The Impact of the Persian Gulf Crisis on the Prices of LDCs' Loans

SUK HUN LEE
Loyola University of Chicago, Department of Finance, 820 N. Michigan Avenue, Chicago, Illinois 60611

HYUN MO SUNG
Summer Institute of Linguistics, 7500 W. Camp, Wisdom Road, Dallas, Texas 75236

JORGE L. URRUTIA
Loyola University of Chicago, Department of Finance, 820 N. Michigan Avenue, Chicago, Illinois 60611

Abstract

The article employs the event-study methodology to examine the impact of the Persian Gulf Crisis on the prices of LDCs' loans. The main empirical findings are that the Gulf Crisis (1) had a significant impact on the loan prices of LDCs; (2) decreased the loan prices of LDCs with low oil reserves but increased the loan prices of LDCs with high oil reserves; (3) imposed a harsh constraint on the ability and willingness of the severely indebted LDCs to meet their debt obligations; (4) had a strong negative impact on the loan prices of low-income LDCs; and (5) produced large economic losses in LDCs with large remittances from the Middle East. The markets for LDC debt are efficient and responded to the crisis according to expectations. It is interesting to point out that most of the changes in the loan prices occurred during the time period that began with the invasion of Kuwait and ended with the allied forces' air attack.

1. Introduction

On the evening of August 2, 1990, Saddam Hussein sent the Iraqi army into Kuwait, and within a matter of hours, was in control of roughly 20% of the world's proven oil reserves. The invasion rudely awoke a world that was beginning to enjoy the end of the Cold War and turned its attention to whether Saddam Hussein would march south into Saudi Arabia and increase his holding of oil reserves to 40%.

The invasion of Kuwait was quickly followed by an oil embargo which had an immediate impact on oil prices. On August 2, 1990, the price of oil increased to $22.70 per barrel from the previous day's price of $20.20. By late Monday August 6, the oil price went up to $25.85 per barrel. This sharp increase in oil prices raised the issue of whether the world economy would face a third oil shock at a time when the developed countries' economies were entering a recession.

The impact of major crises on the developed countries' economies has been examined in the past. Ned Davis Research in Nokomis, Florida has examined 16 market crises of the past 50 years and found that, in general, stock prices initially posted a brief, sharp decline.
lasting a few days or weeks. After the initial decline, however, stock prices tended to rally to make up all the lost ground within a few months. Recently, Malliaris and Urrutia (1992) have studied the response of 14 national equity markets to the Gulf Crisis and have found that overall it had a negative effect on equity prices. They observed negative abnormal returns following the invasion of Kuwait and positive abnormal returns once the Gulf War began.

The purpose of this article is to empirically examine the impact of the Persian Gulf Crisis on the prices of secondary market loans of less developed countries (LDCs). This study is interesting, because LDCs are expected to have the least amount of financial cushion to withstand a global crisis. It is expected that higher oil prices translate into higher oil-import bills and higher export prices for the LDCs’ goods, thereby reducing the demand for their goods. Hence, higher oil prices would reduce the LDCs’ foreign exchange earnings when they were needed the most. Furthermore, any slowdown in the growth of the Organization for Economic Co-operation and Development countries due to higher oil prices would further depress demand and prices for their exported goods.

The Persian Gulf Crisis would also have a significant effect on the remittances from the Middle East. Before the crisis, according to the Wall Street Journal, Asian workers in Kuwait sent home about $1.4 billion of remittances annually, and about $120 million sent from Iraq. In the September 17, 1990 issue of the LDC Debt Report, economists predicted that the Philippines would lose between $1 billion and $2 billion in remittances from expatriates in Iraq and Kuwait. In 1988, remittances from the Middle East were equivalent to about 14% of the Philippines’ total merchandise exports.

On the other hand, oil-producing developing countries, such as Venezuela, Mexico, and Nigeria, stood ready to gain from higher oil prices. According to the August 11-17, 1990 issue of the Economist, a $30 per barrel price would boost Nigeria’s oil exports by the equivalent of 13% of its gross national product, and Mexico would earn an extra $4 billion. Previous studies (i.e., Berg and Sachs, 1988; Vatnick, 1988; Boehmer and Megginson, 1990; Ozler and Huizinga, 1991) have documented that the prices of syndicated loans of LDCs are determined mainly by the economies of these countries. If the markets for LDCs’ debt are efficient, they should reflect the impact of the Gulf Crisis on the economies of LDCs. Fortunately, the rapid development of the secondary market for LDC-syndicated loans provides sufficient data to perform an objective analysis of the behavior of LDCs’ loan prices around the time of the crisis. Our empirical results show that the Gulf Crisis had a significant negative impact on the prices of LDCs loans. During the entire Gulf Crisis, July 17, 1990–February 28, 1991, the secondary market prices for LDC-syndicated loans for the 25 countries included in the sample experienced large negative cumulative abnormal returns (CARs) of \(-50.6\%\), which is statistically significant at the 1% level. Furthermore, more than 80% of the decline in the loan prices occurred during the time period from the invasion of Kuwait to the allied forces’ air attack.

When LDCs are grouped according to their level of oil reserves, the results reveal interesting differences: the market prices for countries with large oil reserves experienced significant positive CARs of 38.8%, whereas countries with small or no oil reserves experienced large significant negative CARs of \(-92.8\%\). Also, countries classified by the World Bank as severely indebted suffered large significant negative CARs of \(-79.7\%\) during the