

FRIEDBERG'S

LDC DEBT COMMENTS

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Argentina

Summary and recommendation

Yields on Argentina's foreign debt have soared well beyond 20% per annum in the narrow and esoteric bank secondary market. While, in our opinion, an eventual work-out of Argentina's debt will assure investors of an above-average return (albeit substantially lower than the current one), we have discovered a more sensible way of accepting Argentina sovereign risk — and with a still-generous 20+% return.

Investors with a low degree of risk aversion may read on.

Background

Argentina's economic performance in the post-war period has been dismal. Growing state control of the economy, a disastrous policy of import substitution, raging, and at times uncontrollable, inflation, and erratic foreign exchange policies have all contributed to lowering Argentina from its elevated prewar ranking as the eighth most prosperous economy in the world to a lowly sixtieth.

The Alfonsín government inherited from the military an economy in shambles. Yet, despite its popularity, it was unable to address the country's main economic problem. In mid-1985, it tried shock therapy to arrest a price spiral that was reaching close to 30% *per month*. The most fundamental reform of the Austral Plan — that of pledging to preserve the new Austral parity at US\$1.25/Austral by stabilizing domestic credit, i.e., not printing money — was flawed. Given the sizable fiscal and provincial budgetary deficits, that pledge was a pipe dream. Three years later, the Austral is only worth US\$0.11, and inflation is once again climbing to the 20% monthly rate.

The specter of hyperinflation is baring the nation's most intractable problem: an insatiable public-sector burdened with a growing, inefficient, and paralyzing bureaucracy in constant search for new taxation schemes to finance its drunken ways.

Taxes take the most ridiculous forms and shapes: forced savings, retention on agricultural exports (what a way to encourage them!), taxes on cheques (purportedly to diminish velocity of circulation), and a recently-introduced bill that

seeks to tax cash payments if they are meant to get around the usage of cheques! The list is endless.

Since this fiscal desperation runs counter to the Laffer-curve principle, it is no wonder that fiscal revenues continue to trend downwards. Tax evasion and a shrinking GDP lifted the 1987 fiscal deficit to 7% of GDP.

Winds of change

The only genuine solution is to cut government expenditures and, more particularly, severely atrophy the bloated bureaucracy. There are signs that the Alfonsín government, and even the main opposition Peronistas, are hearing the message.

The respectable Public Works Minister, Mr. Rodolfo Terragno, has begun to privatize partially two of Argentina's sacred cows: Entel (the telecommunications monopoly) and Aerolíneas Argentinas (the national airline). What is most encouraging is the fact that 40% of these public companies are being sold to capable and profit-maximizing foreign companies, despite strident nationalistic opposition.

Moreover, YPF, the state oil company, has been forced to liberalize foreign participation in oil exploration. Ferrocarriles, the state's railway company and the cause of a huge, persistent and 40-year-long financial drain, is being rumored as a privatization candidate.

Foreign debt

Argentina's foreign debt has soared since 1983 as the nation's exports have been hit by contraproductive export taxes, an overvalued currency, deteriorating terms of trade and an extremely poor infrastructure. Alone among the world's largest debtors, Argentina's exports last year were 19% below those achieved in 1983. Better crop prospects, the virtual elimination of the odious export tax and a sizable increase in grain prices will raise significantly this year's exports to produce a trade surplus in the neighborhood of \$3 billion compared with last year's meager \$490 million.

In sum, a shrinking taxable base (a product of decapitalization, falling incomes, and the growth of the underground

economy) and hyperinflation have foreclosed Argentina's revenue-raising option. The only avenue left is privatization and massive public sector layoffs. Terragno, rumored to be the next finance minister, may be Argentina's man of the hour.

Argentina's debt trades at a discount of as much as 72% from face. In effect, a courageous buyer today would receive (if Argentina pays, of course) a current return of 27% *per annum*. Given Argentina's stagnating, and at best erratic, export performance, it is hard to see how Argentina can fully honor its bank debt at face value, or equivalently, at present rates of interest, *without* receiving continuous doses of "new money." At the same time, commercial banks are unlikely to advance fresh money given the value of the debt in the secondary market. Without fundamental economic reform, Argentina is caught in a catch-22 situation.

Restructuring

Companies on the edge of bankruptcy will restructure their obligations to make the burden of the debt more bearable and more in keeping with their economic possibilities. At this stage of the game and given the level of real rates of interest, Argentina's debt capacity is probably no greater than \$25 billion to \$30 billion.

Alternatively, Argentina could service the approximately \$53.9 billion of gross foreign debt at rates of interest not exceeding 4% per annum. A future work-out of this debt would therefore cut its face value by 40% to 45%. Or, what is more elegant, the debt will be renegotiated to yield 4% per annum.

A buyer today of Argentina's debt in the secondary market will face the inconvenience of repeated halts in interest payments until a proper workout has been achieved. After restructuring, he will earn an approximate *current* return of 13% per annum (buying debt at 30¢, which yields 4% on the face par value) and possibly more to maturity, even though maturities will be extended at least 20 and possibly 30 years.

A better alternative for the investor

A small portion of Argentina's external debt (approximately 6%) is in the form of bearer bonds, called "Bonex." Debt service on these bonds has never been interrupted, and chances are that they will be paid in full, simply because they are held by thousands of anonymous investors with whom no rescheduling or restructuring can be negotiated. In crude terms, a halt in debt service to Bonex holders would constitute a default while a halt in debt service to the international banking community would be called, at worst, a partial debt moratorium until the next rescheduling.

Argentina external dollar bearer bonds (Bonex): history and characteristics

The Argentinian government decided to issue Bonex, which are strictly bearer securities, in order to capture for-

oreign exchange that otherwise would be placed abroad. These instruments were first issued in 1980, i.e., prior to any contemplation of Argentinian external debt restructuring.

Bonex, like floating rate note obligations, are considered to be capital market instruments and are not subject to refinancing under the Republic's various debt rescheduling programs. Bonex provide a legal and formalized way for Argentinians to hold foreign currency interest-bearing obligations that are readily convertible. Bonex are bearer instruments, freely transferable in an out of Argentina.

The government has always fully serviced these obligations. Although Bonex are bearer bonds, and it is therefore impossible to determine definitely who holds them, it is estimated that in excess of 75% of Bonex outstanding are held by Argentinian individuals or corporations.

The four outstanding series, which were issued in 1980, 1981, 1982 and 1984, have 10-year maturities with amortization of principal after a two-year grace period in eight equal annual installments, each representing 12.5% of principal. Bonex bear an interest rate that is adjusted semi-annually and that is equal to the 180 day LIBO deposit rate of Banco de la Nation Argentina.

The Central bank makes interest and amortization payments in cash or through transfers to New York, London, Frankfurt, and Zurich at the option of the holder of the bond. Payments may be settled in US dollars, pounds sterling, German marks, or Swiss francs, although they are almost exclusively paid in US dollars.

Bonex may be purchased in either the primary or secondary markets. The primary market consists of public subscriptions to the bonds issued by the central bank. Each subscription is made through financial institutions authorized to act in these markets and payment is made in either Argentine pesos or US dollars.

The secondary market consists of securities transactions carried out once the bonds have been released into the market through central bank subscriptions. There currently exist active secondary Bonex markets in Buenos Aires, Montevideo, and New York. There are no limitations with regard to amount or purpose of purchase. Roughly 75% of secondary market operations take place in the Buenos Aires stock exchanges and through Argentine over the counter (OTC) trades authorized by the National Securities Commission to deal with securities outside the stock market. Around 15% of market volume is transacted by banks, brokerage houses, exchange houses, and OTC traders in Montevideo. The balance is negotiated by financial institutions and intermediaries in New York.

The secondary market on a normal day will handle approximately US\$10 million in transactions. The most traded issue is the Bonex of 1982, which is also the largest. Other issues trade using the 1982 issue as a benchmark. The 1982 issue currently commands a price of approximately 80%, however, it has been traded as high as 90%, reflecting a previously more favorable parallel exchange environment. *Bonex trade in the secondary market without accrued interest,*

although clearly the price of Bonex will rise (or *should* rise) as we move to interest payment date.

Fees and commissions

Aside from a collection fee (see below), FMG will *not* charge any additional fees or commissions.

Collection fees: 3% of interest collected.
1% of amortization collected.

Conclusion

We recommend the purchase of Bonex 1982 series for risk-conscious accounts.

We offer, as principals, Bonex Series 1982 at 80½, equivalent to \$40.25 on the \$50 residual value. Assuming a LIBOR coupon of 7% through February 1992, this price will show an eternal rate of return of 24.5%. Price subject to change.

Chart 1
Argentina Bonex terms and conditions

Series	1980	1981	1982	1984
Issue date	11-27-80	6-10-81	2-15-82	12-20-84
Amount (million US\$)	500	1,000	2,000	2,000*
Guaranteed minimum interest rate (%)	None	None	None	None
Mark-up over 6-month LIBOR (%)	None	None	None	None
Interest rate on current coupon	7.75	8.0625	7.0	8½
Current coupon number	16	14	13	7
Coupon maturity date	May 27 Nov. 27	June 10 Dec. 10	Aug. 15 Feb. 15	June 20 Dec. 20
Final maturity date	Nov. 90	June 91	Feb. 92	Dec. 94
Residual capital value of certificate (%)	37.5	50.0	50.0	87.5
Amount outstanding (million US\$)	188	500	1,500	875
Capital repayment schedule in 8 annual installments commencing	11-27-83	6-10-84	2-15-85	12-20-87
Price as of June 6/88			40.25	
IRR (%)			24.5%	

*Authorized issue; however, only US\$1 billion has been issued.

Chart 2

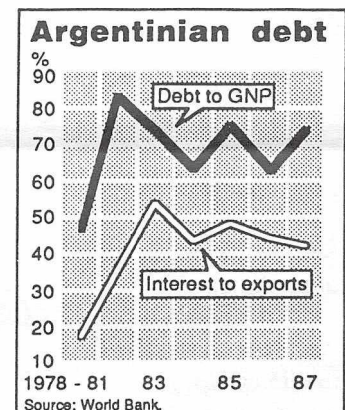
	1982	1983	1984	1985	1986	1987
Money, prices and salaries (Growth rates)						
Domestic credit.....	224.0	400.8	565.7	356.1	86.8	
Public sector.....	206.4	669.8	549.4	389.7	68.1	
Private sector.....	247.5	345.5	576.2	345.4	93.2	
Money supply (M1)	176.3	362.0	546.7	697.9	70.7	
Consumer prices (annual average).....	164.8	343.8	626.7	672.2	90.1	
Real wages	-10.5	29.3	16.0	-14.5	-5.7	
Exchange rate (Annual Average)						
Official rate (national currency units per dollar)	0.00217	0.01054	0.06779	0.60120	0.94303	
Real effective exchange rate (Index 1980 = 100).....	258.3	221.8	193.6	230.1	190.0	
Terms of trade (Index 1980 = 100).....						
	89.1	86.4	93.8	82.2	75.7	
Balance of payments (Millions of dollars)						
Current account balance.....	-2,241.4	-2,439.0	-2,391.0	-953.0	-2,641.0	
Merchandise balance.....	2,583.6	3,710.5	4,003.0	4,630.0	2,595.0	
Merchandise exports (FOB)	7,156.9	7,833.6	8,107.0	8,396.0	6,987.0	6,350.0
Merchandise imports (FOB).....	4,573.3	4,123.1	4,104.0	3,766.0	4,392.0	5,860.0
Net services	-4,857.3	-6,166.0	-6,397.0	-5,583.0	-5,241.0	
Transfers	32.2	16.0	3.0	0.0	5.0	
Capital account (net).....	1,979.3	410.5	2,759.0	397.0	516.0	
Change in net reserves (- = increase).....	640.7	2,473.7	-265.0	556.0	2,125.0	

Chart 3

	GROSS FOREIGN DEBT (In billions of dollars)	INTEREST PAYMENTS ON FOREIGN DEBT AS PERCENTAGE OF EXPORTS	INFLATION CONSUMER PRICES (Buenos Aires)	ECONOMIC GROWTH (Percent change in gross domestic product)	EXPORTS (In billions of dollars)
1983	\$46.9	55%	433.7%	2.9%	\$7.83
1984	49.2	56	688.0	2.5	8.10
1985	50.7	50	385.4	-4.4	8.40
1986	51.7	49	81.9	5.4	6.85
1987	53.9	48	174.8	1.4	6.35

Source: International Economic Data, Morgan Guaranty Trust. Co.

Chart4



Financial Times

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