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CONTENTS

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Latin America's return to the private international capital market

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A necessary condition in order for Latin America to attain acceptable economic growth is the reduction of the negative resource transfer abroad. In addition to the reduction of the existing external debt burden, a substantial volume of fresh external financing is needed, but commercial bank loans will continue to be limited and official lenders can hardly satisfy all the region's needs.

This article explores the possibilities of obtaining resources on the private international credit market, in the light of the recent experience of three countries: Mexico, Chile and Venezuela. Two main channels of financing are identified: bond issues, and foreign portfolio investment in shares. Securities backed up by export income are particularly interesting, as they have made it possible to improve the creditworthiness of borrowers in a number of cases. With regard to foreign portfolio investment, three variants are examined: specialized investment funds; direct sales of stock on domestic stock exchanges, and the offer of shares in Latin American companies on foreign exchanges.

It is shown that the three countries in question have secured considerable amounts of resources in these ways. The growing globalization of the international financial market suggests that there are good prospects for the future expansion of this form of financing. However, the conditions demanded by foreign investors will limit the access of many countries to this market. Furthermore, even for those countries which have managed to return to the market it is necessary to evaluate both the costs and the benefits of these forms of financing and take the necessary precautions to avoid the danger of renewed over-indebtedness.

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Introduction

In order for the nations of Latin America to return to the path of sustained growth in the 1990s, it is essential that gross fixed investment, as a proportion of output, should recover from the sharp drop which it suffered in the 1980s.[1] In order to achieve this, however, it will be necessary to mobilize a large amount of financial resources. It is estimated that in order to raise real output by 5% it would be necessary to increase total saving by 7-8% of the gross domestic product –that is to say, by between US$75 and 85 billion per year– which gives an idea of the magnitude of the effort required. In order to generate such a large volume of resources it will be necessary to obtain a substantial amount of fresh external financing, since domestic saving would hardly be able to cover the whole of the amounts in question. By way of illustration, it has been calculated that even assuming very favourable conditions with regard to reduction of the external debt, improvement in the terms of trade and increases in productivity, it would still be necessary to obtain between US$10 and 15 billion per year from external creditors (Massad, 1991).

Part of the external resources required will come from official agencies. According to the latest estimates of the World Bank, the net resource flow (disbursements less amortization payments) from official creditors to Latin America and the Caribbean rose from US$3.1 billion in 1989 to US$9.6 billion in 1990. However, this increase was due largely to exceptional disbursements in connection with external debt reduction programmes arranged with the commercial banks under the Brady Plan (World Bank, 1990a). For 1991, it is expected that there will be a reduction in the net contribution by official creditors, so that these resources will drop to US$4.9 billion this year.[2] Looking further ahead, it may be noted that

[1] Average gross fixed investment for 19 countries of Latin America and the Caribbean went down from 22.8% of the gross domestic product in 1980 to 15.9% in 1984, after which it remained at a similarly low level, standing at only 16.2% in 1989 (ECLAC, 1990a).

[2] World Bank, 1990b. It may be noted that net transfers from official creditors (disbursements less payments of principal and interest) were positive in 1990 after having been negative during the period 1987-1989, but they are expected to become negative again in 1991.

many countries of the region will have to face heavy repayments of principal to these agencies in the coming years. In view of the impossibility of restructuring this kind of commitments with the multilateral agencies, the net flow of resources from them will obviously be limited, despite the expansion of the lending capacity of the Inter-American Development Bank (IDB) after the recent increase in its capital. Nor can rapid growth be expected in the financing granted by bilateral export credit agencies, in view of the budgetary restrictions that they are facing.

As for private creditors, there are no grounds as yet for expecting that the international commercial banks will resume the granting of loans on a general basis for balance-of-payments financing, except in the case of involuntary loans connected with programmes for restructuring old debts. The problems currently being faced by various United States banks in their domestic operations, especially with regard to real estate financing, have driven even further away the already remote possibility of their granting significant loans on a general basis to Latin American countries.

The procurement of resources on the international capital market, which has latterly undergone a rapid process of globalization, is another way of obtaining external resources; indeed, for two or three years now several Latin American countries –especially Chile, Mexico and Venezuela– have been registering an increasing share in that market. The purpose of the present article is to examine the nature and magnitude of the operations which have been carried out in this sphere. For the countries involved and the region as a whole, this could mean the beginning of a return to the voluntary private international credit market, although on different terms from those observed in the 1970s, when syndicated bank loans predominated.[3]

Section I below makes a very brief analysis of some salient features of recent trends in the international capital market, with the aim of explaining the context in which the new financial flows to some Latin American countries have arisen. In the subsequent sections, which form the core of the study, an analysis is made of the different ways in which the resources from the world capital market are being channelled to Latin America. Thus, section II deals with financing through bonds, section III analyses loan instruments backed up by export income, and section IV deals with foreign portfolio investment. Finally, section V briefly considers the role that the commercial banks could play after the external debt crisis, while section VI presents the conclusions of this study.

I

The globalization of capital markets

Financial market trends in recent years have been characterized by a process of growing integration between countries, market segments, institutions and financial instruments (IMF, 1990, pp. 6-7). The trend towards the international integration or globalization of markets is to be seen in the increase both in financial transactions between residents and non-residents in the national currency of the former and in transactions of foreign-currency assets, regardless of the country of residence of the parties involved.

The integration of the international financial market has been based on various factors. Among these, mention may be made first of all of the adoption by the industrialized countries, in the 1970s and 1980s, of policies aimed at exchange and financial deregulation, with measures aimed in particular at the elimination of controls on the international movement of capital and of restrictions on foreign investment in the financial sector, together with the liberalization of domestic financial markets. A recent change in this respect is a new rule, known as *Rule 144A*, which came into force in April 1990 in the United States and has

[3] Such loans accounted for the major part of the big expansion in external financing in Latin America in the 1970s, taking the place of official credits and foreign direct investment (Devlin, 1989, pp. 9 to 64).

improved the access of foreign enterprises to the private loan market of that country.

The technological advances which have taken place in recent years in systems of telecommunications and computation have also played a fundamental role in the process of the globalization of markets, since they have immeasurably improved the machinery for the transmission of payments between countries and have made it possible to acquire, analyse and disseminate information more rapidly and cheaply.

Finally, the increasingly dominant position of institutional investors (pension funds, insurance companies and mutual funds) in the world capital market has also contributed to the growth of international financial transactions. Institutional investors have more capacity than individual investors for analysing the credit-worthiness of a wide range of borrowers as well as for following markets and responding to their changing conditions. In recent years, many of them have adopted a strategy of greater geographical diversification of their portfolios of assets, with the aim of maximizing and stabilizing their profits.

Table 1 gives a summary of the evolution of the international capital market over the last decade. As may be seen from it, the total value of transactions grew steadily between 1983 and 1989, coinciding with a long expansionary phase in the economic cycle of the developed countries. In the first eight months of 1990, however, there was some slackening in the total volume of operations effected, largely because there was a sharp contraction in the issue of bonds with equity warrants by Japanese enterprises. This contraction was due to the sharp fall in stock prices on the Tokyo exchange in this period.

Table 1

LOANS TAKEN OUT ON THE INTERNATIONAL CAPITAL MARKETS

(Billions of dollars)

	1982	1983	1984	1985	1986	1987	1988	1989	1990
Bonds	75.5	77.1	111.5	167.8	227.1	180.8	227.1	255.7	228.8
Stock	...	...	0.3	2.7	11.7	18.2	7.7	8.1	7.3
Syndicated loans [a]	98.2	67.2	57.0	43.0	52.4	91.7	125.5	121.1	118.2
Committed facilities [b]	5.4	9.5	28.8	42.9	29.3	31.2	16.6	8.4	6.3
Subtotal	179.1	153.8	197.6	256.4	320.5	321.9	376.9	393.3	360.6
Uncommitted borrowing facilities [c]	...	...	...	23.2	67.6	71.0	76.6	73.2	64.7
Total	**...**	**...**	**...**	**279.6**	**388.1**	**392.9**	**453.5**	**466.5**	**425.3**

Source: Organization for Economic Co-operation and Development (OECD), *Financial Market Trends*, various issues.
[a] Excluding renegotiations.
[b] Including Euronotes.
[c] Euro-commercial paper and other non-underwritten operations.

Table 1 also shows that there have been substantial changes in the market structure with regard to financial instruments, favouring securities and adversely affecting syndicated bank loans. Thus, the share of bonds in total transactions (excluding freely disposable lines of credit) increased from 42.2% in 1982 to 63.4% in 1990. At the same time, the share of syndicated loans fell sharply from 54.8% of the total in 1982 to only 16.3% four years later, although it later partly recovered, rising to 32.8% of the overall total in 1990. This recovery took place basically in the developed countries and was due to a substantial increase in loans to private non-financial enterprises, of which a significant proportion went to finance the restructuring or acquisition of companies. The share of the developing countries has remained at a low level, and in the Latin American region has been limited almost exclusively to credits granted in respect of the reprogramming of existing bank debt.[4]

Table 2 gives more details on the behaviour of the international bond markets as from 1982. There was extremely rapid growth up to 1986, both in gross and net issues, followed by a setback in 1987 and fresh increases in 1988 and 1989. Throughout the entire period, however, the share of the developing countries was low, going down from 5.4% of the total in 1982 to only 1.4% in 1989. In 1982, Mexico managed to secure a substantial amount of resources through bonds, but in subsequent years it was Asian economies such as India, Malaysia and South Korea which accounted for most of the operations effected by developing countries.

Table 2

INTERNATIONAL BOND ISSUES

(Billions of dollars)

	1982	1983	1984	1985	1986	1987	1988	1989	1990
Gross issues	75.5	77.1	111.5	167.8	227.1	180.8	227.1	255.7	228.8
Developed countries	59.3	59.5	93.7	137.7	201.2	156.0	198.2	223.9	188.5
Developing countries	4.1	2.6	3.5	6.3	3.1	2.0	4.5	3.6	4.3
International organizations, etc.[a]	12.1	15.0	14.3	23.8	22.8	22.8	24.4	28.2	36.0
Payments of interest and principal	13.1	18.6	19.5	36.1	64.2	76.0	84.9	89.7	110.8
Net issues	62.4	58.5	92.0	131.7	162.9	104.8	142.2	166.0	118.0
Memorandum item: Gross issues, valued at constant December 1986 exchange rates	...	...	124.9	191.4	233.4	169.8	205.9	244.5	203.9

Source: Organization for Economic Co-operation and Development (OECD), *Financial Market Trends*, various issues.
[a] Including Eastern Europe and the Socialist countries of Asia.

With regard to international stock transactions, the figures in table 1 only cover primary issues of new stock, initial public offers, and the sale of existing stock to non-residents through special instruments established for that effect (for example, closed investment funds). Between 1983 and 1987, there was a sudden increase in transactions of this nature, due partly to substantial sales of stock to non-residents under the privatization programmes of some countries (such as the United Kingdom). International issues of new stock contracted sharply in 1988 as a result of the slump in world security exchanges which took place in October 1987, and the Persian Gulf conflict negatively affected the volume of operations in the latter months of 1990.

It is estimated that the total volume of stock transactions on the international market (that is to say, all transactions involving non-residents) grew at an average annual rate of almost 17% between 1979 and 1989, reaching a value of US$1 528 billion in the latter year. The net value of these transactions (purchases less sales) came to the unprecedented figure of US$92 billion in 1989, and at the end of the latter year the total value of stock belonging to foreign investors stood at US$830 billion, equivalent to 8% of the total capital of the world stock market at that moment.[5]

[4] The syndicated loans granted to Colombia (US$957 million in 1985/1986, 1 000 million in 1987/1988, 1 464 million in 1989/1990 and 1 575 million in 1991/1994) have represented a partial exception to this, since although they were connected with the refinancing of amortization commitments, they did not form part of formal operations for the restructuring of outstanding maturities.

[5] The figures given in this paragraph are from Howell and Cozzini, 1990.

Apart from the rapid growth in the volume of transactions, another noteworthy element in the evolution of the international financial market in recent years has been the marked accentuation in the volatility of exchange rates, interest rates and prices of financial assets. As a form of protection against the greater risks involved in such fluctuations, a number of new financial products have been developed, such as futures contracts, options and swaps applied both to interest and exchange rates and to stock price indexes. These products practically did not exist at the beginning of the 1970s, but from then on they have registered spectacular growth, both in the volume and the level of sophistication of the instruments employed (Levich, 1988).

Everything indicates that the integration of the international capital market will become even more marked in the 1990s.[6] This process of increasing globalization offers both important opportunities and challenges to the countries of Latin America and other developing regions. The amount of resources mobilized on the international market is already enormous,[7] and, as noted in a recent study by the International Monetary Fund, the investment of only a small proportion of these resources in the developing countries could have a substantial impact on the inflow of capital into those countries (IMF, 1990, pp. 12 and 13). The increasingly global view taken by institutional investors and their interest in incorporating high-yield instruments in their portfolios of assets means that there is an interesting potential supply of funds, at least for certain developing countries which have profitable investment projects and stable macroeconomic conditions. In the following sections, we shall see that in recent years some Latin American countries have begun to take advantage of these possibilities.

II

The reopening of the bond market for Latin American borrowers

Before the Latin American external debt crisis broke out in August 1982, the region played an active part in the international bond market. According to statistics compiled by OECD, the annual value of the issues made by the Latin American countries between 1977 and 1982 averaged over US$2 billion.[8] Although the bulk of these operations involved Mexico, Brazil, Venezuela and Argentina, a substantial number of other countries, including Chile, Colombia, Costa Rica, Ecuador, Panama and Peru, also managed to secure resources on a smaller scale by this means.

As from 1982, however, the bond market was closed to the Latin American countries, although at the world level it registered extremely rapid growth, as we saw in the preceding section. Latin America's lack of access to this market was directly connected with the serious balance of payments problems suffered by the region during the 1980s, which culminated in the application of stringent macroeconomic adjustment programmes and successive efforts to reprogramme commitments with the international commercial banks. Even so, however, in spite of all the external constraints which arose, there were very few cases of failure to comply with the originally agreed terms for the payment of interest and principal in respect of commitments entered into in the international bond market.

Although there were some sporadic bond issues by Latin American countries after 1982, altogether they were of little significance.[9] This situation of almost total isolation of the region

[6] See, for example, Smith and Walter, 1991.

[7] The magnitude of the respective financial flows can also be appreciated from the balance of payments statistics, which indicate that in 1989 the net outflow from the industrialized countries in respect of foreign portfolio investment came to US$272 billion, i.e., 35% more than in 1988. See IMF, 1991, p. 29.

[8] Calculated on the basis of information presented in OECD, 1984, tables 1.11 and 1.21.

[9] Colombia, for example –the only important debtor country in the region which has not had to negotiate formal reprogramming of its maturities with the commercial banks– issued US$39 million of bonds for private sale in Japan in 1986, while the following year it issued US$50 million on the Eurobond market.

began to change somewhat in 1988, however. In that year, Venezuela made three issues totalling US$256 million.[10] Subsequently, in June 1989, the National External Trade Bank of Mexico obtained US$100 million through a private issue on the Eurobond market: the first issue by a Mexican State body since 1982. A few months later, a private industrial enterprise carried out a similar operation amounting to US$150 million through a branch in the United States.

The volume of operations expanded considerably in 1990, when Mexico took the lead (table 3). In that country, the borrowers were both public bodies and well-known private enterprises, with the national oil company, PEMEX, carrying out the largest volume of operations. It is worth noting that the Mexican State did not enter the market until the beginning of 1991. Previously, the only public bond issuers were financial institutions and enterprises producing goods or services. In February 1991, however, the Mexican State floated an issue amounting to 300 million deutsche marks, which represented the first operation by the Government as a sovereign borrower in the Eurobond market since 1982. Issues have been made in US dollars, German marks, and in one case Austrian schillings. Fixed-interest-rate bonds have been the most common type of instrument, although it may be noted that a private cement manufacturer, CEMEX, has issued bonds convertible into equity: the first operation of this type registered in the region.

For its part, Venezuela made three fresh issues in 1990. Two private enterprises sold non-guaranteed bonds, while the State oil corporation, PDVSA, carried out an operation totalling 200 million German marks through a branch in the Bahamas.

The figures given in table 3 refer to the par or nominal value of the bonds issued. As may seen, the amounts involved have been substantial: in the case of Mexico they came to some US$1.2 billion in 1990. It should be noted, however, that the figures given in the table overestimate the actual contribution of these operations to the balance of payments of the countries in question for various reasons. To begin with, it is necessary to take into account the payment of commissions for the sale of the bonds, normally at the rate of around 2 to 2.5% of the par value of these instruments on the Eurobond market.[11] Furthermore, some Mexican bonds have been placed on the market at a certain discount. It should also be borne in mind that several bond issues have been carried out through

Table 3

MEXICO AND VENEZUELA: IDENTIFIED INTERNATIONAL BOND ISSUES[a]

(Millions of dollars)

	1988	1989	1990	1991 (January-April)
Value of issues				
Mexico	52	250	1 175	517
Public sector	-	100	753	447
Private sector	52	150	422	70
Venezuela	256	10	211	-
Public sector	256	10	131	-
Private sector	-	-	80	-
Number of issues				
Mexico	1	2	15	4
Public sector	-	1	8	3
Private sector	1	1	7	1
Venezuela	3	1	3	-
Public sector	3	1	1	-
Private sector	-	-	2	-
Number of issues, by currency				
Dollars	3	3	13	3
German marks	1	-	4	1
Austrian schillings	-	-	1	-

Source: Compiled on the basis of data from LatinFinance, Financial Times, International Financing Review, El Mercado de Valores and LDC Debt Report.

[a] Excludes issues made as part of the restructuring of existing commitments with the commercial banks. Also excludes instruments guaranteed with export income. The issues denominated in European currencies were converted into dollars at the average exchange rate of the month in which they were made.

[10] There was also another issue of US$500 million of bonds, but this mostly consisted of the conversion into bonds of existing commitments with the international banking system. The US$100 million of fresh resources obtained through this issue were directly connected with this conversion operation, so that they were of a similar nature to the fresh involuntary loans made in the context of the restructuring of the old debt. A similar operation totalling US$263 million which was carried out early in 1989 was designed to pay off the obligations of a State-intervened private bank.

[11] The commission paid in respect of foreign bonds in Germany and Japan is around 2%, while on the United States market it is between 0.5 and 1%. See Grabbe, 1986, p. 290.

overseas branches, so that the amounts collected in respect of their sale have not always entered the national foreign exchange market. Finally, in the case of two issues made by private Mexican enterprises, the bonds were guaranteed with cash deposits in foreign currency, giving the impression that the main motive of the borrowers was to gain prestige on the international market. Nevertheless, even if we only take account of the issues made by public bodies, most of which were sold at close to their par value, the resources effectively obtained (after deduction of commissions at the maximum rate of 2.5%) are estimated to have come to nearly US$730 million, which is by all accounts a significant amount.

With regard to the origin of the resources obtained through recent bond issues, the main purchasers of the initial flotations were Latin American investors, so that these issues acted as a mechanism for the repatriation of private capital. Subsequently, however, the composition of the purchasers became more diversified, with increased participation by foreign investors, both institutional and individual. According to OECD, for example, the main purchasers of Mexican securities in 1990 were United States insurance companies and mutual funds specializing in high-yield bonds and investments in Latin America. Some traditional bond investment funds also showed some interest in investing in the new issues of Mexican bonds (OECD, 1990, p. 71).

Various specific factors have played a part in the return of Mexican and Venezuelan issuers to the international bond market. On the demand side, as already noted in the preceding section, there are investors who are interested in diversifying their portfolios through the incorporation into them of relatively high-yield financial instruments. Likewise, the progress made in the restoration of macroeconomic stability and in economic reforms aimed at giving a bigger role to the market forces have inspired confidence among foreign investors, especially in the case of Mexico. The favourable impressions of the path being followed by the Mexican economy were strengthened when the authorities announced in mid-1990 their decision to reprivatize the commercial banking system of the country, as well as their intention to begin negotiations with the United States with a view to the establishment of a free trade area between the two countries. In Venezuela, the structural adjustment process has made less progress, since it was only begun early in 1989, but even so the country's balance of payments has been markedly strengthened, especially after the rise in oil prices as from August 1990.

The attitude of the international financial market has also been positively influenced by the agreements reached by Mexico and Venezuela for reprogramming and reducing the burden of their existing bank debt.[12] The reductions in the debt and in interest payments thus achieved have been described as relatively modest (ECLAC, 1990b, pp. 21-22), but the agreements have cleared the way for improved future relations of these countries with their international private creditors. Although the proportion of commitments represented by bonds in the total external debt of the countries in question has increased markedly through the conversion into bonds of a large part of the old bank loans, it is still believed that the servicing of the new bonds issued directly on the international capital market will have priority over all other categories of commitments with private creditors (Purcell, Damran and Franklin, 1990). At the microeconomic level, the financial solvency of the issuing bodies has been a necessary condition for gaining access to the market, especially in the case of private enterprises, which are usually seen as involving higher commercial risks than public bodies. Another element which has aided the positive reception given to the bonds by investors is the fact that a number of the issuers have substantial foreign exchange income from exports. Enterprises which are mainly oriented towards the domestic market have sometimes had to put up special guarantees in order to gain a better reception.[13]

On the supply side, the factor which has most strongly impelled Mexican and Venezuelan firms to resort to the international capital market has

[12] Mexico reached preliminary agreement with the creditor banks in July 1989, signed the final agreement in February 1990, and carried out the exchange of old commitments for new instruments in March of that year. For its part, Venezuela reached agreement on the main lines of its reduction scheme with the bank advisory committee in March 1990 and signed the final agreement in December of that year.

[13] For example, the Mexican cigarette company "Empresas La Moderna", whose foreign exchange income represents less than 3% of its total sales, offered shares in two of its subsidiaries as a guarantee to back up its US$ 65 million Eurobond issue made at the beginning of 1990 (see *LatinFinance*, 1990a).

been the shortage and high cost of domestic financing. The domestic credit markets are usually neither big enough nor diversified enough to cover all the financial needs of big national firms –public or private– which are carrying out substantial investment projects aimed at expanding and converting their production capacity. Until recently, domestic interest rates in Mexico were very high in real terms. For this reason, external financing has been attractive in spite of its relatively high cost in international terms and the exchange risk inherent in taking out loans in foreign currency.[14]

In addition to the insufficiency and high cost of domestic credit, another probable motivating factor for Latin American bond issuers was the desire to diversify their sources of financing. Finally, as already noted, in a few cases the main reason was apparently a desire to gain prestige and greater prominence on the international financial market.

To begin with, the cost of the financing obtained on the external market was quite high. Thus, the initial yield of the first issues was between seven and eight percentage points over the six month LIBOR rate. In addition to compensating investors for the sovereign risk factor, this high yield may also have reflected certain shortcomings of the market with regard to the measurement of the creditworthiness of the issuing bodies; up to a certain point, this was a price that had to be paid in order to return to the market. As 1990 progressed, however, there was a clear decline in the yield of the new issues by Mexican public bodies, which went down to levels of three to four percentage points over LIBOR. In contrast, towards the end of that year the issues floated by private companies were still paying LIBOR plus around six percentage points, reflecting the higher commercial risk perceived by the market in respect of these instruments.

The downward trend of the risk premium on Mexican issues shows that the confidence of investors has been rising in proportion as they have become more familiar with the financial situation of the issuing bodies. Furthermore, the consolidation of the process of structural reform of the country's economy and the conclusion of the process of restructuring the outstanding debt with the commercial banking system have also helped to improve the credit rating of Mexican bonds. According to some experts, the trend towards lower yields should be further consolidated in the near future, as the degree of liquidity of Latin American bonds on the market increases (Purcell, Damran and Franklin, 1990).

In addition to having a relatively high cost, especially in the first issues, the bonds issued by Mexico and Venezuela have also had comparatively short maturities. In the case of the instruments issued by public bodies, the maturities have been between three and five years, while they have been somewhat shorter for most of the issues by private enterprises. Consequently, it will be necessary in the future to keep up a continual flow of new issues in order to prevent the net transfers associated with this form of financing from becoming negative after a short time.

Finally, it may be noted that the financial agreements between the Chilean Government and the international commercial banking system signed in September 1990 include the issue of US$320 million of Chilean treasury bonds in two stages: US$200 million in March 1991 and a further US$120 million in March 1992. Although this issue is connected with the reprogramming of the existing debt, it departs from the normal pattern of fresh credits associated with restructuring agreements. It is usually demanded that all bank creditors should contribute to the new loans (this is why they are called "involuntary"). The Chilean bonds, however, were sold to a small number of major creditors (20 banks altogether) which have a long-term commitment with the country. The successful flotation of this issue naturally represents an important step forward in Chile's return to the international private capital market.

[14] By way of illustration of the high cost of financing in national currency in Mexico, it may be noted that the annualized real interest rate of Treasury Certificates (short-term instruments issued by the Mexican Treasury, known as CETES) was 38% in the first half of 1989. Although the rate went down somewhat in the second half of the year after agreement in principle was reached with the international commercial banking system, the real rate still remained at a high level, and for the year as a whole, the cumulative real interest rate for CETES came to around 30%. Moreover, when domestic rates were translated into foreign currency, they showed a highly favourable difference compared with external rates (see Banco de México, 1990). However, as from March 1990 a substantial decline in interest rates was registered in Mexico, especially in real terms.

III

Financial instruments guaranteed by export income

A segment of the international capital market which has grown in recent years after first emerging in the United States financial market is that of securities backed up by assets –such as accounts receivable, mortgages and export income– belonging to the issuing body. Generally these assets are placed in trust in order to guarantee the servicing of the instruments issued. This improvement in creditworthiness enables the borrower to obtain resources on more advantageous terms. This system has been used with success when certain assets of a particular issuing body have a higher credit rating than the body as a whole. Thus, the sale of instruments guaranteed with assets could provide the countries of the region with an important means of obtaining fresh external financing, and this type of security will therefore be analysed separately in this section.

This system has been used in recent years by some Mexican borrowers who have offered their foreign currency accounts receivable as guarantees. The pioneer in this respect was the national telecommunications enterprise TELMEX, which obtained US$420 million of financing in 1987 and US$364 million in 1988 by pledging to the United States enterprise AT&T its future accounts receivable in respect of the positive balance in TELMEX's favour in connection with international telephone communications. TELMEX gained further access to this type of financing at the end of 1989 and the beginning of 1990 in amounts of US$324 million and US$335 million, respectively (*LatinFinance*, 1990b, pp. 28-29). Similar operations were carried out in 1990 by two commercial banks, which offered their accounts receivable in respect of credit card transactions as guarantees, and by the Federal Electricity Commission, which placed in trust its future electricity sales to the State of California. It is estimated that the total resources secured by Mexico in 1990 through such operations came to US$900 million. Early in 1991, TELMEX carried out a fifth issue for the unprecedented amount of US$570 million on the basis of its accounts receivable: an operation described as the biggest voluntary financing achieved in the international market by a Latin American body since 1982. Moreover, unlike previous issues, institutional investors from both Europe and Japan participated in this issue as well as United States investors (*Financial Times*, 1991).

A somewhat different method was used in 1990 by a Venezuelan aluminium manufacturer in order to obtain a credit of US$45 million to complete the financing of a project for the expansion of the firm's production capacity. In this case, the resources were supplied as prepayment for future exports of metal. Two similar operations were carried out in the same year by a private steel company, which obtained a total of US$90 million in new financing in this way.

From the point of view of the issuers, operations of this kind have an important advantage: according to the available evidence, the rate of interest paid for the resources thus obtained is less than in the case of traditional bonds. Thus, for example, the last issue made by TELMEX was placed at a rate of only 1.5 percentage points over the rate for United States treasury bonds. A disadvantage of this method, however, is that it may deprive the issuing bodies of a certain amount of flexibility in the future handling of their foreign currency income. Moreover, the arrangement of these operations usually involves technical and legal problems that increase the initial costs.

It would be well worth studying in greater detail the feasibility and desirability of the possible sale by other countries of the region of securities like those described in this section, which share the common feature of being backed up by foreign currency income. Since this form of financing involves a substantial reduction of the sovereign risk factor for investors, it could be used by countries which have not yet fully restored their credit reputation on the international financial market.[15] This

[15] It may be noted in this connection that in the first part of 1990 the Brazilian enterprise EMBRATEL managed to obtain external resources by the advance sale of US$50 million of accounts receivable in respect of international telephone communications. It is reported that similar transactions on a more modest scale have also been arranged by enterprises in Argentina and Jamaica (see *América Economía*, 1990, p. 11).

could also become a suitable means for making initial contact with private external financing sources, leaving the sale of non-guaranteed instruments for a later stage.

IV

Foreign portfolio investment

1. *Foreign direct and portfolio investment*

The importance of the contribution that foreign direct investment can make to the growth and economic modernization of the developing countries, including those of Latin America, is now widely recognized. This situation contrasts markedly with the questioning of the role of transnational corporations which was common in the past, particularly during the 1970s, when the dependency theory gained much currency. Much less attention has been given to foreign portfolio investment, however, although there has recently been growing interest in the specialized media in the evolution of stock exchanges in the so-called emerging markets, generally located in developing countries.

The basic difference between direct investment and portfolio investment is that in the first-named, the investor seeks to secure a permanent and effective share in the management of the enterprise in which the investments are made, whereas in the second case the investors do not seek management control.[16] Consequently, foreign participation in total equity tends to be greater in the case of direct investment, although it is not always necessary to own the majority of the common stock of an enterprise in order to gain a decisive influence in its management.

It is useful to distinguish between foreign direct investment and portfolio investment, because there are significant differences in both the characteristics and the motives of the respective investors. Portfolio investment is generally carried out by individual investors or, increasingly often, by institutional investors. These agents' decisions regarding the composition of their portfolios are determined solely by considerations of profitability and risk. In contrast, most direct investment is made by big enterprises producing goods or services. This type of investment takes into account not only the general factors of profitability and risk, but also specific elements concerning the market structure in particular industries and, above all, the possibility of exploiting monopolistic advantages (technology, management capacity, product diversification, access to the international market, etc.) through foreign investment.[17]

The topic dealt with in this section is that of foreign portfolio investment and its potential contribution to the external financing of the region. Until recently, this form of foreign investment was of little significance in Latin America, and indeed this is still the case in many countries of the region. There are various factors which explain the low level of participation by foreign investors in the Latin American stock markets. These include in particular the restrictions imposed by the countries themselves on the entry and exit of foreign capital; the restricted size of the formal securities markets and the big fluctuations observed in stock prices; the shortcomings which have often existed in the institutional and regulatory framework, which have deprived the market functioning of some degree of transparency; the frequent instability of the macroeconomic environment, typified by sudden heavy devaluations and exchange losses for external investors, and finally, the lack of reliable and up-to-date information on the behaviour of the stock markets of Latin America and other developing regions.

[16] The usefulness of this distinction has been widely recognized in the literature on foreign investment. Furthermore, the International Monetary Fund recommends its use in classifying capital flows in the balance of payments. It should be noted, however, that according to the definitions suggested by the IMF, portfolio investment includes not only stock and other forms of participation in equity, but also long-term bonds, whereas in the present article these flows are analysed separately (IMF, 1977, pp. 142-153).

[17] The first study which analysed the determining factors in direct investment from this point of view was that by Hymer, 1960. A more recent study which includes the theoretical advances made during the intervening period is that of Lall, 1980.

However, the obstacles to foreign portfolio investment have begun to go down in recent years, more rapidly in some areas than in others, and this has furthered a substantial flow of external resources by this means to various Latin American countries.

It may be noted that some of the stock markets in the region, like others in various developing countries of other regions, have shown considerable growth since the mid-1980s. Table 4 shows the evolution of the Latin American markets between 1984 and 1989, along with comparative figures both for other emerging markets and for the markets of developed countries. As may be seen from the table, in terms of US dollars the markets of Mexico and Chile rapidly increased their capital value (total value of the stocks quoted, on the basis of current prices) during the period in question. The markets in Jamaica and Argentina also registered high growth rates over the same period. The markets of other countries turned in a much less favourable performance, however, and the total capital handled by the Latin American markets as whole, as a proportion of the world total, declined somewhat so that it stood at less than 1% of the latter at the end of 1989. Indeed, even in the most dynamic markets of the region the growth rates of the total value capitalized were lower than those registered in some emerging markets in Asia.

The markets of Mexico and Chile continued to expand briskly in 1990 and in the early months of 1991, while the Venezuelan market, after having suffered a sharp decline in 1989, increased very rapidly in the following year. In view of the favourable rates of profitability registered in the recent past, it is no surprise that some institutional investors in world financial centres have begun to show interest in certain Latin American markets. This willingness to invest in emerging markets, which was observed first of all in the case of Asian and Southern European countries and has latterly spread to Latin American markets, is based on the modern theory of diversification of risks. This theory was developed in academic circles in the 1960s, and it holds that the global risk of a portfolio can be reduced and its expected yield increased if the portfolio of investments is diversified, even though some of the component securities may be high-risk. At the same time, there has been a notable improvement in the quantity and quality of information available on the behaviour of emerging markets, especially through the efforts made by the World Bank's International Finance Corporation (IFC).

Table 4

SIZE OF EMERGING STOCK MARKETS

	Number of companies quoted		Capital value (billions of dollars)	
	Dec. 1984	Dec. 1989	Dec. 1984	Dec. 1989
Latin America	**1 692**	**1 747**	**37.9**	**85.5**
Argentina	236	178	1.2	4.2
Brazil (São Paulo)	522	592	29.0	44.4
Chile	208	213	2.1	9.6
Colombia	180	82	0.8	1.1
Costa Rica	41	78	0.2	0.2[a]
Jamaica	36	45	0.1	1.0
Mexico	160	203	2.2	22.6
Peru	157	265	0.4	0.8[b]
Trinidad & Tobago	36	31	0.8	0.4
Venezuela	116	60	1.1[c]	1.2
Other emerging markets	**6 449**	**8 835**	**55.9**	**525.7**
Taiwan	123	163	9.9	237.0
South Korea	336	502	6.2	140.9
India	3 882	6 000	8.0	27.3
Malaysia	217	238	19.4	39.8
Others	1 891	1 932	12.3	80.5
Developed markets	**17 472**	**18 690**	**3 328.0**	**11 095.4**
Japan	1 444	2 019	644.4	4 392.6
United States	7 977	6 727	1 862.9	3 505.7
United Kingdom	2 171	2 015	242.7	826.6
Germany	449	628	78.4	365.2
France	504	668	41.1	364.8
Others	4 927	6 633	458.4	1 640.5

Source: International Finance Corporation, *Emerging Stock Markets Factbook 1990*, Washington, D.C., April 1990.

[a] 1986.

[b] 1987.

[c] 1985.

Likewise, there has latterly been some easing of the controls on foreign investment in general in the region, and in some cases specific measures have been adopted in order to promote foreign portfolio investment in particular. Serious administrative and tax hindrances continue to exist in a number of countries, but in general terms the barriers to foreign portfolio investment have been greatly reduced. Nevertheless, the gloomy macroeconomic outlook which still persists in a substantial number of countries of the region forms a strong deterrent to foreign investors seeking new areas to invest part of their portfolios.

There are three forms of foreign portfolio investments: investments made through a specialized fund; investments made directly in the domestic stock markets, and the purchase by foreign investors of shares of Latin American enterprises quoted on the securities market of some industrialized country.

2. *Foreign investment funds*

Up to now, a significant proportion of the external resources obtained through portfolio investments have been made through foreign investment funds (country funds). These funds are run by specialized financial bodies which manage their participants' investments in return for a commission. There are two types of funds: closed funds, where a participant who wishes to withdraw must sell his rights to another investor, and open funds, which carry out purchases and sales of securities on the local securities market in response to the net deposits and withdrawals of investors. Furthermore, the funds can either be public companies whose shares are quoted on a securities market abroad (normally London or New York), or private companies, when the resources are contributed directly by foreign investors.

The first Latin American foreign investment fund was launched on the New York stock exchange in 1981 in order to channel resources amounting to US$150 million to Mexico. A little later, the economic crisis connected with the external debt problem broke out, with its inevitable adverse effect on the willingness of foreign investors to risk their resources in the region. Only after six years was the establishment of funds for foreign investment in Latin America resumed, with the formation in 1987-1988 of four bodies of this type in Brazil. In 1989-1990, there was a considerable expansion in the number of funds established. Outstanding in this period was the experience of Chile, which is analysed in some detail in this section in view of its importance, and three new funds were also set up in Mexico. Various regional funds for Latin America have also been established, whose portfolios are made up of investments in various countries, while some global funds for emerging markets have made investments in Latin American securities.[18]

In Chile, the establishment of foreign investment funds has been encouraged by the special legal framework set up under Law No. 18 657, enacted in September 1987. Private or public funds which procure resources outside Chile for the purchase of publicly offered securities issued in that country can take advantage of these regulations.[19]

A condition which public investment funds must fulfil in order to take advantage of this special legislation is that they must be closed. Consequently, when an investor in a fund decides to withdraw his contribution, he must sell his rights on the securities market abroad on which those membership shares are traded, thus ensuring that the net worth of the fund in Chile is not affected by this situation. This aims to prevent the risk of possible instability in the functioning of the securities and foreign exchange markets. The legislation also demands that these funds must have a capital of at least US$1 million and lays down a minimum period for their functioning, namely, five years.

In order to prevent foreign investors from crowding out local shareholders in the ownership and control of domestic companies, it is laid down that the investments by a fund cannot exceed 5% of the voting shares of a particular company. This proportion may be increased to 15% when the extra 10% corresponds to new equity purchased and paid for by the same fund, but in no case may the funds as a whole own more than 25% of the shares of a given limited company.

[18] Various external debt conversion funds have also been established in countries like Chile, Argentina and Venezuela. Although these funds make investments in the securities markets of the country in question, they do not procure new resources, since they are financed through the conversion of external debt paper into national currency.

[19] Two funds have also been set up which operate under Decree-Law 600, the basic rules governing foreign investment in the country. According to the latest information available (end of February 1990), these funds have brought in capital amounting to US$24 million. See Superintendencia de Valores y Seguros de Chile, 1989.

Furthermore, investments in instruments issued or guaranteed by a given issuer may not exceed 10% of the total assets invested by the fund in Chile, except in the case of securities issued or guaranteed by the State or the Central Bank. Likewise, the total investments of the fund in securities issued or guaranteed by companies belonging to the same business group may not exceed 40% of its assets.

With regard to the composition of the investments, the Chilean regulations provide that at the end of the first year of operation of the fund, at least 20% of its assets must be invested in shares of open limited companies, while after the third year this figure must be not less than 60%. In addition, at least 20% of the total assets of the fund must be made up of long-term financial instruments after the third year of operation.

With regard to taxation, the rate of taxation levied on the repatriation of profits of the funds is 10%, and there are no restrictions on their remittance abroad. It should be noted that this represents preferential tax treatment compared with that applied to economic transactions carried out by foreigners who are not resident in Chile, whose profits are subject to a net rate of taxation of 32%. This special treatment explains why these funds have become the main mechanism for channelling external savings to the securities market of the country.

In 1989 and 1990, 10 funds were authorized to operate in the country, and they plan to invest a maximum capital of US$1 105 million in the local market (table 5). During 1989, a total of US$86 million entered the country, while in 1990 the amount was US$252 million. This mechanism has thus made possible the procurement of substantial amounts of external savings. By way of illustration, it may be noted that altogether the funds effected almost 43% of the entire foreign investment made in the country in 1990, other than that connected with external debt conversion.[20]

[20] According to preliminary figures of the Central Bank of Chile, in 1990 net foreign investment, excluding capital invested under Decree-Law 600 and conversions under Chapter XIX of the Compendium of International Exchange Regulations, came to US$594 million.

Table 5

OVERSEAS INVESTMENT FUNDS IN CHILE [a]

(Millions of dollars)

Name of fund	Market on which quoted	Date of authorization	Maximum capital to be invested	Capital invested in 1989	Capital invested in 1990	Capital invested in 1991[b]	Total
Chile Fund Inc.	New York	8/89	200	44	23	-	67
Equity Fund of Latin America	Private fund	8/89	100	20	3	17	40
Genesis Chile Fund Ltd.	London	10/89	200	22	38	-	60
Emerging Markets Chile Fund	Private fund	12/89	75	-	15	1	16
GT Chile Growth Fund Ltd.	London	12/89	150	-	90	-	90
Five Arrows Chile Fund Ltd.	London	1/90	150	-	65	-	65
New Frontiers Development Trust plc F.I.C.E. [c]	Private fund	1/90	5	-	5	-	5
Latin America Investment Fund, Inc.	New York	7/90	100	-	11	-	11
Latin America Investment Trust plc	London	8/90	50	-	2	3	5
Baring Puma Fund Limited	London	12/90	75	-	-	-	-
Total, all funds			1 105	86	252	21	359

Source: Superintendency of Securities and Insurance Companies of Chile.
[a] Refers to funds governed by Law No. 18.657.
[b] January - March.
[c] Originally called CDFC Trust plc F.I.C.E.

At the end of 1990, 79% of the portfolio of the funds was made up of stock; 19% consisted of debt paper: that is to say, time deposits, bonds issued by enterprises, mortgage certificates, and bonds and promissory notes issued by the State and the Central Bank, while the remaining 2% consisted of other types of investments and assets. So far, however, only a marginal part of the investments by the funds has been devoted to new equity, so that they have not contributed directly to the creation of new fixed assets. This could be considered a drawback, since after the initial entry of foreign exchange into the country there is a prolonged outflow abroad in the form of remittances of dividends and, possibly, repatriation of capital, without fresh sources of generation of external income being established as a counterpart. Even if the investments by the funds are not devoted to new equity, however, at all events they promote demand for publicly offered securities and create more liquidity in the market. Thus, indirectly they increase the possibility that enterprises quoted on the market can obtain additional resources for financing fresh fixed investments, and perhaps also new sources of generation and saving of foreign exchange.

For foreign investors, this form of investment has the advantage that it enables them to have a diversified portfolio in the country without needing a detailed knowledge of the domestic securities market. This involves a cost for them, however, since they must pay commissions to the domestic and external managers of the funds. Consequently, public investment funds are not a particularly attractive mechanism for big institutional investors who have their own capacity to analyse emerging markets. These investors usually operate directly on foreign stock exchanges, but as already noted, in the Chilean case there is a severe tax deterrent to this.

Finally, it may be noted that at the end of 1990 the market value of the shares owned by the foreign investment funds (US$359 million) represented only 2.6% of the total value of the shares quoted on the Santiago stock exchange (US$13 636 million). This highlights the fact that the growth possibilities for the funds' investments in Chile are still considerable, even after the notable expansion registered in 1990.[21]

3. *Direct share purchases on the domestic securities markets*

Mexico is the country which has managed to attract the biggest inflow of external resources in recent times through the direct purchase by foreign investors of stocks quoted on the stock exchange. An important event which has encouraged the entry of foreign capital into that country was the enactment in May 1989 of the new legal provisions designed to reduce the controls affecting foreign investment. The new rules expand the range of sectors in which foreign investment is permitted to almost 550 of the 754 existing economic activities, permitting majority participation in many of them.[22] Within this context, over half of the main companies quoted on the Mexican stock exchange allow participation by foreign investors (*El Mercado de Valores*, 1990a).

At the same time, the new legislation also established the system of a "neutral fund" to facilitate the entry of foreign capital into the country's stock exchange. This system provides for the authorization of trust funds through which foreign investors can acquire shares reserved exclusively for Mexicans (series "A" shares), which are represented by ordinary investment certificates. These certificates only cover the pecuniary rights of the shares forming the fund's assets, and therefore do not give a right to vote. The shares placed in the trust fund form series "N" or neutral series and are not taken into account when determining the total amount and share of ownership of foreign investors in the equity of the issuing companies. In accordance with this measure, authorization was given in October 1989 for the formation of a trust fund in Nacional Financiera S.N.C. (NAFIN), the State development bank, in order to permit foreign investors to acquire shares in Mexican companies quoted on the country's stock market (*El Mercado de Valores*, 1989). By the end of 1990, NAFIN's "neutral fund" had built up total assets of

[21] The current regulations are not a significant restriction in this respect. Since the legislation permits the funds as a whole to own up to 25% of the shares issued by a given limited company, the total investment of the funds could have amounted to as much as US$3 409 million at the end of 1990.

[22] The activities which continue to be reserved for the State include oil and natural gas extraction; oil refining; basic petrochemicals; generation, transmission and supply of electricity, and rail transport.

US$686 million, after having totalled only US$36 million at the end of the previous year.

In addition to the investments made through NAFIN's neutral fund, it is estimated that holdings of freely obtainable shares (series "B") by foreign investors amount to some US$2 to US$3 billion, representing between 5% and 8% of the total capital of the market (Heyman, 1990). It is therefore clear that in Mexico foreign portfolio investment has become an important mechanism not only for procuring external savings, but also for satisfying the finance needs of large companies quoted on the stock exchange.

4. *Stock issues on foreign stock markets*

Chile has made use of the third form of foreign portfolio investment referred to above, that is to say, the issue of shares on a foreign stock market. In July 1990, the telecommunications company "Compañía de Teléfonos de Chile" (CTC) carried out an operation of this type through American Depositary Receipts (ADRs).

ADRs are negotiable certificates issued by United States banks (known as "depositary banks") which represent shares in a non-United States enterprise. They facilitate the access of foreign issuing bodies to the United States securities market, since they are freely traded in that country, are quoted in dollars, and their dividends are paid out in the same currency. In order to make an issue of ADRs, it is necessary to obtain the approval both of the Securities and Exchange Commission, which is the body governing the United States securities market, and of the specific stock exchange where it is planned to trade the certificates.

The placement effected by the CTC, the main shareholder of which is the Spanish corporation "Telefónica de España", was carried out on the New York Stock Exchange and represented the first operation of this type by a Latin American company since 1963 (*Wall Street Journal*, 1990). Altogether, 6.5 million ADRs worth US$98.3 million were sold, backed by 110.5 million shares of new equity in the company. After deduction of the commission paid to the corresponding consortium of foreign financial institutions for underwriting the issue, which came to almost 6% of the total value of the placement, the Chilean company received around US$92.5 million. This sum, which represented approximately 13.5% of the equity of CTC at that time, will help to finance the investment plan of the company, which is calculated at US$1.7 billion for the period 1990-1996.[23]

Issues of certificates like those effected by CTC were possible because the Chilean authorities had previously enacted special regulations in this respect. These new regulations were published as Chapter XXVI of the Compendium of International Exchange Regulations, and among the requirements laid down in them are the following: the United States depositary bank must have a net worth of not less than US$1 billion; the ADRs must represent shares that constitute an increase in the capital of the Chilean enterprise; the external capital thus obtained must not be less than US$50 million, and the market value of the shares of the Chilean issuing company, before the increase in capital by this means, must not be less than US$100 million.

Quite apart from the specific provisions laid down in Chile, it is obvious that only a relatively small number of Latin American enterprises could hope to obtain resources on the United States securities market through the issue of ADRs. This is due partly to the strict requirements for approval and registration imposed by the competent bodies of the United States (the Securities and Exchange Commission and the relevant stock exchange). An enterprise which seeks this kind of financing must, at the very least, be relatively large and have a solid financial position. Moreover, in order to attract a sufficient number of foreign investors, it is essential that the macroeconomic position of the country where the enterprise is located should be reasonably strong. Despite these limitations, there are undoubtedly possibilities for considerable expansion of the use of this option in Latin America in the future. Thus, in addition to other Chilean enterprises, several Venezuelan firms are apparently evaluating this mechanism, while it is expected that the privatization of the telecommunications enterprises of Mexico and Venezuela will involve substantial offers of shares on the international securities market.

Finally, it may be noted that although several Mexican enterprises made use of ADRs in 1990,

[23] Subsequent sales of ADRs of the company generated an additional foreign exchange inflow of US$14.3 million between July 1990 and January 1991 (*El Mercurio*, 1991).

these operations –unlike the case of the CTC– did not involve new equity, since they did not provide for the procurement of fresh capital for the issuing companies but only permitted trading in existing shares on the United States securities market.

5. *The potential for foreign portfolio investment*

The details given in this section indicate that the various forms of foreign portfolio investment could become an important source of external resources for many countries of the region in the 1990s. An objection which might be made to this form of external financing is that it is very expensive for the host countries, since it is its high yield which constitutes its main attraction for foreign investors. After the initial entry of foreign capital there may be the drawback of heavy remittances of resources abroad in future years.

In this respect it is worth drawing a distinction between withdrawals of capital on the one hand, and remittances of dividends on the other. With regard to the former, it has been argued that the fact that a substantial proportion of the profitability of stock exchange investments corresponds to capital gains probably means that there will not be immediate pressures on the foreign exchange market. If investors tried to withdraw their funds on a large scale, the prices of the shares would fall and a significant proportion of the profits would disappear (Lessard and Williamson, 1985, pp. 59-60). Nevertheless, this argument does not dispel the possibility of substantial withdrawals of funds by foreign investors –even though this might mean capital losses for them– when the economy of the host country is going through difficult moments. This is undoubtedly a risk that must be borne in mind in connection with foreign portfolio investment.

With regard to the second consideration, since the rate of profitability of enterprises tends to be procyclical, it is possible that remittances of dividends to foreign shareholders would go down in periods of macroeconomic difficulties and restrictions on foreign exchange availability. It might be asserted that this is one of the main advantages of foreign investment as a means of external financing, in contrast with indebtedness through bank loans or the issue of bonds. However, empirical research in greater depth is called for in order to determine exactly how remittances of both dividends and capital in connection with foreign portfolio investment will behave in different phases of the economic cycle.

In a full evaluation of the advantages and disadvantages of this form of external financing it would also be necessary to take account of the effect that the increasing participation of foreign investors would have on fluctuations in stock prices on Latin American securities markets. Although the greater liquidity caused by the entry of foreign capital should act as a factor to stabilize prices, there is also the risk that the greater presence of foreign investors might give rise to the more rapid and intensive transmission to national securities markets of upsets originating on the world's great stock markets.

V

Financing from the international commercial banking system

Although it is not the intention of this article to go into the recent trends in financial flows between Latin America and the international commercial banking system, which have been analysed at length in other documents (ECLAC, 1988 and ECLAC 1990c), some brief comments are called for on the future prospects for financing from this source. The first comment to be made, as already noted in the introduction to this study, is that there is indeed virtually no possibility that Latin America and other developing regions will witness in the near future the restoration of the big syndicated loans for global balance of payments financing which predominated in the 1970s. This state of affairs, which has been confirmed on many occasions by spokesmen of the international banking system itself,[24] is partly due to the losses suffered by the banks in the 1980s on their Latin American portfolios on account of their overexposure in the preceding period. Moreover, the overindebtedness with the banks which persists in many countries of the region (and which is reflected in the big discounts on bank debt observed on secondary markets) constitutes a further deterrent to the granting of fresh loans. Finally, even the few countries which have managed to solve their problem of overindebtedness will probably find that the banks are reluctant to grant loans for general purposes. This may be due to a certain degree of inefficiency in the capital market, in the sense that the creditor banks do not draw any distinction between the different countries of the region with regard to their payment capacity (Devlin and Guerguil, 1991).

However, the fact that the market for balance-of-payments loans to governments is generally speaking closed does not mean that there is no possibility whatever of obtaining external resources in this way. Some banks, particularly those which were not involved in the process of overexpansion of lending to the region in the 1970s, may be interested in granting loans of this type, probably in relatively small amounts, to countries which have taken firm steps towards restoring their international creditworthiness. This is shown by the loan of US$20 million, with a term of eight years and an annual interest rate of 1% over LIBOR, granted towards the end of 1990 to the Republic of Chile by the Dutch bank NMB Postbank. This loan was the first non-guaranteed credit granted on a voluntary basis (that is to say, without being linked with an agreement for the restructuring or refinancing of existing commitments) to a Latin American government since the external debt crisis broke out in 1982. It should be noted that NMB Postbank had not made any loans to Chile before this operation. Although there may be other operations of this type in the future, however, they will probably be relatively isolated and involve limited amounts of funds, so that it is doubtful that on the whole they will become a significant source of external financing for the region.

In general terms, it may be expected that the contribution by the commercial banking system in the form of new loans which are not linked with the restructuring of existing debt will be restricted to short-term external trade financing and, in the case of medium and long-term loans, to the financing of investment projects.[25] Credits for external trade operations are of a revolving nature and are considered to represent relatively low risks for the creditors. Consequently, they have always been available for financing Latin American imports, except in extreme cases of non-fulfilment of payments. Normally, they will tend to grow automatically in line with the expansion of imports. Nevertheless, efforts should be made to find a way of improving the terms on which credits for financing the region's imports are granted and, above all, ways of establishing more flexible and efficient mechanisms for financing the region's exports.

With regard to loans for financing investment projects, it should be noted that bank credits for this purpose usually have external guarantees, either from an official credit agency of some industrialized country, from foreign investors participating in the project, or from foreign exchange income generated by projects oriented towards the external market. In these circumstances, the risks associated with the credit are not borne by the bank but by the agency granting the guarantee. However, guarantees are not usually comprehensive, so that there is often a residual element of risk for the banks.[26] Furthermore, financial packages for big investment projects sometimes include a bank credit component without formal guarantees. In this respect the International Finance Corporation (IFC) –a World Bank subsidiary which provides support for the private sector in developing countries– is playing a role of increasing import-

[24] For example, in a document issued in 1987 at the behest of the main commercial banks of the world it is stated that as private intermediaries whose prime responsibility is to their depositors and shareholders, the banks never thought they would have to assume the main role in granting ongoing balance of payments financing, and that in view of what happened as from 1982, the commercial banks can no longer accept this responsibility, since it is incompatible with their obligations under the trust deposited in them (*Institute of International Finance*, 1987, p. 10).

[25] A document issued by the international commercial banking system itself states that in future bank credits will move progressively away from balance-of-payments financing and return to the financing of trade and investment transactions, so that general-purpose financing will increasingly have to be provided by official creditors (*Institute of International Finance*, 1989, p. 17).

[26] For example, export credit agencies of the industrialized countries only give guarantees up to a maximum of 85% of the total value of a loan.

ance in forming consortia of banks to contribute to the financing of its projects. Although these syndicated loans do not have external guarantees, they do not represent the resumption of voluntary bank loans, since in practice the special status of the IFC has ensured that no loan of this nature is included in any restructuring of the external debt of a borrower country. Nevertheless, the prospects for continued growth of this kind of financing in the future are promising.[27]

Finally, it is necessary to stress the importance of foreign direct investment as a catalyst in the mobilization of external resources from various sources, including the commercial banks, for the contribution made by foreign investment projects to balance-of-payments financing often considerably exceeds that of direct contributions to equity. In Chile, for example, in the five-year period 1986-1990, credits associated with foreign investment totalled US$1.8 billion net, while foreign direct investment (excluding investment funds, ADRs, and the capitalization of investment loans made with external debt promissory notes through Chapter XIX) came to only US$700 million, according to data provided by the Central Bank of Chile.

VI

Conclusions

The main message emerging from the analysis made in the preceding pages is that although access to fresh external capital continues to be difficult for the Latin American region, there are some interesting ways and opportunities for attracting resources from the international private capital market. The two main mechanisms for channeling such financial flows are international bonds, including instruments backed up by foreign exchange income, and foreign portfolio investment. There is also substantial potential connected with project financing, particularly that involving foreign direct investment.

The recent experience of some countries of the region –above all Mexico, Chile and Venezuela– confirms that it is feasible to carry out these kinds of operations and shows that a significant volume of external financing can be obtained through them.[28] It also suggests that there are a number of minimum conditions for obtaining this kind of financing, including the solution in one way or another of the problem of the existing external debt, the existence of a stable macroeconomic environment, and –with regard to borrowers– a solid financial position. At all events, for those countries which have not yet managed to meet these conditions to the full, the system of securities backed up by export income could be a way of obtaining a certain amount of financing without excessive delay and thus initiating a process of return to the international capital market.

The financial instruments analysed in this article, especially conventional bonds, have clear features in common with the type of external financing obtained by the Latin American countries before the credit explosion of the 1970s, which centered predominantly on the commercial banking system. However, there is a fundamental difference in the international context which means that the mechanisms described here now have greater development potential than in preceding periods. This difference consists in the profound changes which have taken place in the international financial market, which now displays a higher degree of integration and sophistication. There is now a growing volume of resources which the institutional and individual investors of the industrialized countries would be willing to invest in emerging markets such as those of Latin America in appropriate circumstances. There is also a much

[27] In the fiscal year 1990, syndicated loans for developing countries organized in conjunction with the IFC totalled US$622 million. See International Finance Corporation, 1990.

[28] With regard to Mexico, the Under-Secretary for International Financial Affairs of the Ministry of Finance and Public Credit of that country was not exaggerating when he stated towards the end of last year that "Mexico's return to the capital markets is already a reality and was achieved much earlier than had been expected". José Angel Gurría, "México: una nueva era en el financiamiento externo", address delivered during the symposium "Investment in Mexico", 23 October 1990, and published in *El Mercado de Valores*, 1990b.

wider range of instruments available for satisfying the specific needs of particular borrowers.

Finally, it should be noted that integration into the dynamic conditions characteristic of international private capital movements could have consequences which are not entirely favourable for developing countries such as those of the region. In particular, the unstable and procyclical nature of such movements means that an external financing strategy based on them could raise serious problems with regard to macroeconomic management. Any reluctance of the international capital market to keep up the flow of financial resources could aggravate possible balance-of-payments deficit situations. On the other hand, in conditions of economic boom and relative abundance of foreign exchange there could be an excessive supply of external resources which could be reflected in other difficulties such as increases in the real exchange rate of the national currency and excessive increases in the external debt. Furthermore, integration into the international financial market means greater exposure to fluctuations in international interest rates and in the exchange rates of the main currencies, and both these types of fluctuations have been increasing in magnitude and frequency in recent years (UNCTAD, 1990, pp.122-130). These are potentially serious costs of the forms of financing analysed in this article. It therefore appears necessary to make a systematic evaluation of the use of these financial instruments, comparing them with other possible sources of external financing such as bilateral and multilateral credits and foreign direct investment. Moreover, it would be necessary to monitor –and if necessary regulate– the entry of private capital in order to avoid a repetition of the excesses of the 1970s, when unrestricted openness to private external financing (on that occasion from the commercial banking system) led to a situation of overindebtedness which culminated in the painful process of adjustment and recession experienced in the 1980s.

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