Even Turkeys Fly When The Winds Are Strong

Ignore the hype about a new Latin American paradigm.

BY DESMOND LACHMAN

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Among the more useful lessons that I learned during my six years on Wall Street came from a seasoned, if cynical, Salomon Brothers bond trader. He taught me that when the winds are strong even turkeys fly. He also taught me that the winds seldom stay strong for long and that when the winds die down the birds all too often come crashing down to earth.

If ever the winds have been strong for Latin America, it has to have been over the past two years. Not only did the global economy grow at its fastest pace in the past twenty years but global interest rates declined to their lowest level since the early 1960s. As if that did not provide Latin America with a sufficiently favorable external environment, not only did international commodity prices reach record highs but China emerged on the scene as a major importer of Latin American goods and as a major investor in the region.

In such a benign global environment, it should have come as no surprise that Latin American equity markets would boom to new record highs. It should also have come as no surprise that, in their desperate search for yield, global bond investors would drive down emerging market bond spreads to levels last seen before the 1997 Asian financial crisis. In that quest, these investors have not been particularly discriminating between good and bad Latin American credits.

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The antics of Venezuela's **Hugo Chavez** *[near right] hardly provide comfort that Latin America will stay the course of reform. When he is not exporting his Bolivarian revolution to the rest of the continent, Mr. Chavez is either raiding his central bank's international reserves or is irreversibly weakening PDVSA, the state oil company.*

Nor does Argentina's President **Néstor Kirchner** *[far right] provide much hope for a sounder economic future. If he is not resisting reforms to Argentina's still very creaky public finances, he is refusing to increase public utility rates to levels that might encourage the much needed investment in Argentina's energy sector for the country's future growth.*

—D. Lachman

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What does come as a surprise, however, is that many investors now appear to be taking the market's present ebullience as an indication of the emergence of a new paradigm in Latin America. In their view, investment grade for the major Latin American credits is but around the corner. How quickly they seem to have forgotten the Argentine debacle of 2001, which constituted the largest sovereign debt default in history? How little do they seem to remember about Latin America's dismal history over the past hundred years of repeated debt defaults by all of its major countries?

What is also surprising is how little attention Latin American investors seem to be paying to the gathering storm clouds over the global economy. How long do they think that global economic growth can be sustained at its recent pace with international oil prices likely to remain at their currently heady levels? Or how long do they think that international commodity prices will remain well bid in a world in which the Chinese economy slows under the weight of its deep macro-economic imbalances and in which Europe stagnates at a time of internal dissension and policy paralysis?

While certain progress has been made on the reform front, most of Latin America's major economies remain very exposed to any real deterioration in the external environment.

The optimistic proponents of a new Latin American economic paradigm point to the increased pragmatism of governments in the region. They note that even the center-left governments in Brazil, Chile, and Uruguay have come to realize the importance of sound macro-economic policy and the need for structural reform. In reflection of that realization, they note that certain reforms have been taken to address some of the macro-economic and financial factors that caused previous crises.

The optimists are also quick to point out that today most Latin American economies run significant external current account surpluses and that they have built significant international reserves. These reserves they correctly assert should at least temporarily cushion those countries from any sudden change in market sentiment. In addition, they note that inflation rates have been substantially reduced by increasingly independent central banks and that large primary budget surpluses have now become more the rule than the exception in the region. These latter surpluses are helping to stabilize Latin America's erstwhile poor domestic debt dynamics.

While there can be no gainsaying that certain macro-economic progress has been made over the past few years, one has to ask how long one might expect political conditions in Latin America to be conducive to macro-economic reform. Leaving aside basket case countries like Bolivia and Ecuador, and focusing instead only on the major Latin American countries, how confident can one be that the recent pace of reform will not be reversed let alone be sustained?

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of the continent, Mr. Chavez is either raiding his central bank's international reserves or is irreversibly weakening PDVSA, the state oil company. Nor does Argentina's President Néstor Kirchner provide much hope for a sounder economic future. If he is not resisting reforms to Argentina's still very creaky public finances, he is refusing to increase public utility rates to levels that might encourage the much needed investment in Argentina's energy sector for the country's future growth.

And then there is the question of the many congressional and presidential elections throughout the region in 2006, and in particular the question of those in Mexico and Brazil. Mexico is all but certain to elect the left-leaning mayor of Mexico City, Manuel Obrador, as its president. He is almost certain to run a populist campaign against the current president Vicente Fox's reform program. Meanwhile in Brazil, Lula, who pleasantly surprised most external observers by his dogged commitment to reform in the early years of his presidency, is very likely to be re-elected. However, judging by his current deep political difficulties, he is likely to be a shadow of his former reform self in a second term, not least because he will not have the congressional mandate to continue with his reform agenda.

Any stalling in the reform process would not be of the greatest concern had Latin America taken full advantage of the window that highly favorable external conditions provided it to reduce its traditional vulnerabilities. Sadly this has not been the case. For while certain progress has been made on the reform front, most of Latin America's major economies remain very exposed to any real deterioration in the external environment.

Among the more troubling of Latin America's vulnerabilities derive from the still shaky public finances and high public debt levels of many of its major countries. To be sure, important countries in the region, like Argentina and Brazil, now do run significant primary budget surpluses in a manner unlike the past. However, it is highly questionable whether these surpluses are sufficiently large to allow these countries to avoid the bad debt dynamics from which they previously suffered in the event of any significant deterioration in the external environment. It is not simply that these countries still have relatively high public debt levels. It is also the fact that these countries have looming social security obligations and that, all too often, their public debt is either indexed to short-term interest rates or to the dollar.

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A further area of Latin American vulnerability derives from the fragile state of many of the region's banking systems. This fragility is only compounded by the still very high level of short-term domestic and dollar-denominated debt of many countries in the region. As the experience of the 1997 Asian crisis attests, in a world of increased capital mobility, weak banking systems combined with high levels of short-term indebtedness are an invitation to financial market instability.

At a more basic level than the region's external vulnerabilities are the still very low levels of Latin American saving and investment. Typically these levels are less than half of those in Asia's tiger economies and they are the principal reason why Latin America remains on a disappointingly low long-run economic growth path. Until such saving and investment behavior materially changes, it would seem to make little sense to talk of a new Latin American paradigm.

This is certainly not the first time that buoyant market conditions have spawned premature talk of a new Latin American paradigm. Which must make one wonder whether markets will ever internalize the lesson I learned from that cynical Salomon bond trader about even turkeys flying when the winds are strong? ◆