

FRIEDBERG'S

LDC DEBT COMMENTS

Friedberg Mercantile Group



Volume 3, No. 1 January 28, 1990

Chile

After 16 years, General Augusto Pinochet is stepping aside as Chile's president. However, the Constitution gives him the right to remain as commander of the army for eight more years. General Pinochet will turn over the reigns of government to Mr. Patricio Aylwin, a Christian Democrat who headed a 17-party, center-left coalition in Chile's recent elections (December 14, 1989). This profound change in Chile's political landscape requires comment about where that country's economy has been and what course it will take in the future.

Pinochet's promises fulfilled

The press has taken great delight in maligning General Pinochet. However, the record shows that he has successfully delivered precisely what he promised in 1973. In addition to restoring democracy, General Pinochet has engineered a deep transformation in the Chilean economy. Specifically, he inherited a deeply troubled socialist system and molded one of the world's most free-market economic orders. This was no small task. Indeed, that economic transformation has never been accomplished before. Needless to say, those in Eastern Europe who sincerely wish to scrap socialism and replace it with free markets should have a chat with General Pinochet. This would certainly be more productive than listening to the theorizing herds of economic gurus who have invaded Eastern Europe.

The remarkable economic legacy left by General Pinochet is summarized in the data contained in Charts 1 and 2. In 1989, Chile turned in a sizzling performance, with real growth at 10%. Unemployment hit a record low at 5.9%. Over the past six years, the Chilean economy has become one of the world's most effective job machines, generating an incredible 1.2 million new jobs. Exports have contributed strongly to that phenomenon, growing at an annual rate of 10% per annum over the most recent six years. Even though that country has been in a boom, which has sucked in record-level imports, and faced unfavorable terms of trade, exports have been so robust that the trade balance has remained positive.

Growth and prudent fiscal management have generated fiscal surpluses and allowed the state to shrink in relative terms. External debt is, through an innovative debt conver-

sion program, trending downward. If this weren't enough, there appears to be adequate growth fuel in the economy. For example, investment projects underway, but not yet on stream, amount to \$15.5 billion, or 60% of GNP. In addition, there is perhaps \$600 million of foreign investment that will move into this new "Asian Tiger" during 1990.

Although low by Latin standards, inflation, at 21.4%, is somewhat troublesome. Indeed, in an attempt to cool down the economy and control inflation, the central bank has increased interest rates three times in the last 10 months.

Chile's performance is put into a Latin perspective in Chart 2. With the exception of Colombia, Chile is the only Latin country that registered a positive growth rate for per capita real GNP in the 1980s.

The 'Chicago Boys'

To design and implement a new set of economic restructuring policies, General Pinochet has relied on a group of relatively young economists. They have come to be known as the "Chicago Boys," because many of them were trained at the University of Chicago. The Chicago Boys have their intellectual roots in the classical liberal tradition. In consequence, they have recommended economic policies that remove government intervention in markets, strengthen the institution of private property and promote its diffusion, eliminate monopoly power in the markets for labor, goods and services, promote free trade, stimulate growth through private entrepreneurship, foster the nondiscriminatory equality of opportunity and stabilize the general price level through strict fiscal and monetary discipline.

The following specific structural changes have been accomplished:

Price controls have been lifted.

Non-tariff barriers have been eliminated.

Tariffs have been reduced from an average rate of 100% to a flat 15% for all products.

Deregulation of markets has occurred. As a result, Chile has an open and active capital market.

Labor laws have been reformed and union monopoly power has been rolled back. Collective bargaining is now at the enterprise level, rather than at the national level. Strikes are permitted under the new labor law, but so are "lock-outs."

In consequence, changes in wages tend to more accurately reflect the real economic conditions in the labor market.

Mining laws have been reformed, so that clear, secure property rights can be established on mineral claims. A mining boom has ensued. In addition to increasing its hold as the world's number one copper producer, Chile is moving up rapidly in the production of precious metals. For example, with projects underway but not yet on stream, Chile will soon become the world's ninth largest gold producer and the sixth largest silver producer.

Social security, along with virtually all of Chile's state-owned enterprises, has been *privatized*. Although the system remains compulsory, the privileges that were available to some groups, notably politicians and public employees, have been eliminated. More importantly, the system has been changed from a public pay-as-you-go system to a private pension system in which participants have individual accounts that are managed by private pension companies. Competition among companies guarantees good service, low administrative costs, and high rates of return (returns are indirectly controlled because limits are placed on the types of "secure" investments in which private pension funds can invest). Today, most of the total labor force has switched from the old public to the new private system.

In addition to being beneficial in its own right, the privatization of social security has provided domestic capital for the Santiago stock exchange. Although limited in the amount and types of equities in which they can invest, private pension companies have invested in some of the newly privatized enterprises.

In one of its most recent and important moves, the government implemented a constitutional law that puts the *central bank* on an *autonomous* footing, which is similar to West Germany's Bundesbank. The constitutional law defines the central bank as "an autonomous body of technical status, with its own assets, whose composition, organization, functions, and powers shall be determined by a constitutional organic law" (Constitution, provision 97). In addition, the Constitution provides that the Central Bank may "only operate with financial institutions," though it "may not grant them its guaranty" (Constitution, provision 98, para. 1). Furthermore, "no public expenditure or loan may be financed with direct or indirect credit from [the Central Bank]" (Constitution, provision 98, para. 2), though an exception may be made "in case of external war or threat of war, as the National Security Council will determine" (Constitution, provision 98, para. 3). Lastly, the Central Bank is forbidden to establish "different or discriminating rules or requirements in respect of individuals, institutions, or agencies conducting operations of the same kind."

Under the Constitution, therefore, the Central Bank is an autonomous body. The Organic Law governing its organization and the extent of its functions and powers circumscribes the scope of its operations to financial institutions, forbids it — with one exception — to provide financing for the central government, and prevents discrimination in its operation.

The central bank's newfound independence holds great promise for Chile. To appreciate this, we consider the findings in a recent study by Mr. Alberto Alesina.

Mr. Alesina ranked central banks by their independence, the least independent assigned one "star," and the most independent four "stars" (see Chart 3). These ratings were determined on the basis of the formal relationship between the central bank and the government, informal contracts, and the rules forcing the central banks to accommodate fiscal deficits by printing more money and so forth. Given Chile's new set up, its Central Bank is now in the four, or, at worst, perhaps three star category.

Mr. Alesina found a strong inverse relationship between the degree of central bank independence and a country's inflation rate; the countries with the least independent central banks had the highest inflation rates, while the most independent had the lowest inflation rates. Mr. Alesina also confirmed lower inflation was not achieved by simply running high unemployment rates. Indeed, the four countries with the most independent central banks had lower-than-average unemployment rates.

These findings suggest that Chile, with its new independent central bank, will be relatively insulated from plundering politicians and will realize an increasingly stable monetary environment.

Staying power

To analyze the staying power of General Pinochet's free-market reforms and the future course for the economy, we must review the outcome of the elections in more detail. The new President, Mr. Aylwin, is a pragmatic man of the center. His anchor is not too heavy, and when gales blow from the left, Mr. Aylwin's ship could drift in that direction. However, in the next year the left winds should not be too strong. In the 120-member Chamber of Deputies, the left won 28% of the seats, the centrists 32% and the right 40%. In the 47-member Senate the left won only 15% of the seats, the center 32% and the right controls 53%. Given that a majority of two thirds is required in both the Chamber and Senate to institute constitutional changes, it is highly unlikely that any structural changes that would threaten the free market can be made. Indeed, the right could block any serious constitutional changes.

This said, we do anticipate several economic policy changes during the next year. Fiscal policy will become more expansive. Indeed, central government expenditures, as a percentage of GNP, will probably increase by two percentage points. This will be financed, in part, by an increase in business taxes and a reduction in the fiscal surplus. The labor law will also be a target for change. However, an increase in the minimum wage will probably be the only damage inflicted by the left's attack on free labor markets. With these policy changes, the free-market structure left in place, the new autonomous central bank (which, among other things, won't be inclined to renegotiate Chile's external debt in 1990), a set of relatively timid (for the time being) politicians, a pro-

market political coalition that can block serious threats from the left and plenty of economic fuel in the pipeline, 1990 will be another sizzling year for the Chilean economy.

STRATEGY: With the plebiscite-election uncertainty out of the way, we're now prepared to update our last recommendation (Nov. 7, 1988). The market for Chilean debt trades in a 62-64.5 range. We advise buying in the 58-60 range, if available.

Chart 1
Chile's Basic Economic Statistics
(Selected Years)

	Import Substitution Plan Implemented 1970	Political Economic Crisis 1973	Boom 1981	Recession 1982	Recovery		Growth		1989
					1985	1986	1987	1988	
GNP Growth Rate (%)	1.4	-5.6	5.5	-14.1	2.4	5.7	5.4	7.4	10.0
Inflation Rate (consumer prices %)	33.0	353.6	19.7	9.9	30.7	19.5	21.5	12.7	21.4
Unemployment (%)	3.8	negative	12.1	21.6	11.9	8.8	7.9	7.4	5.9 ¹
Central Government Expenses (% GNP)	19.8	35.7	30.3	31.2	31.6	28.2	26.1	24.0	N.A.
Fiscal Deficit (% GNP)	2.9	13.0	-2.6	1.0	2.4	1.9	.8	.8	N.A.
Exports (billion dollars)	1.2	1.2	3.9	3.7	3.8	4.2	5.2	7.1	7.4
Trade Balance (billion dollars)	0.3	0	-2.7	-0.6	.9	1.1	1.2	2.2	1.8 ²
Real Interest Rates for Short-Term Loans (%)	N.A.	—	38.7	35.1	11.0	7.5	9.2	7.4	11.8

¹November

²January-October

N.A. = not available

Chart 2
Growth of GNP and GNP per Capita in the 80's

EVOLUCION DEL PRODUCTO BRUTO Y POR HABITANTE EN LA DECADA DE LOS OCHENTA		
PAIS	Producto Bruto 1989/1980	Producto Per Cápita 1989/1980
1. Colombia	36,9	13,9
2. Chile	27,5	9,6
3. Paraguay	32,1	0,0
4. Brasil	21,0	- 0,4
5. Ecuador	25,7	- 1,1
6. Costa Rica	20,9	- 6,1
7. Uruguay	- 2,0	- 7,2
8. México	11,9	- 9,2
9. Honduras	19,8	-12,0
10. Panamá	0,4	-17,2
11. El Salvador	- 6,3	-17,4
12. Guatemala	5,6	-18,2
13. Haiti	- 4,1	-18,6
14. Argentina	-13,5	-23,5
15. Perú	- 5,1	-24,7
16. Venezuela	- 3,8	-24,9
17. Bolivia	- 6,3	-26,6
18. Nicaragua	- 9,6	-33,1

Source: *Economic Commission for Latin America*

Chart 3
Inflation, Unemployment and Central Bank Independence (1973-1986)

	Average inflation	Average unemployment	Index of Central Bank independence
Italy	13.7	8.1	1/2
Spain	13.6	11.3	1
New Zealand	12.0	2.2	1
UK	10.7	8.1	2
Finland	9.8	4.8	2
Australia	9.7	6.2	1
France	9.2	6.5	2
Denmark	8.8	7.2	2
Sweden	8.7	2.4	2
Norway	8.4	1.7	2
Canada	7.8	8.5	2
Belgium	6.9	11.9	2
US	6.9	7.2	3
Japan	6.4	2.1	3
Netherlands	5.5	7.8	2
Switzerland	4.1	0.5	4
Germany	4.1	5.7	4

Source: *Economic Policy* April 1989

Argentina

Bonex 1982 series: An intriguing speculation yielding 39.9%

No sooner had the ink on the Plan Erman (see *FLDC Debt Comments*, Dec. 26, 1989) dried, than the authorities were forced to pen a new Plan Erman II, conceived and implemented in one short, frantic week over the New Year holiday.

The problem was the following: In the past many years of fiscal and monetary mismanagement, the central bank had progressively raised commercial banks' reserve requirements in an effort to force the private sector to fund the government's soaring deficits. Reserve requirements as high as 89% meant that the biggest debtor in the marketplace was the central bank and, consequently, any rise in interest rates affected primarily the central bank, which was forced to print money to service its rising indebtedness.

This phenomenon was called the quasi-fiscal deficit, to differentiate it from the "normal" operating Treasury deficit resulting from transfers to money-losing state enterprises, transfers to money-hungry and corrupt provinces, and payroll of the oversized central government bureaucracy. With real interest rates of 6% to 10% *per month*, the quasi-fiscal deficit amounted to 9% of GNP compared with 3% for the fiscal deficit. Clearly, rising interest rates were perpetuating the hyper-inflation.

In late December, rumors swept the financial markets that the government had decided to "dollarize" the economy, a project favored by Rossi, the new head of the central bank. Given the government's holdings of disposable reserves, (US dollars and gold), the exchange rate had to be set at somewhere between 4,000 and 5,000 australes to the dollar (from 1,200-1,900 australes post Plan Erman I) so as to be able to convert all australes into dollars and eliminate, once and for all, the threat of inflationary finance. Interest rates on seven-day term deposits in australes soared to 300% *per month* (compared with an expected inflation rate for December of 50% and the same for January) as a way of compensating austral holders for the upcoming mega-devaluation.

The situation became desperate — 250% real interest rates per month were threatening, via the quasi-fiscal deficit, to unleash a hyperinflation that would topple the government.

In a matter of days, the government changed course and adopted a more modest approach: Instead of a 100% dollarization of the economy (opposed by a good number of cabinet ministers), the authorities forced the banks to pay out newly-created (they have not as yet been printed) US-dollar-denominated external bonds maturing in 10 years, paying

LIBOR every six months and amortizing yearly after the end of two years, for all maturing austral term deposits. To accommodate immediate living expenses, the government permitted the withdrawal of \$500 worth of australes per deposit.

It was estimated that more than \$3 billion of austral term deposits were being exchanged, practically the nation's entire M2. Since there were other shorter-term external bonds (Bonex) outstanding, it was possible to estimate the level at which this new issue would trade: somewhere between 35% and 40% of par. In one fell swoop, the government had 1) confiscated 60% of the value of almost every austral in the country (to be fair, the effect would have been the same if, instead, the authorities had opted for a devaluation from 1,800 australes to 4,000-5,000 australes as had been contemplate) and 2) had lost practically whatever credibility it enjoyed by forcing private parties to renege on freely negotiated contracts.

On a more positive note, the central bank has wiped out the quasi-fiscal deficit, thus eliminating the main source of money creation. It remains to be seen whether the government can follow up on this daring move and balance the books of the Treasury via layoffs and privatizations. While skepticism runs high in Buenos Aires, there is a good chance that straggling, with fits and starts, Argentina has turned the corner.

From the investor's point of view, it is clear that Argentina's lifeline hangs on its various series of BONEX outstanding. The prompt servicing of these obligations (now owned almost entirely by domestic residents and constituting practically 100% of domestic residents' liquid or other wealth) is a condition *sine qua non*, to help restore Argentina to financial and political health.

STRATEGY: *The active BONEX 1982 series, which we own, and continue to recommend, trade at 79.15% of par, enjoying an internal rate of return of 39.9%. As pointed out last month, 33.3% of the principal will be amortized on February 15, 1990, together with the payment of the semi-annual interest coupon.*

Last Argentina update: Dec. 26, 1989.

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