

# FRIEDBERG'S

## LDC DEBT COMMENTS

Friedberg Mercantile Group



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## Argentina: Stabilization at last

**Bonex 1982 series: 82¾ offered. IRR: 28.9%.**

After defaulting on its own internal debt and repudiating 70% of its currency, the state has been left without a shred of credibility, unable to pay for even the most basic services. It has therefore been forced to lay off as many as 200,000 public employees who are close to retirement (with some ongoing pay). Depleted of most of its liquid international reserves, the State was forced to float freely the austral; dollars are now bought and sold legally in the streets of Buenos Aires for the first time in 40 years. The enormous drain of the subsidization has forced the government to put up for sale Entel, its telephone monopoly, and Aerolineas, the national airline. Clearly, despair can also be the mother of enlightenment.

The interim measures have stabilized inflation and the currency. While March's inflation came close to 90% for the month, April will show the impact of the new zero-domestic-credit-creation policy, and prices may show a 0%-10% rise for the month. The austral, which in early February was trading at 6,000 to the dollar, is now practically stable around 5,000 to the dollar, despite some relatively heavy Central Bank dollar purchases.

We have been major buyers of Argentina's dollar-denominated external bonds, called Bonex, where annual yields of up to 50% were available as recently as early March. They have responded well to the recent forced liberalization moves, and

yields have fallen to below 30%. Even the stock market has begun to respond with some vigor. Optimists that we are, our Argentinean funds are fully invested. Clearly, there is no denying a speculative opportunity.

As always, the Argentinean scene is and will remain highly volatile. President Menem has lost the support of an important part of his Peronista party still bent on the preservation of old, bankrupt ideas. He is trying to forge a center-right coalition made up of some members of his party, some former luminaries like Alfonsin, the present head of the main opposition party Mr. Angeloz and the smaller libertarian party headed by Mr. Alsogaray. He faces an incredibly tough uphill battle: Lined up against him are the oligopolistic unions, big special-interest industrialists, the huge bureaucracy, and the natural distaste of the population for the harsh but necessary adjustment measures. The reform task ahead is massive. Realistic chances of his success are probably under 50%.

**STRATEGY:** *We believe that in the short run, Argentina's situation will continue to improve. In view of the still-high yields obtainable, we would be well advised to maintain our position in Bonex. On the other hand, should the external bonds trade up to the point that yields fall to 20%-22% per annum, we advise liquidating them.*

**Last update: Jan. 28, 1990.**

## Brazil: Can Mr. Collor deliver?

Although the cerebral Mr. Jose Sarney officially turned over the reigns of the Brazilian government on March 15, 1990, this darling of the international chattering class had actually stopped acting as Brazil's coachman months before. In consequence, that nation's economy was careening out of control. Inflation, for example, was surging at about 85% per month.

To remedy the situation, Brazil's new charismatic President, Mr. Fernando Collor de Mello, has come out with all guns blazing. Indeed, he has introduced a radical program to rescue the economy. It combines free-market reforms and authoritarian intervention in a bewildering mix. To gain support, Mr. Collor has used old populist tactics. For example, his post-election speeches have attacked financial markets, the business elite, and speculators. Mr. Collor's tactics have, to date, been surprisingly effective. Even though his government lacks a stable political base (his National Reconstruction Party holds only 31 seats in

Congress), the Congress approved, by a 249 to 204 vote, the heart of Mr. Collor's economic proposals.

\* \* \* \* \*

Let's turn to an evaluation of the major elements in Mr. Collor's program.

### • The Liquidity Squeeze

When Mr. Collor took office, Brazil was liquid. Indeed, the broad measure of money (M4) was about 33% of GDP, or \$120 billion. To squeeze liquidity out of the economy, the government has impounded \$96 billion for 18 months. This has left liquidity at \$24 billion, or about 7% of GDP. It would appear that this is very low, given that 14% of GDP is typical of earlier periods of stability in Brazil. If this weren't enough, the public sector (excluding state-owned enterprises — SOEs) holds 25% of the

remaining liquidity, leaving the private sector in a very tight situation.

After 18 months, \$60 billion of the \$96 billion that was impounded will be filtered back into the economy at a rate of \$5 billion per month, and the "owners" of the released funds will receive 6% interest plus an indexation adjustment for the pain that they have had to endure.

The difference between the impounded \$96 billion and the released \$60 billion (\$36 billion) will be accounted for in the following manner over the next 18 months: \$10 billion will be taxed away, and \$26 billion will be either auctioned off (old cruzados for new cruzeiros) or transformed into privatization bonds.

Financial institutions will be required to purchase new cruzeiro privatization bonds that can only be used to purchase newly privatized firms. There will be an incentive to use these bonds rapidly because they will be biodegradable, i.e., they will depreciate 1% per month up to a maximum of 40%.

That policy contains some technical pitfalls that could shake confidence and jeopardize Mr. Collor's reforms. For example, the squeeze could be too severe. Even though the squeeze is, for the time being, killing off inflation (a "good"), it is also killing off the real sector of the economy (industrial production fell 14.7% in March). This last consequence is a "bad."

As a result, the economy is going into a recession and also being destocked of industrial commodities. For example, aluminum stocks have been pouring out of Brazil and into Rotterdam and London at a record rate as Brazilian owners liquidate to obtain scarce cash. If this continues, the Brazilian shelves of industrial commodities will soon be bare. This will create massive inventory imbalances in Brazil.

If the recession forces Mr. Collor to open up the gates on the impounded funds, confidence will evaporate and hyperinflation could reappear. The hyperinflation spectre could also become real at the end of the 18-month waiting period. If confidence is waning at the end of 18 months, an injection of \$5 billion per month will cause Brazil's inflation motor to roar once again. In the monetary sphere, Mr. Collor is clearly performing a delicate highwire act. Indeed, one that does not employ a safety net.

### • The Fiscal Squeeze

The aggregate public sector deficit was 7% of GDP in 1989. Mr. Collor's proposals are intended to transform this into a surplus of 2% of GDP in 1990, or a fiscal swing of 9% of GDP.

**Administration reforms** require that 11 ministers, dozens of government agencies, and 80,000 civil service jobs (out of a total of six million) be eliminated. This proposal amounts to only 0.5% of GDP.

**Fiscal reforms** (new taxes on financial transaction, price increases for public services and excise taxes) will account for another 3% of GDP.

**Privatization of SOEs** is the super big-ticket item, accounting for 5% of GDP. Although large, the privatization program has put Brazil's largest commercial bank (Banco de Brazil), the

state oil company (Petrobras), the national telecommunications giant (Embratel), the postal service, and the nation's development banks off limits. In addition, foreign ownership will be limited to 40% of the voting capital. Moreover, the Congress has reserved the right to veto individual privatizations.

**Other fiscal squeeze measures** will add up to 0.5% of GDP.

Although we applaud the fiscal squeeze, we must conclude that it will not be met in 1990. The elements of this squeeze have been attempted on a much smaller scale in Brazil before, and they have failed. As soon as Mr. Collor begins to actually implement these policies, he will step on political toes, and progress will be slowed.

We anticipate that a great deal of trench warfare will be required for implementation, and we are not convinced that Mr. Collor's inexperienced, thin troops will be able to prevail. Indeed, if satisfactory progress (forget the 9% of GDP fiscal swing target) cannot be sustained, confidence could crumble. This would jeopardize Mr. Collor's entire program.

### • Implications

Mr. Collor has won the first major battle. The Congress has passed his economic reform package, which, in principle, passes many of the growth criteria tests we apply. Indeed, there is a considerable amount of euphoria present on the Brazilian scene. This has injected some nominal confidence into Brazil. For example, the stock market, after falling 73% from its 1990 highs, has stabilized and begun a slow upward climb. However, it remains 54% off the highs.

The super-sensitive black market premium for dollars has collapsed from well over 100% to about 33%. Although this is a favorable development, we hasten to add that this premium remains very high, particularly when we consider the massive liquidity squeeze that has been applied. Hence, the stock and dollar black markets are registering some confidence, but both remain troubled, indicating some underlying real confidence problems.

This brings us to Brazil's external bonds. After falling about 15%, they have recovered and are trading at close to their pre-election highs. Given the fragile nature of Mr. Collor's program and the risks that confidence will evaporate as implementation battles begin, these bonds are fully priced, if not overpriced. Their current yields to maturity are 21.3%. Stand aside and consider purchases on price pull-backs that translate into yields to maturity of between 30% to 35%.

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**— Dr. Steve H. Hanke**

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**Subscription Enquiries**  
Friedberg's LDC Debt Comments  
347 Bay Street  
2nd Floor  
Toronto, Ontario, Canada  
M5H 2R7  
(416) 364-1171

**Trading Accounts**  
All enquiries concerning trading accounts should be directed to Friedberg Mercantile Group  
347 Bay Street  
Toronto, Ontario M5H 2R7  
(416) 364-2700

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