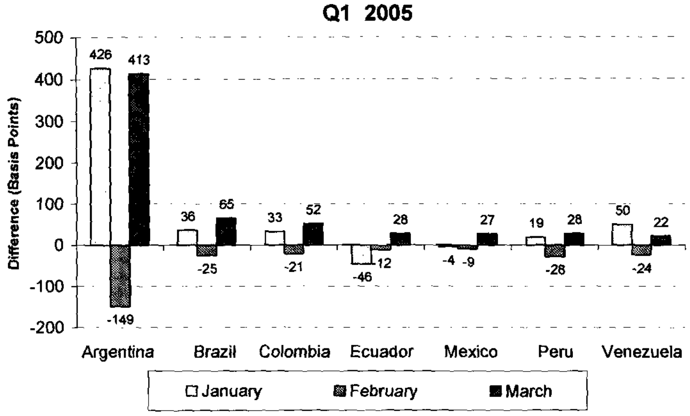
On a monthly basis, after tightening in February, spreads for all countries in our sample increased in March (Chart 6), as market sentiment deteriorated and global credit markets began to loose momentum. EMBI+ spreads reached a historical low on March 8, but widened during the rest of March. Despite the March widening, spreads remained roughly equal to pre-Asian crisis level at the end of the first quarter.

**Chart 5: Spread Differentials Q1 2005**




Source: ECLAC, on the basis of data from JP Morgan.

**Chart 6: Monthly Spread Differentials Q1 2005**




Source: ECLAC, on the basis of data from JP Morgan.

After tightening in the fourth quarter of 2004, Argentina's spreads widened by 690 basis points in the first quarter of 2005. Spreads increased to 5393 bps at the end of March, from 4703 at the end of December. Spreads tightened after Argentina launched its debt-exchange offer on January 14. By February 25, six weeks later, the government announced that 76% of its creditors had accepted the debt exchange offer, a rate that was considered a clear success for Argentine President Nestor Kirchner, thus Argentine spreads tightened by 149 bps in February. In March, however, the president's decision to boycott Shell's oil stations after the company had increased prices by up to 4% and a U.S. court hearing on the defaulted debt,[5] complicating Argentina's plan to wrap up the debt restructuring involving US$103 billion in past due obligations, contributed to a 413 bps increase in spreads.

In the case of Brazil, despite the increase in volatility induced by rising U.S. interest rates, economic fundamentals in the first quarter compared well with 2004. However, the deterioration in the external environment combined with negative political and economic

[5] On March 21, Judge Thomas Griesa of the U.S. District Court in Manhattan agreed to freeze as much as US$7 billion in defaulted bonds due to be swapped into the new securities, in response to a petition from NML Capital, a Cayman Islands-based investor with more than US$360 million in claims against Argentina. Although the petition delayed the exchange, its arguments were ultimately rejected, and on June 2 Argentina's debt exchange was completed.

developments in the domestic market, such as the government failure to secure the presidency of the lower house, the dormant reform agenda and the deceleration in economic activity, contributed to an increase in first quarter spreads. Brazilian spreads widened to 458 bps at the end of March, from 382 bps at the end of December 2004. Although domestic developments are a concern, from investors' point of view the main risk facing the Brazilian economy is the deterioration of the global environment.

Colombia's fundamentals remained strong in the first quarter, the acceleration of growth continued, as well as higher oil revenues and the strength of the peso. However, following the overall trend in emerging markets, spreads widened by 64 bps (as risk aversion gained momentum during the quarter), to 396 bps at the end of March 2005 from 332 bps at the end of December 2004.

Spreads in Ecuador tightened by 30 bps in the first quarter, from 690 bps at the end of December 2004 to 660 bps at the end of March 2005. Oil prices have been supportive, although financing conditions are tight. On the political front, however, tensions escalated towards the end of March with the decision by Guillermo Castro, the head of the then recently appointed Supreme Court, to confirm a 2001 ruling that granted the former president Abdala Bucaram immunity from corruption charges, allowing him to return to Ecuador. The political situation deteriorated from this point, culminating with a 'constitutional coup' in April, endorsed by the military, removing President Lucio Gutiérrez from office and elevating Vice-President Alfredo Palacio to the presidency.

Mexican spreads tightened in January and February, but widened in March by 27 bps. Mexico's spread increase in March was triggered by the problems in the United States' high grade market, particularly after General Motors announced lower earnings and saw its ratings outlooks revised to negative. GM accounts for one-third of Mexico's auto output. Analysts believe that investors overreacted, however, given that Mexico's fundamentals are solid, its external financing needs are low and domestic financial markets have strengthened, thus Mexican bonds should remain attractive despite the GM sell-off.

Spreads in Peru followed the same pattern as the spreads in the other countries of our sample, tightening in February and widening in March. Spreads widened by 19 bps in the first quarter, from 220 bps at the end of December 2004, to 239 bps at the end of March 2005. The economic dynamics is positive, with sustained growth boosting consumer and business confidence, despite the context of popular frustration with party politics and the president's performance.

Finally, Venezuelan spreads widened by 48 bps, from 411 bps at the end of December 2004 to 459 bps at the end of March 2005. Oil prices remain highly supportive of Venezuelan debt, but Venezuela was not spared by the market wide increase in risk aversion in March. According to J.P. Morgan on the basis of Venezuela's Finance Ministry information, the government has completed its external debt issuance plan for 2005 and has cash left for later buybacks.

## B. Issuance

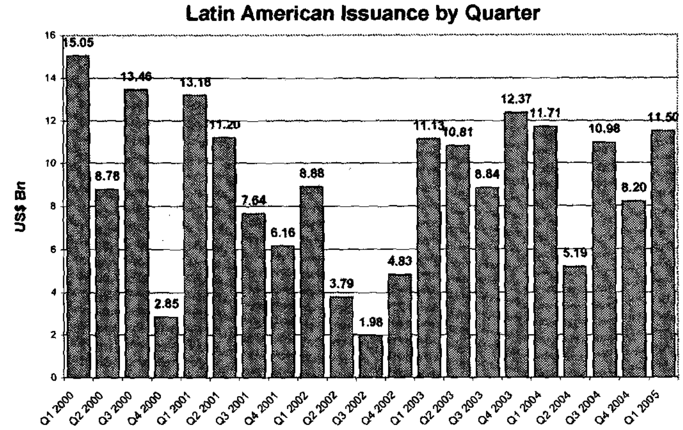
According to Merrill Lynch, emerging markets issuance reached US$31.4 billion in the first quarter of 2005 (up from US$19 billion in the fourth quarter of 2004), the highest first quarter supply since 1996. New issuance responded to favorable borrowing conditions and historically low yields. Investors continued to have a strong appetite for emerging markets and Latin American debt, despite the loss of momentum towards the end of the quarter.

Latin American bond issuers placed a total of US$11.5 billion in international capital markets in the first quarter, up from US$8.2 billion in the fourth quarter 2004 (Chart 7). Latin American issuance was the second largest share of total emerging markets issuance, following Emerging Europe, and covered more than half of the expected annual supply from the region (Chart 8).

Latin American issuance was higher in January and February, and slowed in March (Chart 9).[6] Mexico and Brazil were the largest net issuers from Latin America in the first quarter, with a net borrowing of US$5.2 and US$3.8 billion.

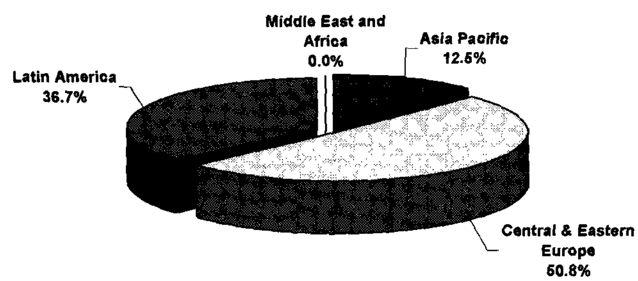
Two of the largest issues from the region were denominated in euros. In February, Mexico's Pemex Project Funding Master Trust issued a 20-year bond with a face value of €1

Chart 7:
Latin American Issuance by Quarter



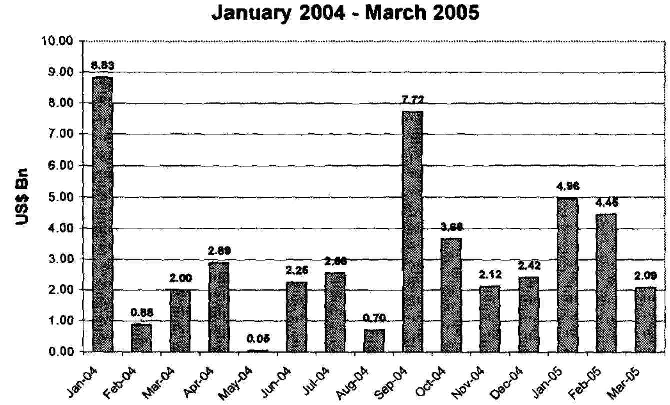

Source: Merrill Lynch, Emerging Markets Debt Monthly, several issues.

Chart 8:
Emerging Markets Debt Issuance: Regional Breakdown
Q1 2005




Note: Total emerging markets debt issuance for Q1 2005 is US $31.4 million.
Source: Merrill Lynch, Emerging Markets Debt Monthly, 2005

Chart 9:
New Latin American Debt Issuance
January 2004 - March 2005




Source: Merrill Lynch, Emerging Markets Debt Monthly, several issues.

[6] See appendix C for a list of monthly issuance by Latin American sovereigns and corporates in the first quarter.

billion (US$1.32 billion).[7] In March, the Republic of Venezuela issued a 10-year bond with a face value of €1 billion (US$1.34 billion), its first global bond since September and its first euro-denominated sale since 2001. Venezuela also refinanced 17.9 billion yen (US$170 million) of samurai bonds in March. The original bonds, which were due to mature in 2006, were refinanced with securities maturing in 2011, consistent with the Finance Ministry's goal of extending the country's debt profile.

The government of Brazil issued two bonds denominated in U.S. dollars, with face values of US$1.25 billion (in January) and US$1 billion (in February). With these issues Brazil met US$4.4 billion of its US$6 billion external target for 2005. The Mexican government also issued a bond denominated in U.S. dollars in January, with a face value of US$1 billion, and a spread of 145 bps over 10-year U.S. Treasuries. This was the lowest spread the sovereign has achieved on a 10-year issue. In March the Mexican government announced that it plans to complete its external 2006 financing requirements by June. Analysts estimate this would require the country to raise another US$1 billion.

Other sovereigns to tap the international capital markets in the first quarter of 2005 were Colombia and Peru. Colombia issued a 5-year bond with a face value of 293,747 Colombian pesos (US$126 million) in January, and a 10-year bond in February, with a face value of 757,430 Colombian pesos (US$325 million). Markets received the peso-denominated global bonds issued by Colombia well, and in mid-February the government announced that it may offer holders of its international bonds the opportunity to swap into local currency-denominated debt. The country wants to reduce its foreign currency-denominated bonds from 46% of its total debt to 44% by the end of 2006. The government also prepaid US$250 million of loans owed to the IDB in March. The payment was financed by a transfer of funds from the central bank to the finance ministry. Peru issued a US$400 million bond in January, reopening its 2033 global bond, at a spread of 346 bps over comparably maturity.

Corporate issuance in Latin America was US$5.2 billion in the first quarter of 2005 (up from US$3.25 billion dollars in the fourth quarter), which represented 46% of Latin American issuance, while sovereign issuance amounted to US$6.3 billion or 54% of Latin American issuance. Dollar-denominated debt represented 64% of the whole amount issued in Latin American in the first quarter, with euro-denominated debt following in second with a 28.8% share, and issuance denominated in local currencies (Colombian pesos and Brazilian reais) in third, with a share of 5.7% (Table 2).

**Table 2**

**Latin American Currency**

| | OTHER | EUR | JPY | GBP | US$ | Total |
|---|---|---|---|---|---|---|
| January | 126 | 648 | 0 | 0 | 4,182 | 4,956 |
| February | 531 | 1,321 | 0 | 0 | 2,600 | 4,452 |
| March | 0 | 1,341 | 170 | 0 | 580 | 2,091 |
| Total | 657 | 3,311 | 170 | 0 | 7,362 | 11,499 |
| Percentage | 5.7% | 28.8% | 1.5% | 0.0% | 64.0% | 100.0% |

**Latin American Issuance Type**

| | Corp. | Sov. | Total |
|---|---|---|---|
| January | 1,532 | 3,424 | 4,956 |
| February | 3,127 | 1,325 | 4,452 |
| March | 580 | 1,511 | 2,091 |
| Total | 5,239 | 6,260 | 11,499 |
| Percentage | 45.6% | 54.4% | 100.0% |

Source: ECLAC, on the basis of data from Merrill Lynch.

[7] In February, Pemex also sold 15 billion pesos (US$1.3 billion) of bonds in local markets to finance investments. Pemex has traditionally financed its investments in the international market, but the increasing liquidity of the local market has resulted in higher demand for its debt and lower borrowing costs.

## II. Portfolio Equity Flows into Latin America

During the first quarter of 2005, Latin American stocks gained only 1.81% of its value according to the Morgan Stanley's MSCI (Morgan Stanley Capital International) Index, a smaller gain than the 16.81% of the fourth quarter 2004.[8] The increase in the MSCI EM Latin American Index was driven by increases in the Stock Price Index of Brazil (26.37%) and Argentina (13.19%). Among the seven biggest Latin American economies, Colombia, Mexico and Venezuela saw a decrease of their Stock Price Index (Table 3; Chart 10).

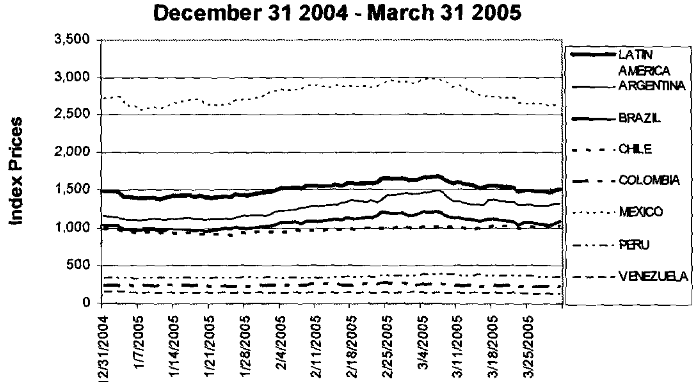
**Table 3**

**Variation of Stock Price Indexes Q4 2004**

| | 31-Dec-04 | 31-Mar-05 | Variation |
|---|---|---|---|
| Emerging markets | 542.174 | 548.689 | 1.20% |
| Latin America | 1483.584 | 1,510.47 | 1.81% |
| Argentina | 1162.98 | 1,316.37 | 13.19% |
| Brazil | 862.926 | 1,090.51 | 26.37% |
| Chile | 997.324 | 1,027.34 | 3.01% |
| Colombia | 245.007 | 236.54 | -3.46% |
| Mexico | 2715.559 | 2,643.43 | -2.66% |
| Peru | 343.392 | 355.897 | 3.64% |
| Venezuela | 151.033 | 127.631 | -15.49% |

Source:MSCI Equity Indices, http://www.msci.com/equity/index2.html

**Chart 10: MSCI Equity Indexes Prices December 31 2004 - March 31 2005**




Source:MSCI Equity Indices, http://www.msci.com/equity/index2.html

The lower value gain according to the MSCI Index and the decrease in stock prices for some Latin American countries seemed to be mostly driven by investors' concerns that a stronger-than-consensus increase in Fed Funds rate could disrupt the positive outlook for equities. The market view remains positive for the Latin American region, based on the fact that the economies of the region have become more resilient to shocks and Latin American companies are de-leveraging and improving profitability. However there are two main risks to the market view: the importance of country fundamentals for sovereign risk reduction in the region may have been overstated, and spreads may be lower mainly due to low real interest rates in developed countries; in addition, inflation risks in the United States may be higher than expected, as core inflation expectations have been rising, although U.S. data on inflation released since the beginning of the year has been volatile.

## II. Bank Lending

Latin America experienced a net outflow of US$9 billion for the fourth quarter of 2004, according to the latest available information on actual bank lending.[9] This eleventh

[8] The MSCI EM (Emerging Markets) Latin America Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in Latin America. As of June 2004 the MSCI EM Latin America Index consisted of the following 7 emerging market country indices: Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.

[9] BIS *Quarterly Review*, June 2005.

consecutive outflow from the region resulted primarily from a relatively large placement of deposits in BIS reporting banks, with total liabilities vis-à-vis the region rising by US$7 billion to US$289 billion. In addition, there was a US$2 billion reduction in claims on the region, the third consecutive quarterly decline (Table 4). Claims on the region are now 22% of total claims on emerging markets, down from 27% a year earlier. Since 2000, short-term credit to the region has trended downwards as a percentage of total international claims, mainly reflecting reduced short-term positions on borrowers in Argentina, although this trend is also evident in several other borrowing countries.

**Table 4**

**Cross-border bank flows to Latin America**

Exchange rate adjusted changes in amounts outstanding, in billions of US$ dollars

| | Banks Position* | 2002 Year | 2003 Year | 2004 Year | 2004 Q1 | 2004 Q2 | 2004 Q3 | 2004 Q4 | Stocks at end-Dec 2004 | Stocks at end-Sept 2004 | Growth |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Latin America | Claims | -26.3 | -15.8 | -14.9 | 5.2 | -6.3 | -12.0 | -1.8 | 256.7 | 254.5 | 0.9% |
| | Liabilities | -26.9 | 25.0 | 13.0 | 15.3 | -1.1 | -8.0 | 6.8 | 289.1 | 278.5 | 3.8% |
| Argentina | Claims | -11.8 | -8.5 | -5.3 | -2.6 | -1.1 | -1.1 | -0.4 | 18.9 | 18.9 | -0.1% |
| | Liabilities | 0.0 | -0.8 | -0.8 | 0.3 | 0.1 | -0.2 | -0.6 | 24.8 | 25.1 | -1.4% |
| Brazil | Claims | -11.2 | -7.2 | -7.4 | 1.8 | -4.0 | -2.9 | -2.2 | 77.3 | 78.4 | -1.3% |
| | Liabilities | -8.0 | 14.4 | -4.8 | 5.0 | -3.6 | -7.0 | 0.9 | 53.2 | 51.1 | 4.0% |
| Chile | Claims | 0.5 | 1.4 | -1.8 | -0.6 | -0.4 | -0.8 | 0.0 | 20.9 | 20.6 | 1.4% |
| | Liabilities | -1.1 | -2.6 | 0.9 | 1.6 | -0.4 | 0.4 | -0.7 | 15.3 | 15.8 | -3.1% |
| Mexico | Claims | 3.1 | -0.8 | -0.8 | 7.5 | -0.6 | -8.0 | 0.4 | 63.9 | 65.2 | -2.0% |
| | Liabilities | -11.4 | 6.2 | -4.7 | 4.0 | -0.7 | -6.2 | -1.8 | 58.1 | 59.1 | -1.8% |
| Venezuela | Claims | 1.1 | -1.7 | -0.7 | -0.2 | -0.4 | 0.1 | -0.2 | 13.7 | 13.6 | 0.9% |
| | Liabilities | 0.5 | -3.6 | 7.5 | 0.9 | 2.3 | 0.2 | 1.5 | 33.7 | 31.9 | 5.7% |

Source: BIS Quarterly Review (Table 6A), June 2005

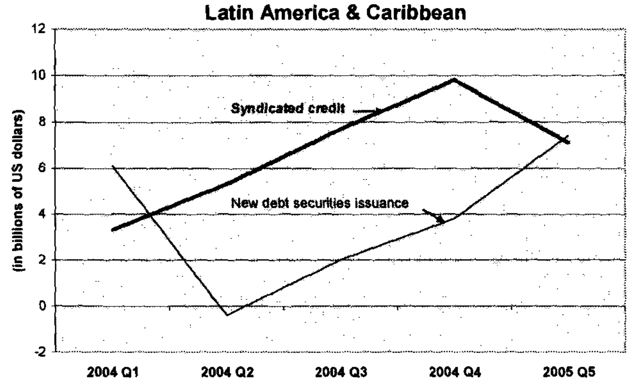
* External on-balance sheet positions of banks in the BIS reporting area. Liabilities mainly comprise deposits.

An increase in claims represents an inflow into Latin American economies; an increase in liabilities an outflow.

Brazil was the country with the largest outflow of funds in the region during the fourth quarter of 2004, followed by Venezuela. Total claims on Brazil fell by US$2.2 billion, to US$77.3 billion at the end of the quarter, from US$78.4 billion in the previous quarter. Given also an increase in liabilities, Brazil experienced a net outflow of US$3.1 billion in the fourth quarter of 2004. Venezuela experienced a net outflow of US$1.7 billion. Argentina, Chile and Mexico experienced small net inflows of funds, of US$0.2, US$0.7 and US$2.2 billion, respectively.

The overall volume of announced syndicated lending to emerging markets in the first quarter of 2005 was US$7.1 billion. A Mexican oil corporation rolled over US$4 billion, maintaining Latin American volumes at high levels, although lower than in the third and fourth quarters of 2004 (Chart 11).

**Chart 11:**
**Announced Syndicated Lending and Securities Issuance in Latin America & Caribbean**




* Net Issuance: Gross Issues - Repayments

Source: ECLAC, on the basis of data from the Bank for International Settlements (BIS).

## IV. Prospects

The global background for Latin American credit and equity markets deteriorated towards the end of the first quarter of 2005, as investors retreated from investments with higher risks because of rising concerns with economic conditions, including inflation fears in the United States and prospects for more aggressive Fed tightening, as well as lower liquidity in global markets. As a result, emerging markets and Latin American spreads widened in March.[10] Despite the increase in March, Latin American country risk premiums remained low, and investors showed renewed interest in emerging markets and Latin American debt issues.

Most analysts continue to see local markets in Latin America offering excellent opportunities in 2005, both because of country-specific reasons, and because of expectations of continued dollar weakness. Due to the consolidation of credible fiscal and monetary policies in the region, local rates have been increasingly decoupling from external debt spreads, to the extent that domestic markets have become investment alternatives. According to a new report by the Organization for Economic Cooperation and Development (OECD) released in June, Latin American countries are beginning to overcome the effects of the 2002 Argentine currency crisis and are witnessing a rebound in investment.

[10] Although not as much as corporate spreads in the high yield sector, since the events that resulted in repricing in corporate credit markets (brought about by the problems faced by General Motors and Ford), such as profit warnings, accounting problems and leveraged buyouts, had little impact on sovereign debt markets. The strength of domestic conditions in emerging and Latin American markets helped limit the reaction to these events.

## APPENDIX

A. Credit Ratings in Latin America
B. Latin American Spreads
C. New Latin American Debt Issuance

## A. Credit Ratings

**Table 1:**

| Rating Scale | | | | | |
|---|---|---|---|---|---|
| | MOODY's | S&P | | MOODY's | S&P |
| Upper Investment Grade | Aaa | AAA | Lower Non-Investment Grade | B1 | B+ |
| | Aa1 | AA+ | | B2 | B |
| | Aa2 | AA | | B3 | B- |
| | Aa3 | AA- | | Caa1 | CCC+ |
| | A1 | A+ | | Caa2 | CCC |
| | A2 | A | | Caa3 | CCC- |
| | A3 | A- | | Co | CC |
| Lower Investment Grade | Baa1 | BBB+ | | C | C |
| | Baa2 | BBB+ | Default | | SD |
| | Baa3 | BBB- | | | D |
| Non-Investment Grade | Ba1 | BB+ | | | |
| | Ba2 | BB | | | |
| | Ba3 | BB- | | | |

## B. Latin American Spreads

**Table 2:**

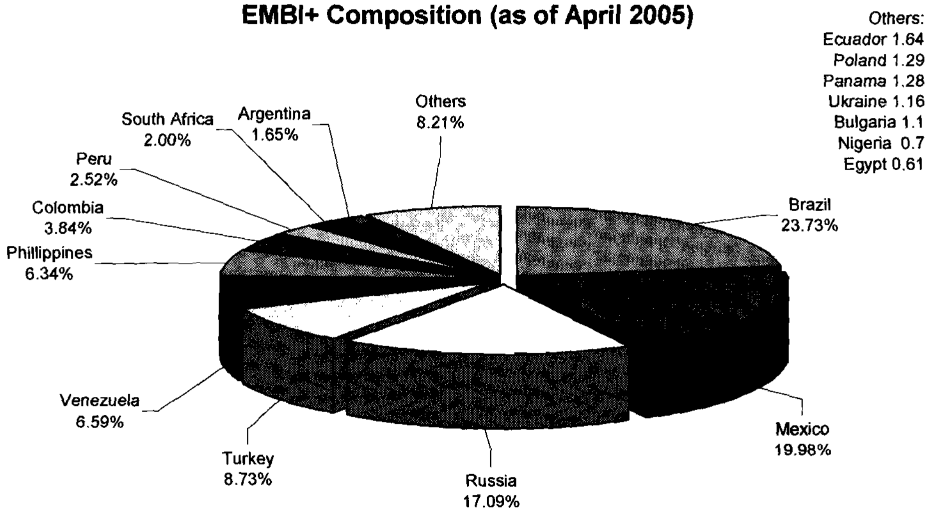
**Sovereign Spreads on JP Morgan EMBI+ and Latin American Composites**

| | *EMBI+* | *Argentina* | *Brazil* | *Colombia** | *Ecuador* | *Mexico* | *Peru* | *Venezuela* | *Latin America* | *Non-Latin* |
|---|---|---|---|---|---|---|---|---|---|---|
| 30-Jan-04 | 432 | 5764 | 493 | 430 | 714 | 204 | 343 | 641 | 536 | 280 |
| 27-Feb-04 | 449 | 5815 | 579 | 426 | 762 | 189 | 356 | 733 | 568 | 289 |
| 31-Mar-04 | 432 | 4873 | 559 | 379 | 701 | 183 | 343 | 667 | 536 | 281 |
| 30-Apr-04 | 478 | 4628 | 663 | 443 | 925 | 201 | 393 | 692 | 598 | 309 |
| 28-May-04 | 508 | 4964 | 701 | 523 | 909 | 208 | 473 | 666 | 626 | 338 |
| 30-Jun-04 | 493 | 5188 | 650 | 486 | 952 | 215 | 439 | 647 | 607 | 329 |
| 30-Jul-04 | 466 | 5036 | 593 | 437 | 852 | 200 | 411 | 581 | 566 | 316 |
| 31-Aug-04 | 436 | 5258 | 521 | 408 | 813 | 183 | 357 | 550 | 524 | 303 |
| 30-Sep-04 | 421 | 5440 | 469 | 408 | 778 | 188 | 323 | 490 | 498 | 306 |
| 30-Oct-04 | 413 | 5440 | 473 | 400 | 745 | 183 | 318 | 462 | 493 | 294 |
| 30-Nov-04 | 377 | 5194 | 414 | 338 | 696 | 172 | 274 | 407 | 451 | 261 |
| 31-Dec-04 | 356 | 4703 | 382 | 332 | 690 | 166 | 220 | 411 | 420 | 255 |
| 31-Jan-05 | 366 | 5129 | 418 | 365 | 644 | 162 | 239 | 461 | 439 | 249 |
| 28-Feb-05 | 343 | 4980 | 393 | 344 | 632 | 153 | 211 | 437 | 419 | 220 |
| 31-Mar-05 | 384 | 5393 | 458 | 396 | 660 | 180 | 239 | 459 | 466 | 254 |
| 29-Apr-05 | 395 | 6298 | 457 | 407 | 810 | 188 | 234 | 492 | 482 | 257 |

Source: "Emerging Markets Bond Index Monitors"; JP Morgan

EMBI+ composition by market sector (end-April 2005): Brady, 23.07%; Benchmark Eurobonds, 76.48%; Loans, 0.45%.
by country: Brazil and Mexico account for 42.36% of the total weighting.
by region: Latin: 59.87%; Non-Latin: 40.13%.

**EMBI+ Composition (as of April 2005)**



# Table 3:

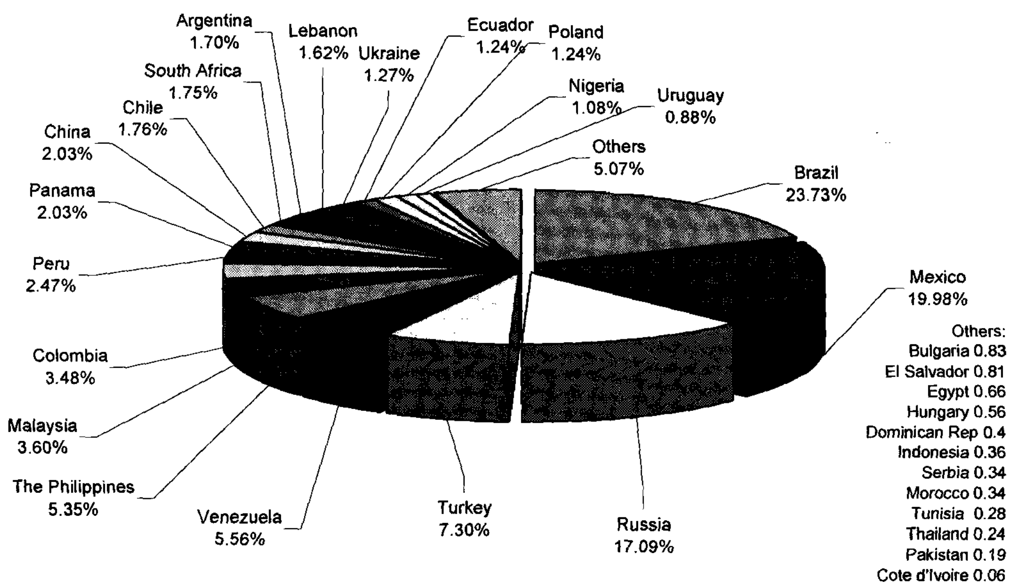
**Sovereign Spreads on JP Morgan EMBI Global and Latin American Composites**

| | EMBI Global | Argentina | Brazil | Chile | Colombia | Ecuador | Mexico | Peru | Uruguay | Venezuela | Latin America | Non-Latin |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 30-Jan-04 | 414 | 5619 | 489 | 94 | 425 | 714 | 205 | 357 | 585 | 633 | 531 | 258 |
| 27-Feb-04 | 431 | 5622 | 575 | 88 | 424 | 762 | 191 | 371 | 638 | 720 | 563 | 265 |
| 31-Mar-04 | 414 | 4840 | 554 | 91 | 379 | 701 | 184 | 355 | 576 | 647 | 531 | 257 |
| 30-Apr-04 | 468 | 4534 | 660 | 92 | 443 | 925 | 204 | 406 | 658 | 684 | 588 | 295 |
| 28-May-04 | 494 | 4838 | 696 | 92 | 521 | 909 | 210 | 483 | 682 | 659 | 614 | 323 |
| 30-Jun-04 | 482 | 5087 | 646 | 83 | 483 | 952 | 218 | 450 | 710 | 643 | 600 | 316 |
| 30-Jul-04 | 453 | 4994 | 590 | 80 | 435 | 852 | 201 | 424 | 601 | 584 | 556 | 304 |
| 31-Aug-04 | 425 | 5237 | 518 | 70 | 406 | 813 | 184 | 372 | 598 | 550 | 518 | 290 |
| 30-Sep-04 | 409 | 5389 | 466 | 78 | 407 | 778 | 189 | 340 | 497 | 490 | 492 | 289 |
| 30-Oct-04 | 399 | 5269 | 470 | 81 | 401 | 745 | 185 | 337 | 507 | 459 | 481 | 277 |
| 30-Nov-04 | 363 | 4987 | 410 | 73 | 340 | 696 | 181 | 293 | 414 | 400 | 433 | 255 |
| 31-Dec-04 | 347 | 4527 | 376 | 64 | 332 | 690 | 174 | 239 | 388 | 403 | 415 | 239 |
| 31-Jan-05 | 356 | 5022 | 412 | 60 | 364 | 644 | 172 | 267 | 402 | 452 | 434 | 234 |
| 28-Feb-05 | 333 | 4827 | 388 | 59 | 343 | 632 | 161 | 247 | 344 | 427 | 413 | 215 |
| 31-Mar-05 | 373 | 5105 | 455 | 71 | 393 | 660 | 188 | 277 | 427 | 455 | 459 | 247 |
| 29-Apr-05 | 384 | 5757 | 452 | 72 | 406 | 810 | 198 | 279 | 470 | 494 | 473 | 254 |

Source: "Emerging Markets Bond Index Monitors"; JP Morgan

EMBI Global composition by market sector (end-April 2005): Brady, 18.26%; Benchmark Eurobonds, 80.84%; Loans, 0.90%.
by country: Brazil and Mexico account for 37.12% of the total weighting.
by region: Latin: 57.46%; Non-Latin: 42.54%.

## EMBI Global Composition (as of April 2005)



## C. New Latin American Debt Issuance

### C1. January 2005

Table 4:

| New Latin American Debt Issuance<br>First Quarter of 2005<br>Jan-05 | | | |
|---|---|---|---|
| **Country** | **Issuer** | **Amount US$ (mm)** | **Maturity** |
| Brazil | Banco Votorantim | 100 | 24-Jan-07 |
| Brazil | CSN Islands Corporation | 200 | 15-Jan-15 |
| Brazil | Banco Itau | 125 | 31-Jan-08 |
| Brazil | Federative Republic of Brazil | 648 | 3-Feb-15 |
| Brazil | Banco Alfa de Investimento SA | 40 | 15-Jan-09 |
| Brazil | Federative Republic of Brazil | 1,250 | 4-Feb-25 |
| Colombia | Republic of Colombia | 126 | 1-Mar-10 |
| Mexico | United Mexican States | 1,000 | 3-Mar-15 |
| Mexico | Axtel SA | 80 | 15-Dec-13 |
| Mexico | Grupo Posadas SA | 75 | 4-Oct-11 |
| Mexico | First Citizens Bank of St. Lucia | 100 | 1-Feb-12 |
| Mexico | Telefonos de Mexico (Telmex) | 650 | 27-Jan-10 |
| Mexico | Vitro Envases Norteamericano | 80 | 23-Jul-11 |
| Mexico | Vitro SA de CV | 82 | 23-Jul-11 |
| Peru | Republic of Peru | 400 | 21-Nov-33 |
| **Total** | | 4,956 | |

Source: ECLAC, on the basis of data from Merrill Lynch, "Emerging Markets Daily".

***January average maturity*: *12.61* years.**

**Currency Breakdown**
(% of Latin America's Total)

| Currency | Jan-05 |
|---|---|
| Dollar | 84.38% |
| Euro | 13.08% |
| Other | 2.54% |

Source: Merrill Lynch

**Issuer Type Breakdown**
(% of Latin America's Total)

| Issuer Type | Jan-05 |
|---|---|
| Sovereign | 69.09% |
| Corporate* | 30.91% |

*Also includes bank issuance.

Source: Merrill Lynch

## C2. February 2005

**Table 5:**

| New Latin American Debt Issuance<br>First Quarter of 2005<br>Feb-05 | | | |
|---|---|---|---|
| **Country** | **Issuer** | **Amount US$ (mm)** | **Maturity** |
| Brazil | Banco Bradesco SA | 100 | 2-Jan-08 |
| Brazil | Banco BGN SA | 50 | 15-Feb-08 |
| Brazil | Unibanco - Uniao de Bancos Brasileiros | 48 | 11-Feb-10 |
| Brazil | Banco ABN Amro Real SA | 58 | 22-Feb-10 |
| Brazil | Federative Republic of Brazil | 1,000 | 7-Mar-15 |
| Brazil | Banco Votorantim | 100 | 28-Feb-08 |
| Colombia | Republic of Colombia | 325 | 22-Oct-15 |
| Mexico | Telefonos de Mexico (Telmex) | 300 | 27-Jan-10 |
| Mexico | Telefonos de Mexico (Telmex) | 150 | 27-Jan-15 |
| Mexico | Pemex | 1,321 | 24-Feb-25 |
| Mexico | America Movil SA de CV | 1,000 | 1-Mar-35 |
| **Total** | | 4,452 | |

Source: ECLAC, on the basis of data from Merrill Lynch, "Emerging Markets Daily".

***February average maturity*: 16.60 years.**

**Currency Breakdown**
(% of Latin America's Total)

| Currency | Feb-05 |
|---|---|
| Dollar | 58.4% |
| Euro | 29.7% |
| Other | 11.9% |

Source: Merrill Lynch

**Issuer Type Breakdown**
(% of Latin America's Total)

| Issuer Type | Feb-05 |
|---|---|
| Sovereign | 29.8% |
| Corporate* | 70.3% |

*Also includes bank issuance.

Source: Merrill Lynch

## C3. March 2005

**Table 6:**

| New Latin American Debt Issuance<br>First Quarter of 2005<br>Mar-05 | | | |
|---|---|---|---|
| **Country** | **Issuer** | **Amount US$ (mm)** | **Maturity** |
| Argentina | Argentine Beverages | 150 | 22-Mar-12 |
| Brazil | Banco Mercantil do Brazil | 30 | 7-Mar-15 |
| Mexico | Grupo Televisa | 400 | 18-Mar-25 |
| Venezuela | Bolivarian Republic of Venezuela | 1,341 | 16-Mar-15 |
| Venezuela | Bolivarian Republic of Venezuela | 170 | 21-Mar-11 |
| **Total** | | 2,091 | |

Source: ECLAC, on the basis of data from Merrill Lynch, "Emerging Markets Daily".

*March average maturity*: **10.92 years.**

**Currency Breakdown**
(% of Latin America's Total)

| Currency | Mar-05 |
|---|---|
| Dollar | 8.1% |
| Euro | 27.7% |
| Other | 100.0% |

Source: Merrill Lynch

**Issuer Type Breakdown**
(% of Latin America's Total)

| Issuer Type | Mar-05 |
|---|---|
| Sovereign | 72.3% |
| Corporate* | 27.7% |

*Also includes bank issuance.

Source: Merrill Lynch