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I. Introduction

Over the last two years, several Latin American borrowers have regained limited access to voluntary financing from international capital markets. This followed a period of over six years in which these countries' private external borrowing was limited essentially to concerted financing, primarily in the form of principal reschedulings and new money packages. Although the process of market re-entry is still at an early stage--in terms of both volume and number of borrowers--it has nevertheless attracted considerable attention. It has affected a wide range of external financing instruments, including bank lending, equity flows, derivative products, foreign direct investment and capital repatriation. The aim of this paper is to draw upon recent country experiences (viz., Chile, Mexico and Venezuela) to provide an overview of the process of market re-entry, to assess the factors that have facilitated it, and to discuss some of the elements affecting the prospects for the period ahead.

II. Restoration of Access to Spontaneous Capital Market Financing--Some Quantitative Indicators

1. Loan and Bond Financing

International capital markets were a major sources of external financing for developing countries in the seventies and early eighties. Medium and long-term publicized international bank credit commitments totalled some US$225 billion in 1976-82. In 1982 alone, such commitments amounted to US$42 billion, with Latin American countries accounting for US$23 billion. As regards bond financing, publicized developing country issues amounted to US$27 billion in 1976-82. Of this amount, US$4 billion was issued in 1982, with Latin American borrowers accounting for US$2 billion.

These estimates are in stark contrast with those for the following six years. In effect, the outbreak of severe debt servicing problems in several Latin American countries in 1982 was associated with a virtual drying up of all sources of voluntary financing, with the exception of short-term trade facilities. As a result, the total amount of voluntary loan and bond financing flows to Latin American countries during the 1983-88 period was considerably smaller than that for 1982 alone. Specifically, financial flows to Latin America in the form of voluntary medium- and long-term bank credits and bonds totalled only US$7 billion. Concerted financing became the main source of private international financial support. Restructured medium- and long-term bank debt amounted to some US$310 billion during this period, 1/ with the associated cash flow relief being supplemented by new money facilities.

1/ This includes the rescheduling, under multi-year restructuring agreements, of obligations that would have fallen due beyond this period.

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Several developments indicate that the international credit rationing facing Latin America in the 1980s has been gradually relaxed in the last two years. Although still limited in terms of magnitude and countries, the process of market re-entry is gaining momentum and is affecting a wide range of external financing instruments. An important source of voluntary financing (in value terms) has been international bond markets. Mexico and Venezuela--the two countries that have re-entered these markets in a significant manner--are reported to have issued some US$3 billion of bonds in the 18-month period ended December 1990. The majority of these were placed on markets in the U.S. and Germany and mobilized primarily institutional investor funding and residents' capital held abroad. On the borrowers' side, they tended to involve corporations with established international reputations and sound export history and prospects.

The renewed access to international bond markets has been accompanied by some relaxation in the constraints on voluntary commercial bank borrowing. Despite increasingly binding regulatory capital-asset requirements, international banks' interest in lending to selected Latin American countries is slowly recovering. Specifically, spontaneous long-term bank credit commitments rose sharply to US$6.5 billion in 1989-90. These have tended to take the form of trade and project financing, with Chile using such financing as the main source of voluntary external funding. 1/

Available partial indicators point to a further pick-up of bank loan activity in 1991, including in the form of a US$320 million 5-year loan to Chile from a group of 20 banks. At the same time, there has been a significant increase in bond activity. Issues by Mexican public and private sector companies exceeded US$1.5 billion in the first five months of 1991.

The relaxation in credit rationing has been accompanied by an improvement in market terms. This is most apparent in the sharp drop in yields on Mexican bond issues. The first unsecured voluntary bond issue by a Mexican public enterprise since 1982 (Bancomext in June 1989) carried an initial yield of some 17 percent, implying a spread (or "risk premium") of about 820 basis points over U.S. Government bonds. By the third quarter of 1990, the weighted average spread for new Mexican bond issues had declined to an estimated 320 basis points. It increased somewhat in the final quarter due to a tightening in general market conditions, particularly investors' "flight to quality" reflecting uncertainties associated with the Middle East crisis. This was reversed in the first half of 1991, with the recent bond issue by Bancomext carrying an initial yield of under 10 percent, implying a spread of only some 200 basis points. The February DM 300 million UMS benchmark issue by the Mexican Government was marketed at an estimated spread of some 180 basis points over comparable German Government bonds.

1/ Also included is the September 1990 Chilean loan of US$20 million, reported to be the first fully voluntary, unsecured general bank loan to a Latin American country since 1982.

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These measures of improving creditworthiness are subject, however, to bias on account of the changing composition of borrowers and structures of bonds (particularly, the degree of credit enhancements). This bias may be overcome by tracking an individual borrower--albeit at the cost of limiting the coverage of the analysis. The yield on the traded PEMEX issue reportedly fell from 14 percent in mid-1989 to under 10.5 percent by end-May 1991, implying a reduction in the risk premium from some 530 basis points to around 250 basis points during this period. Over the same period, the yield on the Bancomext June 89 issue fell from 17 percent to around 10 percent.

2. Equity Financing

A number of Latin American corporations--including Mexico's TELMEX and Vitro and Chile's Compania de Telefonos--have also completed equity offerings in industrial country markets; this complemented the impact of a growing number of country funds channeling resources to "emerging capital markets" in the region. The equity placements were the first significant Latin American foreign stock offerings since the 1960s. In the 1970s, borrowers found it easier to resort to debt financing in the form of bank loans. In the 1980s equity markets were effectively closed to Latin American borrowers as a result, inter alia, of the heightened perceptions of country transfer risk.

The TELMEX privatization, completed on May 20, 1991, involved the issuance of some US$2.3 billion of equities on several capital markets including in Canada, France, Germany, Japan, Switzerland, the United Kingdom, and the United States. The issuance included the triggering of the 15 percent over-allotment provision (from the residual Government share) to meet larger-than-anticipated investor demand. The equity offering is reported to constitute the sixth largest placement of shares in the world (nominal values) and the largest for any Latin American country. Vitro, a private glass manufacturer, raised a total of US$73 million in April 1991 through the sale of 4 million shares. The issue was oversubscribed despite having been increased from an initial US$50 million offering. The earlier (July 1990) Chilean telephone company offering raised US$98 million.

3. Other Capital Inflows

The above developments have been reinforced by substantial capital inflows in the form of foreign direct investment and capital repatriation. In Mexico, for example, registered foreign direct investment inflows in 1989-90 were twice the level recorded in 1987-88, with the "pipeline" of new investment registration growing to over US$5 billion. Similar developments were recorded in Chile. The magnitude of capital repatriation is difficult to specify with confidence. The majority of available indicators point to a significant turnaround in the last two years in the process of capital flight that has plagued several countries in the region. These include a recent study by Chartered West LB Ltd which estimates net total inflows of US$14.1 billion for Chile, Mexico and Venezuela in 1989-90; this compares to

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an estimated outflow of US$4.5 billion in 1987-88, implying a turnaround of almost US$20 billion.

III. Factors Contributing to Market Re-entry

The restoration of access to voluntary capital market financing has clear benefits. Its direct beneficial impact includes providing a wider and more flexible range of financing instruments to fund productive activities, as compared to concerted sources of financing. This is particularly important in the context of narrow, albeit expanding, domestic capital markets and increasingly protracted negotiations on debt restructurings and concerted new money loans. Capital market re-entry also has several indirect benefits, the most significant of which is the signal provided to agents in other international and domestic markets as to the reduction in credit and transfer risks.

The growing availability of, and improving terms on, voluntary external financing for several Latin American countries--the manifestation of the pronounced improvement in private sector perceptions of creditworthiness--reflects four basic elements: the successful implementation of economic adjustment policies, the appropriate restructuring of existing indebtedness, a reduction in transactions costs for accessing capital markets, and greater effectiveness in customizing financing instruments to market conditions.

1. Economic Policy Implementation

Just as inappropriate economic policies, together with adverse exogenous developments, were major contributors to the emergence of debt problems, the sustained implementation of adjustment policies has been the critical factor in the restoration of voluntary access. Appropriate macroeconomic and structural reform policies have reduced perceptions of country transfer risk.

While the economic and financial programs have varied in the countries under consideration, including in entailing different policy trade-offs, it is possible to identify several key elements. First, a reduction in domestic financial imbalances due to improved budgetary performance and prudent monetary policies. This has involved a reinforcement of the fiscal revenue effort, a rationalization of expenditures and allowing domestic interest rates to reflect fully the cost of compensating savers for the considerable initial risk premia. Second, enhancing the supply responsiveness of the economy through appropriate pricing policy, including promoting the competitiveness of the tradeable sector. Third, improving economic efficiency through fundamental structural reforms. These have included, at various stages, the liberalization of the trade regime, reform of the taxation system, divestiture of public sector enterprises, financial liberalization, rationalization of legal and other procedures governing foreign investment, and deregulation of domestic activities.

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2. Restructuring of Existing Indebtedness

While the sustained implementation of appropriate economic and financial policies is a necessary condition for market re-entry, it may not be sufficient in all cases. The experience of Latin American countries in the 1980s suggests that, in some cases, the implementation of sound policies may be undermined by continued high risk aversion on the part of the private sector on account of the country's outstanding contractual debt obligations--the so-called "debt overhang" effects.

The growth in indebtedness increases concerns among economic agents as to the country's ability to service fully its debt in a sustained manner. Specifically, investor sentiment deteriorates as questions arise as to the authorities' ability to meet contractual payments without further increases in effective taxation. Agents' concerns mount further if the process of securing sufficient concerted financing is subject to protracted negotiations, with uncertainties as to the timing and nature of the outcome. The latter increases the risk of creditor/debtor confrontation, with adverse implications for other forms of capital inflows. As a result, the expected return on investment activities declines, discouraging agents from undertaking them.

Debt overhang effects require that the debt problems in some countries be addressed through contractual debt and debt service reduction operations rather than through the refinancing/rescheduling of obligations falling due. By lowering perceptions of country risk, the reduction in contractual obligations would trigger an investment response that is in excess of that which would result solely from the larger domestic availability of resources associated with lower debt servicing payments. Debt and debt service operations may also improve the willingness and ability of the authorities to implement adjustment policies; this is linked to perceptions that foreign creditors will not secure an "undue" share of the benefits of adjustment.

After the outbreak of debt servicing problems and until 1987-88, most Latin American countries were involved in a process of repeated and often protracted debt renegotiations. Centered on the provision of liquidity support through principal rescheduling and concerted new money, the process resulted in an increase in contractual debt obligations. Specifically, despite some improvements in the non-interest current account performance, the region's external debt rose from US$331 billion (271 percent of exports of goods and services) in 1982 to US$420 billion (344 percent of exports of goods and services) in 1987.

It is in this context that Chile, Mexico and Venezuela took steps to reduce the burden of bank contractual indebtedness through market-based debt and debt service reduction operations. The Chilean authorities reduced the country's total debt to banks by more than half in four years, from US$14.5 billion at end-1985 to US$6.7 billion in 1990 (the stock of restructurable bank debt declined to around US$4 billion). This was done through a series of voluntary market-based debt conversions. Mechanisms for

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these conversions were introduced in mid-1985 and supplemented, inter alia, by direct cash buybacks in 1988-89. The latter extinguished some US$440 million of bank debt at a cost of US$250 million, involving an average discount of 43.5 percent.

In contrast to Chile, Mexico and Venezuela reduced their indebtedness through comprehensive bank restructuring packages. The 1990 Mexican package covered some US$48 billion of bank claims. It resulted in an effective gross bank debt reduction of US$15 billion through conversions into partially collateralized discount bonds (65 percent of face value) and reduced interest (6 1/4 percent, fixed) par bonds. An additional US$3 billion of claims would be extinguished if the conversion rights awarded under the new debt-equity program are fully exercised.

Venezuela's 1990 bank agreement involved an effective gross bank debt reduction of US$4.6 billion. This was achieved through a menu of five options including an "indirect buyback" (discount of 55 percent) and conversions of claims into partially collateralized discount bonds (70 percent of face value), reduced interest (6 3/4 percent) par bonds, and front-loaded temporary interest reduction bonds (5 percent for first two years, 6 percent for years 3-4, 7 percent for year 5 and LIBOR plus 7/8 percent thereafter).

Preliminary indicators suggest that, together with appropriate economic policies, the debt and debt service reduction operations have reduced debt overhang concerns. This is most evident in the case of Mexico where announcement of agreement on the bank financing package was followed by a sharp and immediate improvement in indicators of country risk. Real ex-post domestic interest rates fell by 20 percentage points to around 10 percent per annum--a decline that was sustained thereafter. At the same time, the yield on Mexican external traded bonds fell sharply (by 75-230 basis points). Finally, the secondary market price for bank claims on Mexico generally improved, with its ratio to other Baker 15 countries rising from 1.20 before the package to 1.34 by end-1990. Similarly, the secondary market prices for bank claims on Chile and Venezuela recovered strongly. By end-May 1991, the prices for bank claims on these three countries were at their highest relative levels since comprehensive reporting of such data was initiated in the mid-1980s. Moreover, in the case of Chile, the secondary market discount fell to only 10 percent, consistent with the discounts for several developing countries having retained voluntary market access throughout the 1980s.

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3. Reduced Transaction Costs

The improvement in country fundamentals (i.e. lower transfer risk) has been accompanied by a reduction in the transactions costs for accessing international capital markets. This has resulted, inter alia, from regulatory changes in industrial country capital markets and increased market-credible information regarding borrowers' creditworthiness.

The most important regulatory changes have occurred in the U.S. markets. Specifically, the 1990 approval of "Regulation S" and "Rule 144A" reduced the transaction costs and liquidity problems facing developing countries in tapping U.S. capital markets.

Before April 1990, the average costs of meeting bond registration and disclosure requirements for first time developing country issuers were estimated in the order of US$500,000-US$700,000. Avoidance of some of these costs through private placements was possible but involved reducing the liquidity of the instruments. Thus, the prevailing Securities Act required that buyers of securities not offered publicly to hold them for at least two years after the initial offering. At the same time, the Act imposed heavy penalties on issuers that adopted the public offering route but were not capable to meet fully all the registration requirements. Indeed, under the Act, a purchaser of a security could choose at any time to rescind a transaction that has not been properly registered. By clarifying the definition of what constitutes a sale and offer of a security in the U.S., Regulation S facilitated the sale of Euro-issues to U.S. citizens. It exempts securities from registration requirements provided the buyer is outside the U.S.; if within the U.S., the exemption conditions relate to the marketing of the securities.

Concurrent with the reduction in transactions costs, the adoption of rule 144A reduced the loss of liquidity associated with "private placements". The changes relaxed the two year holding period requirement provided the sale of the financial instrument is to a "qualified institutional buyers." Such buyers are defined as entities managing and owning at least US$100 million in securities and, in the case of banks, having a net worth of at least US$25 million. 1/ On this basis, it is estimated that there are about 5,000 qualified institutional buyers in the U.S.--mainly insurance companies, commercial banks and money managers.

The above-cited changes have reinforced the possibilities offered by the American Depository Receipts (ADR) program under which developing countries may access equity markets without meeting the full costs of offerings/listings on these markets. Under this program, each American Depositary Share (ADS) traded in the U.S. represents a batch of shares in the local market. This route was used by a number of Latin American

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1/ Registered dealers-brokers are exempt provided they own and manage a total of US$10 million in securities.

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corporate re-entrants, including Chile's telephone company in mid-1990 for an offering of 6.5 million share raising US$98 million. These ADS correspond to more than 110 million shares of Series A Common Stock on the Santiago exchange or 13.5 percent of the company's equity. In the case of the TELMEX privatization, the 65 million ADS correspond to 1.3 billion shares.

Increased interest among international investors in bond issues by re-entering Latin American entities has led to, and been reinforced by, the establishment of market-credible credit ratings, thereby reducing some of the costs investors face in compiling purchase information. In December 1990, Mexico received its first credit rating by Moody's Investors Service. The ceiling rating for Mexican debt was set at Ba2--just below investment grade--with Brady bonds receiving a Ba3 rating as a result of the perception of greater restructuring risk based on historical experience. More (Chile) and improved ratings (possibly Venezuela, currently Ba3) are reported in the making. Moreover, the potential existence of investment grade paper would, ceteris paribus, open to Latin American re-entrants new segments of the market, particularly those involving industrial country pension funds and other institutional investors subject to risk level cut-offs.

4. Customizing Financial Instruments

In an environment of still significant--albeit declining--perceptions of credit and transfer risks, borrowers must pay particular attention to customizing their borrowing instruments to the requirements of the market. This becomes more important when there is a general tightening of market conditions, as was the case during 1990.

In several of the bond issues by market-re-entrants from Latin America, borrowers have attempted to differentiate the instruments by providing explicit credit enhancements. This has been done, most often, through collateralization (on the basis of existing assets or an expected stream of receivables) but also through various put options, including preferential treatment in the case of privatization and early redemption possibilities.

The credibility of collateralization, and therefore the extent to which it improves market terms, has depended on the form of the collateral, its location and the costs involved in taking possession and disposing of it, should the need arise. Several borrowers have provided collaterals in the form of assets/receivables located or generated outside the country, thereby allowing them to address investors' concern about both transfer and credit risks. TELMEX, for example, provided investors protection in the form of a claim on payments due from AT&T on account of international communications. Accordingly, investors' exposure to TELMEX credit and Mexican transfer risks was effectively transformed into an exposure to AT&T credit and U.S. transfer risks. Other forms of collateralization have included bank deposits and electricity accounts, suppliers and credit card receivables.

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IV. Short-term Prospects

The above overview provides important indications for Latin American countries, as well as those in other developing countries that are still seeking to normalize financial relations and restore access to voluntary capital market financing. It may also be used to shed some light on the short-term prospects for countries that have succeeded in restoring market access.

Given the small magnitudes involved relative to the size of the markets (international bond financing (gross) totalled an estimated US$256 billion in 1989 (US$166 billion, net), and international bank lending amounted to some US$820 billion), these borrowers may be viewed as facing "small country conditions" on international capital markets. Consequently, the re-entry of Latin American borrowers is unlikely to result in a tightening of market conditions. Moreover, increased effective demand (as opposed to notional demand) from Eastern Europe and the Middle East may have some impact on market terms but is not expected to crowd-out Latin American re-entrants provided they succeed in sustaining the improvement in credit and transfer risks. Moreover, the potentially adverse impact on terms may be minimized by the actions of borrowers themselves.

The key aspect will remain the sustained implementation of sound economic and financial policies, and avoiding a renewed round of excessive borrowing. This would need to be supported at the country-level by efforts to reduce exposure to adverse developments in exogenous prices. This would involve greater use of interest rate hedging mechanisms (as has been done in Chile) and commodity hedges (such as the recent Mexican action of selling future oil contracts consistent with the price assumed in the specification and implementation of the government budget). This would reinforce the beneficial impact of export diversification (e.g., in Mexico where the share of petroleum receipts in total export has declined from over 70 percent in 1980-82 to an estimated 30 percent in 1988-90), the establishment of commodity stabilization funds (e.g., Chile's oil and copper stabilization funds), and the reduction in bank debt subject to commercial variable interest rates (an important component of the Mexican and Venezuelan debt packages). In this context, corporate borrowers should also seek to make greater use of financial risk management techniques, thereby avoiding the excessive "open positions" associated with pre-1982 borrowings. The improvement in credit and transfer risks has rendered less costly the increased use of such techniques for both public and private sector entities.

The reduction in exposure to adverse exogenous shocks would accompany a careful use of collateralization and other credit enhancements. While useful in allowing re-entrants to overcome the initial levels of extreme market risk aversion (compounded by "adverse selection" effects and other information-related market influences), these enhancements should be used only by entities that have already strengthened their underlying financial position. Moreover, their use should be subject to prudent aggregate limits

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that balance the immediate gains of lower borrowing costs against potential longer-term adverse effects on liquidity management and access to unsecured voluntary credits. In effect, by pledging existing assets or future receipts, borrowers may lose future financial flexibility as well as lower the seniority of creditors with unsecured debt. There may also be precedent/contagion effects for other re-entrants, thereby increasing their borrowing costs and raising public policy issues.

Industrial countries may also have a role to play in reducing barriers to developing countries' return to voluntary financing. It should be recognized, however, that such actions would have only a marginal impact when compared to those cited above which derive from actions by the borrowers themselves. Consideration could be given, for example, to introducing, where necessary, greater flexibility in regulatory provisioning requirements in industrial countries. Such requirements affect the willingness of bank creditors to hold loan and bond instruments issued by countries with recent debt-servicing problems. In several industrial countries, regulatory provisioning requirements are determined by backward looking factors (particularly events of reschedulings and/or arrears) and tend to respond with a lag to a recovery in debtors' prospects (typically involving a five-year rule). There is thus need, in some cases, to provide for flexibility in "graduating" a country from regulatory provisioning requirements in response to evidence of a fundamental improvement in its economic and financial outlook. 1/

V. Concluding Remarks

In concluding, it is worth summarizing four key points. First, the progress achieved so far by Latin American countries in restoring market access, while still limited in magnitude and country distribution, is to be welcomed and encouraged. The turnaround in market sentiment has been substantial in the case of Chile, Mexico and Venezuela. It has allowed for a return to voluntary loan, bond and equity placements at sharply improving terms; it has also encouraged foreign direct investment inflows and the repatriation of flight capital. Second, the progress in restoring market access has to be consolidated and steps taken to reduce the risk of a "re-exit." Third, the main contributor to the restoration and consolidation of market access remains the reduction in country transfer risk that results from the sustained implementation of sound macroeconomic and structural reform policies. With such policies, and given prudent debt management practices, public and private borrowers are able to complement their access

1/ An example of increased flexibility is provided by the Canadian system where the Superintendent of Financial Institutions may, at his/her discretion, remove a country from the provisioning list 2 years (rather than the standard 5 years) after the most recent rescheduling if the country has shown ability to raise funds of over one year maturity on international capital markets.

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