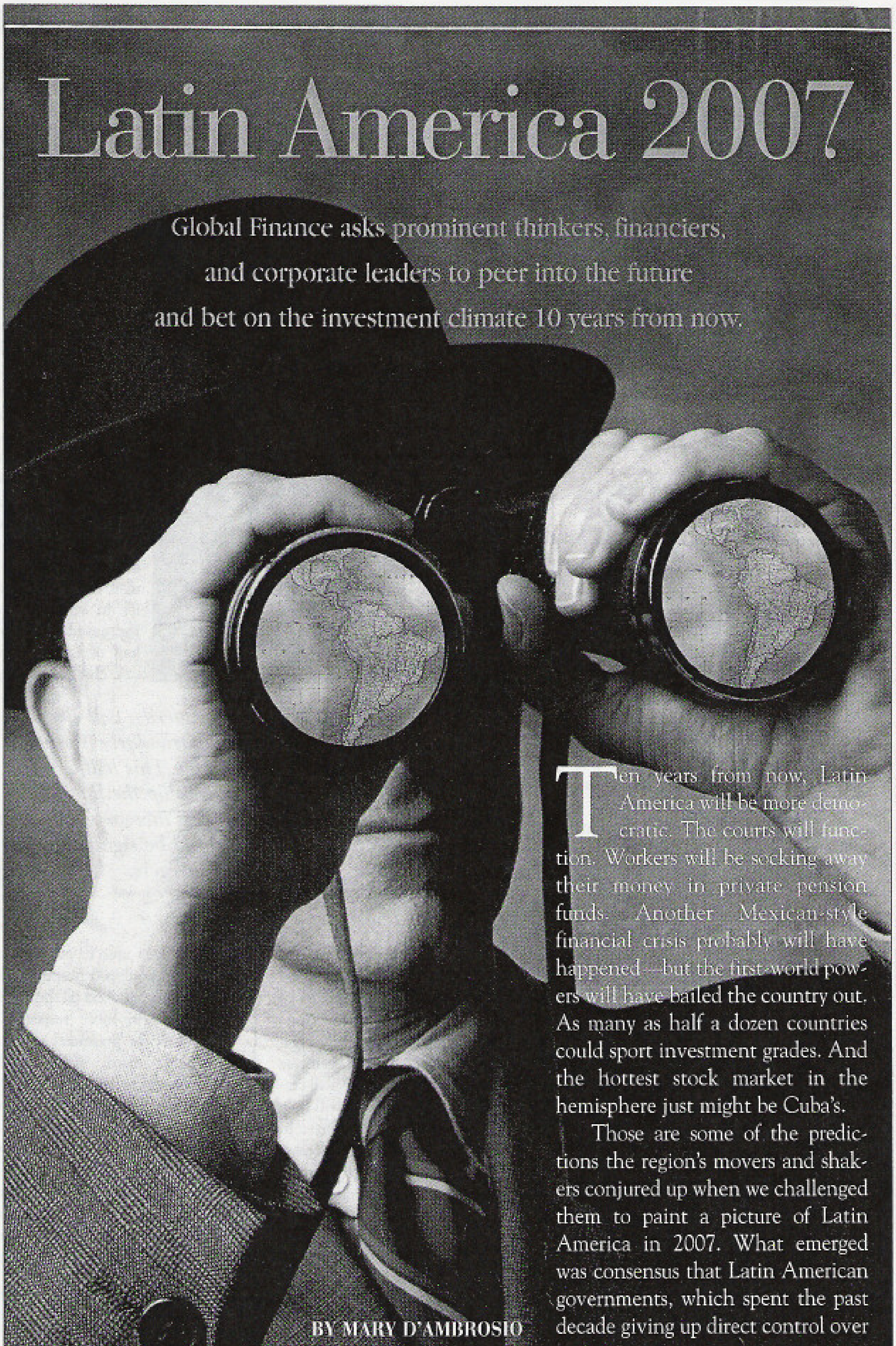
SPECIAL REPORT



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Latin America 2007

Global Finance asks prominent thinkers, financiers, and corporate leaders to peer into the future and bet on the investment climate 10 years from now.

BY MARY D'AMBROSIO

Ten years from now, Latin America will be more democratic. The courts will function. Workers will be socking away their money in private pension funds. Another Mexican-style financial crisis probably will have happened—but the first-world powers will have bailed the country out. As many as half a dozen countries could sport investment grades. And the hottest stock market in the hemisphere just might be Cuba's.

Those are some of the predictions the region's movers and shakers conjured up when we challenged them to paint a picture of Latin America in 2007. What emerged was consensus that Latin American governments, which spent the past decade giving up direct control over

"The countries that are going to be most successful are the ones that can organize the better governments. Education is a critical task. More than half of the kids who should be in high school are not. These kids are going to be around for the next 60 years."

– Ricardo Hausmann, chief economist, Inter-American Development Bank

their economies, should spend the next decade stepping back in. But this time the focus is on strengthening young democracies, following policies that stoke growth, cleaning up judicial systems, and making sure the fruits of reform reach the general population.

"Governments and politicians have to be able to sell their economic reform programs to the public at large, to make sure the proper backing is available," says Citibank vice chairman William Rhodes. Rhodes, perhaps more than any other banker in the world, is in a position to look forward clearly. Billions of dollars were outstanding to Citibank when Mexico, Brazil, Argentina, Venezuela, and other Latin countries defaulted on their debts to international banks in the early 1980s. Rhodes spent a decade leading negotiations between Latin governments and the world's large banks to restructure the debts and return the region to creditworthiness. He considers Latin America's economic future extremely bright: "The perception around the world is that Latin America will be one of the hot areas for growth well into the next century," he says. "People are now looking at Latin America as one of the best places to invest."

Ana Patricia Botin, CEO of Santander Investment, the investment banking affiliate of the Spanish bank making an enormous push into Latin America, stresses the link between market development and pension fund reform. "The financial markets of Latin America will clearly continue to deepen and widen, particularly if private pension programs continue growing," Botin says. "This will create a pool of savings that will help develop the financial markets. In banking, competition will increase and financial margins will narrow, close to the levels recorded in the more developed financial centers of the world. Savings and competition, together with more transparent accounting and regulatory practices, could lead to significant bank consolidations and mergers." Banco Santander Chile recently merged with Banco Osorno, beginning a merger wave in Chile. Santander's recent purchases of Banco Mexicano in Mexico, Banco de Venezuela in Venezuela, and Bancoquia in Colombia "will also energize these markets," she adds.

Education, health care, and judicial reform are at the top of the list for Inter-American Development Bank chief economist Ricardo Hausmann. "Education is a critical task," Hausmann says. "Latin America has been a laggard in its accumulation of human capital. Inequality in schooling has increased." About half of Latin America's children of high school age aren't enrolled in school. Ill-equipped hospitals need more resources. And public service needs to win more respect. "A judge must be presumed to be an honorable man, if honorable men want to become judges," Hausmann says. The next reforms should be about strengthening the education, health, and judicial systems, he says— topics that will be key issues at the IADB's annual meeting this month in Barcelona.

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"The perception around the world is that Latin America will be one of the hot areas for growth. We're prepared to buy more banks. We're looking at more branches."

– William Rhodes, vice chairman, Citibank

"Until NAFTA can redeem itself, it seems premature to assume total freedom of trade in Latin America."
– *Kees Sanders, Systems Union*

poverty line, the fight against poverty should be as important as macroeconomic stability," says Isaac Cohen, Washington director of the United Nations Economic Commission for Latin America and the Caribbean. "The challenge is to accomplish both simultaneously."

Many think it likely that another Mexican-style economic crisis will materialize somewhere over the next 10 years: "The 'tequilazo' was not expected, yet it happened," points out Kees Sanders, Latin American regional manager for the US software company Systems Union. "As long as governments have reasons for not divulging growing problems within their economies, it seems naive to assume that it will never happen again."

"A Mexico-style currency crisis will remain a permanent possibility, given the rapid movement of capital flows in international markets," says Roberto Salinas Leon, executive director of the Mexican think tank CISLE. Rogelio Ramirez de la O, director of the Mexican consulting firm ECANAL, thinks countries "with the greatest income inequalities and lack of democratic institutions" will be most prone to future economic crises.

But Joyce Chang, chief of Merrill Lynch's prodigious emerging markets research team, points out that countries have taken preventive measures, as Argentina did by issuing a $6-billion repo facility to bolster its reserves, and as Venezuela did by establishing a macroeconomic stabilization fund.

Our commentators seem confident that another crisis would stir the US government or the International Monetary Fund to the rescue, anyway. "Given the success of the Mexico financial assistance package and official creditors' willingness to continue to work with smaller countries such as Bulgaria, I believe that the international response would be to avert a crisis," Chang says.

Indeed, Latin nations as a group are growing more, not less, creditworthy. "The credit outlook for the major countries in Latin America is more favorable than at any time during the past three years," says Lacey Gallagher, Standard & Poor's Latin America sovereign ratings director. Single B credits, a category that includes Brazil, Venezuela, and the Dominican Republic, have traditionally exhibited a 29% default rate over a ten-year horizon. But she points out that investors have "a 71% probability of receiving full and timely debt service in the year 2007."

FDI Will Break Records

"Foreign direct investment will go back to the highest levels seen in the 1970s," predicts Citibank Brazil President Jose Monforte, gravitating toward telecommunications, energy, automotives and durable goods.

"The next three years will bring increased growth, fueled by privatization in sectors formerly sacred, such as telephone monopolies," says Kees Sanders. "And that will generate momentum for technological development."

FDI, attracted by low inflation and economic and political stability, is already rising powerfully. Last year ECLAC tallied it at $30.8 billion, up from $21.6 billion in 1995 and just $6.6 billion in 1990. Other countries besides Brazil, Mexico and Argentina are beginning to see more of it: Colombia, Chile, Venezuela, and Peru are all receiving significant flows. Interestingly, FDI flows were undamaged by the Mexican crisis. "The very countries that had made efforts to encourage [FDI] were best equipped to weather the storm," ECLAC found.

A Single Free Trade Agreement?

Some commentators expect a single free trade area for Latin America by 2007, while others see the strengthening of two separate blocs. But no one suggested that Latin America would reinstitute

"The Brady bond market will virtually disappear in Latin American countries. Latin governments can refinance the bonds more cheaply by offering country risk directly to investors."
– *Joyce Chang, managing director, Merrill Lynch*

"Dropping mortgage rates and the creation of a market for mortgage securitization will create a real estate boom in Argentina."
– *Fernando Elsztain, IRSA*

protectionism.

"If the World Trade Organization and free trade in general are successful, I think that over the next ten years global trade will blossom strongly," says Botin. At least, she expects, Chile will be part of NAFTA by 2007.

"There's a reasonable hope that you could have some sort of free trade area," says Rhodes.

Others see trade developing along at least two blocs. "There will be freer trade and free trade agreements in the hemisphere, but there seems to be no basis for a single trade bloc," says Ramirez. That's because national interests differ: Regional blocs such as Mercosur will likely endure and even deepen—but as they respond to regional interests, the agreements will be harder for outsiders to reach. Roberto Salinas Leon, executive director of the Mexican think tank CISLE, forecasts the expansion of NAFTA, Mercosur, and the Andean Pact; a Central American common market—and bilateral treaties between blocs.

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The stance of Brazil and the United States will be key. "It is very likely that a hemispheric free trade zone will develop over the next 10 years," says Citibank's Monforte. "It would seem that the axle of power would be aligned around the United States at the north and Brazil at the south."

But some doubt there can be a unified trading area by 2007. "Until NAFTA can redeem itself, it seems premature to assume total freedom of trade in the area," says Sanders. Cohen says at least three conditions must be met if the region is to create a free trade area for the Americas by 2005, the plan hammered out in Miami in December 1994 among President Clinton and 33 Latin American and Caribbean heads of state. "First, the United States must exercise leadership," Cohen says. "Second, Brazil and the United States . . . must agree on the same objective; and third, there must be a consensus building process to incorporate all the economies of the hemisphere."

"NAFTA lost momentum, and Latin America seems to be getting too little attention in the United States," says Ruth de Krivoy, Venezuela's former central bank president, who has founded the consulting firm Sintesis Financiera.

The Hottest Stock Markets

Mexico and Brazil were almost everyone's first choices. Commentators said the best markets would be in larger countries, furthest along in economic and market reform, with more listed companies to provide liquidity, and more privatization to create listings.

But there were surprises. "In 10 years, it will be Cuba—and Haiti in five," predicted ANZ Investment Bank emerging markets research chief Jerome Booth. These are untapped markets, with assets ripe for privatization. "Cuba is number one," agreed ECANAL's Ramirez, citing "untapped demand for capital, good education and health systems, some natural resources, and good geographical location."

Watch to see which countries are making the best progress toward reforming pension systems—policies which will generate domestic savings, suggests Botin. "Argentina, Peru, Uruguay, Mexico, and Venezuela, which have introduced or are in the process of introducing pension reforms, will be big winners in terms of deepening the capital markets," she says. Chile, the first to establish a private pension fund system, has a domestic capital markets capitalization equal to about 55% of GDP; most Latin countries only have 20% to 25%, she notes.

Joyce Chang chose Brazil and Mexico. "Brazil boasts the largest and most dynamic private sector in the region and still has more major assets to privatize than any other Latin country," she says. Mexico will profit from its position as the entryway for US investors into Latin American securities.

By 2007, at least half a dozen Latin American sovereign borrowers are likely to be rated investment grade. The credit outlook for the major countries in Latin America is more favorable than at any time during the past three years.
– Lacey Gallagher, Latin American sovereign ratings director, Standard & Poors