

# FRIEDBERG'S

## LDC DEBT COMMENTS

Friedberg Mercantile Group



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## Swapping Brazil for Argentina

### Brazil

The reformist, "right-wing" candidate Collor de Mello's electoral win was too narrowly based to provide him with the powerful mandate required to reform the Brazilian economy. At the very outset, he will be deeply enmeshed in a political guerilla warfare over the issue of removing corrupt officials. Since there are tens of thousands of these spread out over the vast Brazilian territory, all with varying degrees of political clout drawing on powerful vested interests, it is reasonable to assume that his strength will be sapped relatively early on.

Furthermore, well-intentioned legislative initiatives will get bogged down, or diluted at best, in Congress, where his tiny party will have to negotiate innumerable compromises.

In addition, there will be formidable resistance that will be put up by a relatively well-organized left led by the charismatic Marxist leader Luis Inacio Lula da Silva.

Finally, Collor will govern with his hands tied behind his back by a fatally flawed constitution, one that prescribed by law the maximum real rate of interest (in a country whose internal debt at US \$70 billion (!) rolls over daily because of a lack of confidence), the share of natural resources ownership that foreign investors may own, the work-week (shorter than any high standard European country), and so on.

To top it off, Brazil's inflation rate has reached the hyperinflation stage, with December's rate at well over 50%

monthly. The spread between the official and the unofficial cruzado/dollar rate remains at an unhealthy 120% (see Chart 1), a situation that spells continuous capital flight, a deteriorating trade surplus (down to \$14 billion this year from \$19 billion last year) and the virtual exhaustion of international reserves.

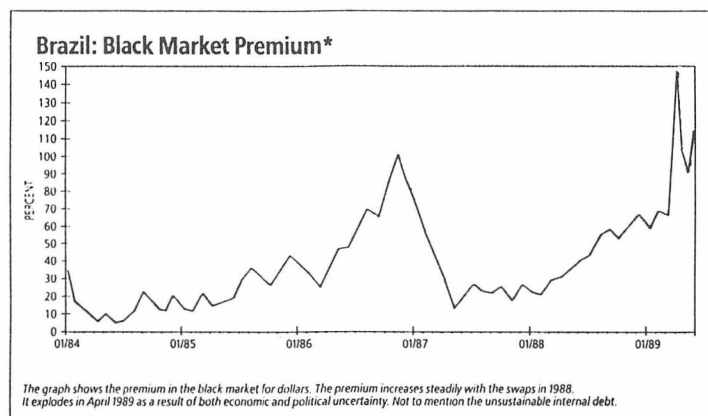
Brazil's moratorium on foreign debt has allowed it to build up reserves to a *rumored* \$7 billion, at the cost of losing most short-term international lines of credit. As we predicted in our June 18, 1989 issue, Brazil paid its October 15 coupon despite the cease-payment on the rest of the foreign debt. We continue to believe that default on the external debt is unlikely *unless the country runs out of reserves*. This is certain to happen if the spread of black market dollars over official dollars remains as wide (and, surely, if it widens) as it is today.

Given the hyperinflationary stretch yet to be travelled before Collor's assumption in March, and the difficulties we foresee for him during his first few months in office, we'd prefer to liquidate our Brazilian external bonds, first recommended in June 1989 at a price of 51, and now trading at 57. During this period, we earned a current annual return of 22% plus an annualized capital appreciation of 23.6%, for a total annualized return of approximately 45.6%.

We will be monitoring events closely for a new reentry point.

**Last Brazil update: June 18, 1989**

Chart 1



LatinFinance

Chart 2  
Brazil external debt ratios  
(US\$ millions)

	1983	1984	1985	1986	1987	1988	Projected	
	%	%	%	%	%	%	1989 %	1990 %
T1. external debt/exports of goods and services	400.5	347.3	363.3	445.7	432.2	325.3	315.5	295.6
T1. external debt/GNP	50.1	52.6	49.1	42.0	39.4	34.5	31.0	30.3
Interest on public long term debt/GNP	4.8	4.5	4.2	3.3	2.2	3.7	2.7	2.6
Floating rate debt/exports of goods and services	79.2	78.9	75.5	72.9	72.1	82.2	83.3	82.4
Concessional debt/exports of goods and services	1.6	1.5	1.5	1.5	1.3	1.3	1.3	1.2

Source: 1989 World debt tables, International Bank for Reconstruction and Development.

## Argentina

The catastrophic fall in the standard of living over the past 20 years culminated with the onset of hyperinflation last May. This forced President Alfonsin to hand over the reins of government to the newly-elected president Mr. Carlos Menem, six months ahead of schedule.

A charismatic politician, once in power Mr. Menem turned his back on Peronism and its sequel of statism and cronyism and appointed a member of the Bunge Born conglomerate to carry out a plan of economic liberalization. Facing hyperinflation (July prices had risen 196%), the government's first priority was the application of a shock program to tame the beast. The implementation of the plan was flawed *ab initio*.

In the medium to long-term, Argentina has to restructure (or better yet, completely revamp) its economy: The government has to privatize its state-controlled enterprises, the largest 12 of which account for well over half of the nation's fiscal deficit, it must simplify and reduce taxes, it must slash import quotas and tariffs, it must eliminate export retentions, it must break up labor's monopoly, and so on. This was well understood by the Menem people. Unfortunately, the fossilized bureaucracy and a Congress dominated by dirigistic elements (both Peronists and Radicals) blocked in countless ways enabling legislation.

Instead of popular capitalization as in Chile or even the UK, privatization is proceeding in a typical Argentinian style: sale of monopolies to the private sector, to the fortunate handful of industrialists with close ties to the ruling class. Disenchantment among the population at large may, we hope, change the methods of privatization that will be used in the future.

Tax reform, i.e., lower rates applicable to a greater number of taxpayers, was passed last week, but the virtual bankruptcy of the state forced it to pass simultaneously a \$630 million "emergency tax collection," a typical Argentinian incoherency.

The State is unable to borrow any longer (it declared a two-year moratorium on *internal* debt), and it is unable to collect taxes from more than 50,000 taxpayers. It must therefore cut spending, which still includes billions of dollars of subsidies, but it has, as yet, not found the time to tackle this problem rationally, because it has continued to worry, *first*, about hyperinflation and the value of the austral (which has fallen from US\$0.058 in January 1989 to a recent US\$0.00066) — *form rather than substance*.

The initial stabilization plan put forth by the Minister of Economy, Mr. Rappanelli, contained four major errors: 1) it fixed the austral at 650 to the dollar, contrary to the wishes of his own Central Bank, despite the fact that it had not eradicated the source of inflation (the 70% rise in prices *since July* clearly overvalued the austral); 2) it left in place an odious export retention tax (as a source of fiscal revenue), thus killing any hope of an export-driven economy; 3) it sought to obtain a single-digit monthly wage and price pact (a typical feature of previous stabilization plans) while 4) it unleashed a huge expansion of money on the (incorrect) theory that returning confidence and stabilization would increase the demand for money, i.e., monetize the economy, and offset the inflationary implications of the surge in supply.

On all four accounts Rappanelli was wrong. While admittedly he sought only to gain time with these measures

while the administration was moving to implement long-term, structural reform, the hypersensitive Argentinian money market rejected the cosmetic arrangements: The black market austral began to distance itself from the official rate, day by day (in Argentina that always spelled the death of any ongoing "stabilization plan") until it forced Rappanelli to an official devaluation: from 650 to 1000 australes to the dollar.

The tampering did not stop there: He raised the export tax, declared a two-year moratorium on the internal debt and reintroduced (for the nth time in Argentinian's economic history) a dual exchange rate. Rappanelli's fate was sealed, and he resigned. While Menem's credibility had suffered a substantial blow, he still enjoyed enough political capital to stage a comeback.

Proving to the nation that he had, in fact, been converted to the cause of economic liberalism, Menem appointed Antonio Erman Gonzales, a close personal friend, who immediately 1) floated the austral, unifying the exchange rate and legalizing the purchase and sale of foreign currency; 2) eliminated the export retention tax; 3) dismantled all wage and price controls; and 4) pledged to continue Menem's plan of reform.

In addition, Menem appointed Rodolfo Rossi as the new president of the Central Bank, a man known for his advocacy of a strong currency and of Central Bank independence. In his first day in office, Rossi pledged that he will stop printing money, saying that "as of today (Dec. 19), interest rates will

be set by the market." By Friday, December 22, local interest rates had shot up to 100% for 30 days, a real rate of 50% monthly after taking into account an anticipated inflation of 50% for the next 30 days. The 'Plan Erman' was daring and correct.

With one stroke, the government of Mr. Menem has relieved itself of the necessity of having to lose reserves to needlessly maintain an overvalued currency; put the monetary mechanism in place to obtain true reductions in inflation; increased, via the free disposition of export proceeds at equilibrium rates, the supply of dollars; and removed the impediments to a more proper allocation of resources. Menem has gained crucial time to implement the long, arduous phase of economic reform. In coming weeks and months, we will be monitoring closely the pace of these reforms.

Keeping in mind the incredible fluidity of Argentinian politics, we feel confident enough to recommend once again, to risk-conscious accounts, the judicious purchase of Bonex 1982 series. We offer, as principals, Bonex Series 1982 at 87.65, equivalent to 32.87 on the 37.50 residual value. A one-time government tax of 4% is applicable to the February 1990 coupon. Assuming a LIBOR coupon of 8.3654 through February 1992, the price will show an internal rate of return of 22.16%. Price subject to change.

For a full description of Bonex, see our *LDC Debt Comments* of June 13, 1988.

**Last Argentina update: November 7, 1988.**

**Chart 3**  
**Argentina external debt ratios**  
(US\$ millions)

	1983	1984	1985	1986	1987	1988	Projected	
	%	%	%	%	%	%	1989	1990
							%	%
T1. external debt/exports of goods and services	461.4	474.7	470.0	547.9	660.7	527.2	457.1	452.4
T1. external debt/GNP	77.3	67.5	81.5	66.8	73.9	74.6	67.5	64.0
Interest on public long term debt/GNP	9.1	6.0	8.4	5.8	5.4	6.1	5.8	6.5
Floating rate debt/exports of goods and services	84.8	85.9	82.9	81.4	79.9	77.7	84.2	83.1
Concessional debt/exports of goods and services	.5	.5	.4	.4	.4	.3	.3	.2

Source: 1989 World debt tables, International Bank for Reconstruction and Development.

## A Tale of Horrors (Cry for me, Argentina)

- Between 1965 and 1987, 13 state-owned enterprises incurred an accumulated deficit of US\$52.3 billion...

This works out to an annual deficit of US\$2.37 billion on average annual expenditure of US\$8.47 billion...

- The Treasury covered 69.1% of their deficit, approximately US\$1.6 billion per annum...

Borrowing US\$700 million, they ran up total debts of US\$19 billion compared with Argentina's total external and internal debt of approximately US\$73 billion...

The cost of their deficit to the Treasury amounted to 2.5 times defence expenditures, 6.5 times social security expenditures, 5 times health expenditures, 2 times education expenditures...

- Subsidies to the *private sector* (in 1986) amounted to a whopping US\$4 billion...

Equal to 7% of GDP, 70% of the public sector deficit, 70% of public investments, 37% of wages paid by the national government, 23% of tax revenues...

Friedberg Capital Markets is a division of Friedberg Mercantile Group, a securities dealer and futures commission merchant. Friedberg Mercantile Group and Friedberg Commodity Management Inc. are under common beneficial ownership, control and management.

Chart 4

### Argentina Bonex terms and conditions

Series	1982
Issue date	2-15-82
Amount (million US\$)	3,000
Guaranteed minimum interest rate (%)	None
Mark-up over 6-month LIBOR (%)	None
Interest rate on current coupon	8.3654%
Current coupon number	16
Coupon maturity date	Aug. 15 Feb. 15
Final maturity date	Feb. 92
Residual capital value of certificate(%)	37.50
Amount outstanding (million US\$)	1,125
Capital repayment schedule in 8 annual installments commencing	2-15-85
Price as of Dec. 26/89	87.65%
IRR (%)	22.16%

Chart 5

### 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.

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