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Capital Flows to Latin America 2004 Highlights



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CAPITAL FLOWS TO LATIN AMERICA

2004 Highlights

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Investors expect a strong finish for emerging markets this year, as market environment remains supportive of credit products, especially those with strong fundamentals and interesting yields, which is the case for emerging markets. Since the start of the year there were two sets of forces driving emerging markets debt: global liquidity and fundamental credit improvements. To a large degree, improving credit quality has itself been the result of ample global liquidity and the low interest-rate environment. Against this backdrop, spreads reached record low levels and issuance was boosted. The weakening dollar also stimulated issuance in local Latin American currencies for the first time as well as in euros. Low spreads and the impulse to issuance in currencies other than the dollar were two important themes in 2004.

Two other important topics were Argentina's debt restructuring process and the oil windfall and its repercussion in Latin American countries. Argentina's debt exchange offer should be formally launched in the beginning of 2005. If successful, the offering will end a difficult period in Argentina's history and will positively affect the whole region. With respect to oil, in 2004 the impact of higher prices on oil exporter countries was a net positive, but given the weight of oil exports in countries such as Venezuela and Ecuador, a decline in prices may bring trouble.

1. Spreads reach record low levels

In 2004, 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. For example, according to Peru's Central Bank, its 2012 sovereign bond reached at the end of November a spread of 251 basis points, achieving its historic low of 2.51% over US Treasuries. The Central Bank also highlighted the upgrade of Peru's foreign currency debt by Fitch from BB- to BB as a contributing factor, which was based on the country's favorable fiscal accounts, the solid macroeconomic performance, the growth of exports and the progress of the pension fund reform.

Merrill Lynch's overall market Emerging Markets (EM) IGOV spreads has never been lower since the indices were created in 1991. However, the quality of the index has improved and now includes 22% BBB-rated bonds, compared to 7% in 1997. If we exclude the BBBs, the Emerging Markets debt index IGD0 (BB and below) still has 18 basis points to go to hit its historic low¹.

By credit rating, however, no Emerging Markets sub-index has hit a historic low point. The BBB, BB and B sub-indices are 11, 15 and 24 basis points away from their historic lows, respectively. The CCC sub-index is 185 bps wider than its 1997 level. From this perspective, there is more room for spread tightening before historical levels are reached.

* 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 See Merrill, Lynch, Emerging Markets Daily, 3 December 2004.

2. Issuing Global Bonds in Local Currencies

Emerging market local currencies were major beneficiaries of the downward trend in spreads. In November, Colombia issued a peso bond targeted at foreign investors. The sale of US\$375 million of a global bond maturing in 2010 denominated in pesos was Colombia's first issuance in local currency in global markets. Colombia is the fourth emerging markets issuer and the second sovereign to issue such a bond, following a similar offering by Uruguay last year and in August of this year.² Colombia and Uruguay's issues capitalized on growing investor wariness about the U.S. currency, which has weakened world-wide amid increasing trade and fiscal deficits. Colombia's peso has been one of the currencies to benefit from the weakening in the dollar, having appreciated about 9% against the U.S. currency so far in 2004.

In terms of valuation the new Colombian bond can be compared with the domestically issued TES bonds. However, to make the bond attractive to foreign investors, the government made the interest and principal calculated in local currency but payable in U.S. dollars at a reference rate³. Although the bond is equivalent to investing in a local debt instrument, investors do not have to undertake a spot currency transaction every time they need to turn the local currency proceeds into dollars. In addition, the new bond is not subject to Colombian taxes. For investors buying this bond the primary concern is the future path of the Colombian peso.

Colombia's issuance in pesos was followed by Banco Votorantim, a Brazilian bank, which sold US\$75 million of bonds indexed to the Brazilian real at a yield of 18.5%. Although the size of the issue was small, it was significant for being the first time a Brazilian company had sold domestic-currency linked bonds internationally. Other emerging market issuances in local currency followed (see Box 1) and analysts indicate that generalized dollar weakness may lead to an increase in demand for local currency-denominated instruments. In addition, Latin American governments appear to be ready to replace significant stocks of dollar and euro-denominated debts that have left them vulnerable to balance-of-payments crises in the past when their own currencies weakened suddenly.

BOX 1: Issuance in Latin American currencies in 2004

Following Colombia's lead, two weeks later *Banco Votorantim*, a Brazilian bank associated with the country's largest industrial group, sold US\$75 million of bonds indexed to the Brazilian real. After that, at the end of November, Brazil's largest private bank, *Banco Bradesco*, sold the equivalent of US\$100 million of Brazilian real-denominated bonds overseas. In the first week of December, Brazil's fifth-largest bank, *União de Bancos Brasileiros*, sold US\$75 million of real-denominated 18-month bonds in external markets, the third such issuance by a Brazilian bank in 2004.

On December 6, the Inter-American Development Bank announced that it had raised funds in Latin American currencies for the first time in its 45-year history, issuing bonds in Mexican and Colombian pesos, as well as Brazilian reals.

² In November 2002 Bancomext, a Mexican bank specializing in foreign trade finance, issued a Mexican-peso-denominated Eurobond for 1 billion pesos or US\$100 million. Uruguay issued the equivalent of US\$200 million in local currency in October 2003 and another US\$250 million in August of 2004.

³ The reference rate is the average spot rate over a period of 20 business days ending 3 business days prior to the payment date.

3. Longest maturity euro-denominated debt deal ever by a Latin American nation

Low spreads set a favorable backdrop for what underwriters said was the longest maturity euro-denominated debt deal ever by a Latin American country. The offering by investment-grade-rated Mexico made on November 16, amounted to €750 million (US\$974 million) due in February 2020 (a 15-year bond). According to the finance ministry, US\$500 million of the proceeds raised represented pre-financing for 2006, with the 2005 external debt financing requirement already having been completed with a US\$1.5 billion issue in September. The government aimed to take advantage of the favorable financing conditions, as well as to avoid the need to issue in the period leading to the 2006 Mexican presidential elections.

Latin American countries are tapping the euro-denominated market in order to diversify currency holdings amid the weakening of the dollar. Europeans invested significantly in Latin American debt in the 1990s, before leaving Latin American markets after Argentina's default in 2001. But since October, in a sign of recovering demand, Peru sold its first sovereign debt offering in euros, €650 million in 10-year bonds. Brazil has issued €1 billion in 8-year bonds since September and a unit of Mexico's state-owned oil company *Petroleos Mexicanos* (PEMEX) sold €850 million of 12-year bonds in July.

4. Argentina's Debt Restructuring

In the beginning of November, Argentina presented the details of a planned exchange offering to restructure US\$103 billion in foreign debt to the Security and Exchange Commission. The exchange offering proposed to swap 152 different bonds issued in six currencies and eight different jurisdictions (and held by more than 500,000 bond holders around the world) into nine new bonds issued under four legal systems and currencies. According to the Wall Street Journal⁴, the proposal was the government's attempt to entice a higher level of acceptance than the 50%-60% range that many market analysts have predicted. In addition to bringing forward interest payments and offering small bondholders preferred access to sought-after par bonds, the new proposal set up an incentive plan based on the overall level of acceptance.

However, soon after its announcement, the Argentina's offer was described as unacceptable by some creditor groups. In response, finance minister Roberto Lavagna warned investors holding the country's defaulted debt that those who rejected the forthcoming debt-restructuring offer "could find themselves in a default situation perhaps indefinitely". The minister said the transaction would be launched November 29th in those jurisdictions that had approved the exchange, which excluded Italy and Japan, two key financial centers in which a large number of retail investors held defaulted debt. The Bank of New York, however, announced it would not be operationally ready to support the exchange by November 29th, and the government had to seek another bank.

On November 21 the G-20 group of the world's leading developed and emerging market economies met in Berlin and adopted a voluntary code of conduct on debt restructuring in emerging markets. The code of conduct attributes a significant role to credit committees and criticizes unilateral announcements of restructuring terms. Argentina decided not to participate in the meeting, whose outcome was a negative blow to Argentina's debt exchange plans.

⁴ "Argentina Details Plan to Swap Debt" by Michael Casey, Dow Jones Newswires, November 2, 2004.

The operational difficulties faced by Argentina's government led it to delay the launching of the debt exchange process until January 2005. The reasons were the difficulties in finding a bank to take care of the operational matters involving the exchange, as well as the risk that the lack of approval in some jurisdictions could hold back the entire process (since whether the 70% participation threshold is achieved or not is a major risk factor). On December 9, however, stocks in Argentina rallied as local market optimism regarding the debt swap increased. The Merval rose 1.2% as President Kirchner signed two decrees that set out terms for the US\$103 billion debt exchange (without specifying a launching date, or naming a clearing agent).

5. Andean region: oil windfall fueling spending

Many of the emerging market countries have now well established oil stabilization funds in place to ensure that the windfall originating from high oil prices is saved. Thus, in contrast to past oil boom periods, the majority of emerging market oil exporters appears to be saving their oil dollars. The Andean region, however, is an exception, where spending is on the rise. The region may be averting hard choices and forgoing a chance to set the basis for solid economic growth.

In Venezuela, where oil represents 80% of export revenue, President Chavez has increased government spending significantly this year. Ecuador, where oil is 44% of export revenue, seems likely to spend most of its oil windfall to close its finance gap in the absence of an IMF program. At the end of November data revealed that Ecuador's oil stabilization proceeds had been used to buy back US\$155 million of domestic debt since the start of the year. In the beginning of December the government announced its intention to buy back US\$250 million of domestic debt using savings from the oil stabilization fund.

The cash influx has taken the pressure off governments to push for structural changes designed to improve economic growth, but both Ecuador and Venezuela may be vulnerable to a decline in oil prices, which can produce sudden and huge deficits.