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Capital Flows to Latin America

2005 Highlights

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In 2005, abundant global liquidity, as well as low bond yields and flat yield curves, encouraged investors to seek higher returns in emerging markets, compressing credit spreads and helping borrowers to increase new bond issuance and engage in liability management. Investors were also encouraged by improving credit quality in emerging markets, pouring record amounts of money in mutual funds specializing in emerging market nations, helping to raise the total private capital flowing to those countries to unprecedented highs.

Against this backdrop, spreads reached record low levels (below pre-Asian crisis), and were less volatile than spreads for investment grade and high-yield corporate bonds. The favorable external environment also boosted new debt issuance and liability management operations. In Latin America, the strengthening of local currencies against the dollar and of domestic fundamentals stimulated issuance in local Latin American currencies, which, for the first time, were less volatile than the Euro and the Dollar. Moreover, there was record corporate issuance in emerging markets, and corporate issuance was higher than sovereign issuance in Latin America, another first.

Countries took advantage of the favorable financing conditions to pre-fund their borrowing requirements. Many issuers accelerated their 2006 and in some cases 2007 borrowing programs in anticipation of higher global bond yields. Several Latin American countries completed buy-backs and exchanges of external debt, in an effort to improve their debt structure and to extend the maturity profile. Argentina and Dominican Republic completed their debt restructuring process.

Finally, emerging markets countries, particularly in Latin America, continued to reap the benefits from the commodities boom, while rising oil prices continued to be a net positive on oil exporter countries.

1. Spreads reach record low levels

In 2005, spreads in emerging market debt reached record tight levels, and the improvements in fundamentals and in the health of the asset class resulted in superior credit quality.[1] With the recent rise in the average credit rating to Ba1/BB+, the J.P. Morgan EMBIG is now only one notch below investment grade.

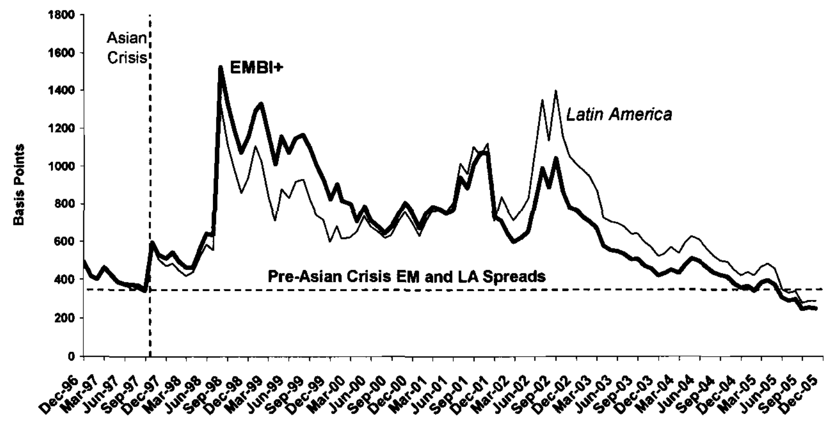
* This document has been prepared on the basis of market views and developments. All data and information are from market sources, unless otherwise noted.

[1] As evidence of the increasing stability of the economic environment in Latin American markets, the Brazilian Central Bank announced it will reduce the number of policy meetings in 2006 to 8 from 12, while Mexico's Central Bank announced it will have just one monetary policy meeting per month (from the current practice of two meetings per month). The argument is that stable macroeconomic conditions no longer justify a high frequency of monetary policy meetings.

Emerging markets and Latin American spreads have fallen below pre-Asian levels (Chart 1). They were less volatile than spreads in other credit markets, including high grade and high yield corporate spreads.

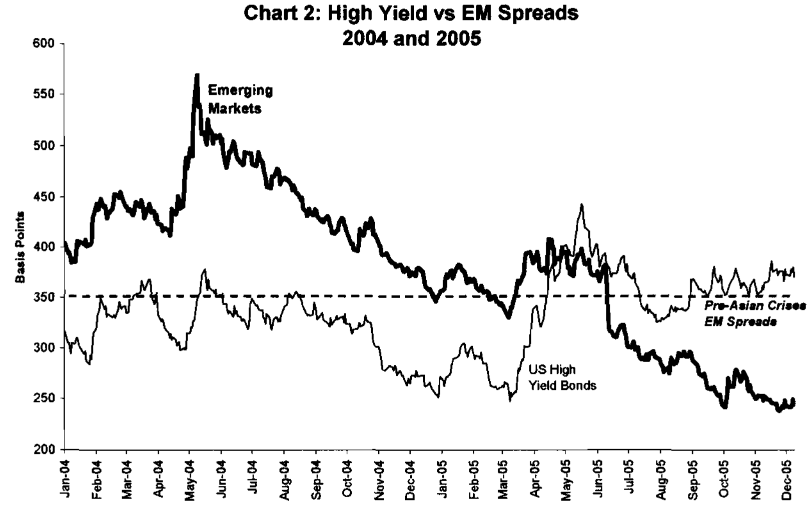
The market reaction to the turmoil in U.S. credit markets in early May was much more subdued in emerging and Latin American markets than in the U.S. and European high-yield markets. Emerging market spreads decoupled from U.S. corporate spreads in 2005, peaking earlier (in mid-April) and returning more quickly to their previous lows (Chart 2). The correlation index between emerging market and U.S. high-yield spreads fell from 0.8 in the first quarter of 2005, to 0.2 in the second, and turned negative in the third and fourth quarters.

Chart 1:
Spreads on JP Morgan EMBI+ and Latin American Composites
December 1996 to December 2005



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

Chart 2: High Yield vs EM Spreads
2004 and 2005



Source: ECLAC, on the basis of data from Merrill Lynch's U.S. High-Yield Master II Index (H0A0), and JP Morgan Chase's EMBI+.

2. Issuing Global Bonds in Local Currencies

The share of local-currency denominated bonds in total Latin American debt in the period from January to October 2005, including sovereigns and corporates, was 9.4%; 6.2% was denominated in Brazilian *reais*. Two sovereigns, Colombia and Brazil, issued local-currency denominated bonds, accounting for 57% of the total Latin American local-currency issuance in the period. Latin American corporate issuance in local currency was 43% of the total, with Brazilian banks and corporates representing 52% of the corporate total (Table 1).

On September 19, Brazil issued a benchmark global bond in *reais* that was remarkable in its size, maturity and pricing. It amounted to BRL3.4 billion or the equivalent of US$1.5 billion; it extended the local-currency yield curve significantly, and was priced well below dollar-bonds of equivalent duration and domestic local-currency bonds. The issue helped Brazil reduce the currency exposure and extend the duration of its debt, and created a benchmark for extending the duration of local-currency bonds issued by Brazilian corporates.

Table 1: Global Local-Currency Denominated Bond Issues in 2005

Announcement Date	Issuers	Currency	Maturity	US$ Equivalent (million)
13-Jan-05	Colombia	COP	1-Mar-10	125
3-Feb-05	Unibanco	BRL	11-Feb-10	125
15-Feb-05	Banco ABN Real	BRL	22-Feb-05	58
16-Feb-05	Colombia	COP	22-Oct-15	325
18-Feb-05	Banco Votorantim	BRL	28-Feb-08	100
24-Feb-05	Bradesco	BRL	10-Dec-07	50
7-Apr-05	Banespa	BRL	13-Apr-08	58
10-May-05	Banco Bradesco	BRL	10-Dec-07	50
23-Jun-05	Eletropaulo	BRL	28-Jun-10	200
19-Sep-05	Brazil	BRL	5-Jan-16	1,479
22-Sep-05	Bradesco	BRL	4-Jan-10	100
29-Sep-05	America Movil	MXN	15-Jan-16	463
3-Oct-05	Telefonica del Peru	PEN	11-Apr-16	225
Total				3,358

Source: ECLAC, on the basis of data from Merrill Lynch and J.P.Morgan.

With the September 19 issuance in *reais,* Brazil followed Uruguay (October 2003 and August 2004) and Colombia (November 2004, January and February 2005), as well as a number of Latin American corporates, Brazilian banks in particular, in a trend that is becoming more common given the strength of emerging market currencies and the global search for yield by international investors.

3. The intensification of liability management operations

In an effort to reduce vulnerability to external shocks, Latin American sovereigns continued to improve their debt structures in 2005, by carrying out active liability management operations. For example, Mexico's seven-year US$204 million Swiss franc bond in May and 10-year US$921 million euro bond in June were part of this effort, helping Mexico to meet its debt refinancing program, as well as to lengthen the average maturity of its debt. Mexico completed its debt financing operations for both 2006 and 2007 at the end of July.

The retirement of US$4.4 billion of Brazilian C-bonds (capitalization bonds) in July, was also part of the effort to improve the country's debt structure. The C-bonds were exchanged for new A-bonds (amortization bonds), and with this exchange Brazil extended the maturity profile of the public sector external debt (shifting amortizations that would have taken place during the period 2005-14 to 2009-18) and reduced further its amount of outstanding Brady debt. The C-bond has been a benchmark for many years, accounting for around 10% of all emerging market debt trading in the ten years through 2003. However, it has lost its liquidity since then, as the 2040 bond has grown in importance.

Argentina, in an effort to meet its financing needs for the year, sold US$150 million in May and US$450 million in June in a new Boden 2012 (local bond) to Venezuela. Venezuelan Finance Minister Merentes proposed in July the creation of an intra-country debt market for regional emerging markets. Having already purchased debt from

Argentina, he suggested that the government was considering buying debt from Bolivia, Brazil and Ecuador.

4. The Year Ahead

The external backdrop should be less supportive in 2006, as global liquidity is expected to slowly recede as a result of the concerted tightening in the G-3 countries. A possible rise in Asian inflation may lead to currency appreciation in that region, also contributing to reduce the U.S. dollar global liquidity surplus. Although Latin America has deleveraged, it has not done it fast enough, thus a reduction in liquidity is a risk.

Uncertainty over the transition at the helm at the Fed and over the magnitude of the tightening cycle in the U.S. may lead to higher volatility in 2006. In addition, the increased vulnerability to political noise in 2006 as a result of the electoral calendar in Latin America may also add volatility.

The result of this less supportive scenario may be a widening in Latin American spreads, although improved credit quality and a broader investor base are likely to act as mitigating elements to increased market pressure. Investors expect the current emerging market technical and fundamental trends to continue in 2006, leading to a further degree of decoupling between emerging markets and U.S. credit.

Finally, given the degree of pre-funding that took place in 2005, emerging and Latin American sovereign financing needs in 2006 will be lower than in 2005, and liability management operations should continue. Latin American bond issuers placed a total of US$35.7 billion in international capital markets from January to October 2005, covering all of the expected 2005 supply from the region, as well as 80% of its external financing needs for 2006 (Table 2).

Table 2: Latin America external new issuance estimates for 2006

US$ million	***Planned***	***Actual***	***Remaining***
Brazil	4,500	2,979	1,521
Chile	-	-	-
Colombia	2,000	2,000	-
Dominican Republic	-	-	-
El Salvador	225	-	225
Mexico	3,100	3,100	-
Panama	640	250	390
Peru	-	-	-
Venezuela	1,215	1,215	-
Other	1,000	560	440
Total	**12,680**	**10,104**	**2,576**

Sovereign external financing requirements as of November 2005
Source: J.P. Morgan.