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CONVERSION OF OFFICIAL BILATERAL DEBT

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AND

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PART A

ISSUES INVOLVED IN THE CONVERSION OF OFFICIAL DEBT

CHAPTER I: THE NEED FOR FURTHER DEBT REDUCTION

Justification, Objectives & Initiatives

Is the Debt Crisis Over?

Third World debt is no longer front-page news. The end of the crisis is heralded frequently in many quarters. Its continuing impact on inhibiting recovery in affected developing countries is regarded as yesterday's concern. Several reasons account for this euphoria. First, the progress made in debt and debt service reduction (DDSR) over a decade has finally resulted in Chile, Mexico and arguably Venezuela, emerging from the throes of the debt crisis into voluntary or quasi-voluntary access to funds on international capital markets. Their experience has led to hope that other indebted countries will quickly follow in their footsteps. Recent reports on Argentina's recovery, following large-scale commercial debt conversion/reduction, have added to the sense of optimism. Second, Paris Club reschedulings of official debt for Poland and Egypt in mid-1991, led to reductions equivalent in net present value (NPV) terms to half their official debt stocks and to sharply reduced debt service obligations for these two countries. Those restructurings underlined the ability of creditor governments to take far-reaching action when they perceived it to be in their political interest. Third, helpful and widely publicized proposals on far more meaningful debt relief for the poorest countries were made by two European leaders (John Major and Jan Pronk). The impression was conveyed that one of these proposals would swiftly be acted upon. Fourth, the market in trading third world debt finally emerged in 1991 as a large, potent and profitable segment of the "niche" market in global trade of third world debt securities as a respectable form of high-yield, manageable-risk "junk bond"; leading to the view that what governments wouldn't or couldn't do about debt, markets would. Another possible reason that the debt crisis is no longer seen as a threat to the stability of the global economy, and to peace and prosperity, is that it has taken a far back seat to the still-unfolding aftermath of momentous events in Eastern Europe, the former Soviet Union and in the Middle East following the Gulf War.

Unfortunately, such euphoria is premature and misplaced. It is true that prospects are better now than they have ever been for the debt crisis to be relegated to history. Ten years on, bilateral, multilateral and private creditors are more realistic (if not yet quite as educated by experience as one might wish) about debt service capacity and the impact of a debt overhang on impeding adjustment than they have previously been. But for the crisis to be resolved much more needs to be done. Premature sanguinity is therefore unhelpful if not dangerous to the extent that it lulls policy-makers in creditor countries and multilateral institutions, and publics at large, into the comfortable, self-serving belief that a crisis has been contained or a problem solved when it has not. Such perceptions lead to negligence and inattention on the part of governments at a time when deliberation, care and continued commitment to further progress become more not less imperative in taking the necessary next steps to consolidate and build on what has already been achieved.

Chile and Mexico have broken through the debt barrier; Argentina and Venezuela have not yet done so. They might also cross the threshold if present relief and growth trajectories are maintained and public impatience with painful adjustment does not weaken government resolve. But they represent only four of twenty severely indebted middle-income countries (SIMICs). Progress on the other sixteen still needs to be made. Poland and Egypt have definitely benefitted from the most generous debt reductions ever offered by creditor governments. However they represent only two of the thirty-five countries afflicted by unmanageable burdens of <u>official</u> debt and not even the most deserving two if rational economic criteria had been used in the allocation of creditor largesse. Yet OECD governments have made it clear that the Poland/Egypt write-offs and reschedulings are exceptions not precedents. The Trinidad Terms and bilateral debt stock write-off proposals went beyond Poland/Egypt terms. They were bold and ambitious yet realistic in acknowledging the severity of the problem; lamentably, they did not materialize as agreed plans of action. Instead the Paris Club diluted the proposed Trinidad Terms into an "enhanced version" of the previously ineffective Toronto Terms denying the poorest indebted countries the treatment doled out to two much better-off countries and prolonging the pain of desultory reschedulings whose hallmark has been "too little, too late". More robust, wider and deeper markets in developing country debt have certainly emerged offering the promise of more variegated solutions. But these solutions, especially those involving <u>market-based reductions of official debt</u>, have yet to be conceptualized and made to materialize. Intelligent government intervention will be necessary (as it was for the Brady Initiative) to make markets work better. In the face of this large chasm between rhetoric and reality in "resolving the debt crisis" the global community is ill-served by a diversion of attention from the need for <u>creditors</u> to go much further yet in providing greater debt reduction (through write-downs and conversions) and more debt service relief, and for <u>debtors</u> to accelerate the pace of domestic policy reform and properly conceived structural adjustment. In that context, the Craxi Report is useful in reminding the global community of the crisis that persists and what still needs to be done through a combination of market-based and concerted public action:

"The stability and development of the world community in the coming years face four major threats - war, poverty, debt and the destruction of the environment. .... (they are) closely related, and facing one of them means facing them all. They are all parts of the same international political agenda for the 1990s. .... The political and economic developments of recent months should heighten awareness of the frequency and seriousness of local conflicts and their expansion to the international arena. .... They also point to the need to give priority attention to debt relief and concessional financing to these countries which provide evidence of their respect for human rights, strive for peace and adopt sound reconstruction and development plans. ....

The debt problem .. is not a normal problem of relations between creditors and debtors. ... It is a global issue which, if not properly answered through common action, will seriously endanger the welfare of the industrialized countries and the existence and financial stability of the multilateral institutions. ...... The co-ordination of debtors and creditors, which is ensured by domestic bankruptcy laws in many countries, will not be achieved at the international level without an appropriate set of universally recognized rules. ... There is clearly a need for ... a framework to achieve collective agreements that do not materialize spontaneously. In the establishment of such a framework all actors have to do their part..."

The Role of Debt & Debt Service Reduction in Promoting Structural Adjustment

DDSR & Adjustment : Clearly from a creditor viewpoint DDSR is not worth doing for its own sake except perhaps on moral grounds. Most creditors are interested more in claims recovery and the sanctity of the debt contract than in morality. For creditors DDSR is only worth considering if it contributes to enhancing political leverage in a bilateral or multilateral context, achieving other worthwhile objectives and resulting in the prospect of improvement and restored creditworthiness in debtor economies. Upto now the creditor community has used its leverage (by applying or witholding DDSR) to achieve structural adjustment and economic transformation in debtor economies along market-based lines with an enthusiasm which has occasionally implied an ideological rather than economically rational agenda for change. The widespread failure of non-market economies has, however, convinced many debtor governments themselves of the superiority of the market alternative without needing to be pushed by the creditor community. It is amply apparent, however, from the examples of the "breakthrough" cases so far (Argentina, Chile, Costa Rica, Mexico, Venezuela) and from those which have had less successful experience (e.g. Jamaica, the Philippines and almost all the severely indebted developing countries - SIDCs - in Africa) that there are three essential preconditions to successful economic adjustment and recovery in the SIDCs.

The first is that DDSR is necessary and must be of a size which achieves a substantial reduction in negative net transfers on the external debt account (i.e. from levels of 3-4% of GDP to levels of 1-2%). DDSR has to be significant in its impact; if creditors have doubts about how much DDSR needs to be provided they should err on the side of providing more rather than less relief. Second, there must be significant inflows of private capital (whether of repatriated flight capital or new investment) responding to a revival of private investment. This condition does not occur in the absence of the first. Nor does it occur when left simply to market forces especially in the SILICs which do not have environments which are particularly favourable to inducing foreign capital inflows. Third, DDSR is neither a panacea nor a sufficient condition for successful adjustment and recovery. It is a necessary condition which becomes operative and effective only when domestic <u>policy reform</u> efforts aimed at achieving market-clearing levels for the "big prices" (i.e. exchange rates, interest rates, labour costs, and food and energy prices), and <u>structural reform</u> efforts including large-scale privatizations, public sector shrinkage and improvements in resource management, become sufficiently credible to be bolstered by supportive domestic behaviour (in the form of private savings and investment) and international behaviour from the creditor and investor community. A separate lesson that debtors have learnt is that official creditors do not respond as decisively with DDSR in support of debtor adjustment efforts unless they perceive a clear and urgent political or security-related self-interest (as is apparent in the cases of Mexico, Poland and Egypt but not in too many other places) in doing so. That element of political favouritism in DDSR introduces an element of irrationality and inequity in the behaviour of the creditor community which makes more wide-ranging solutions to the debt crisis difficult to achieve.

The Efficacy of Adjustment Prescriptions : What has also been learnt over the last decade is that the prescriptions for adjustment which indebted countries have been asked to apply in the context of reschedulings and DDSR negotiations are flawed, in some cases quite seriously. In the first two phases of the debt crisis it became apparent that adjustment in the SIMICs, in the face of very large negative net transfers, simply could not be sustained. Excessive early emphasis on savage demand compression and trade-oriented adjustment resulted not in stabilization or adjustment but in economic implosion. In the SILICs, particularly in sub-Saharan Africa, traditional neoclassical adjustment prescriptions aimed at "getting prices right" were not having the intended supply side response. The production structures of these economies were too weak, too narrowly-based, too import-dependent and insufficiently broad or deep to enable effective domestic switching to occur in response to exchange rate changes. Increases in production of traditional export commodities (e.g. coffee and cocoa) as a result of "successful adjustment" led to price collapses resulting in countries earning less export revenue for more production. The amount of new concessional money for transitional financing for adjustment in Africa has been severely (and repeatedly) underestimated by the donor community, as have the amounts of DDSR required for these countries and the time period required for transitional adjustment to achieve structural transformation and economic flexibility. The net result of these flaws in adjustment design and financial programming have been prolonged inflation-devaluation spirals which have proved difficult to stabilize and which have led to further erosion of savings and investment. In all these cases the need for substantial DDSR to accompany adjustment programmes could not be clearer.

The Conversion-Privatization Link : Where debt reduction is achieved mainly through debt conversions the association of debt conversions with the sale of public assets has been an important linkage in achieving a combined effect of DDSR plus improvements in both productive as well as allocative efficiency without incurring the usual risk of inflationary consequences. In the absence of such a link, debt conversions are an inferior option to outright cancellations because they need to be slowed down to conform to tight monetary control targets. In some unusual cases however (such as Jamaica and Zambia) there may well be a case for arguing that debt conversions might be a superior option to cancellations if such conversions (focussing on privatizations) can be employed to overcome the sustained losses of reputation which these economies have incurred in the eyes of private investors. Through appropriate structured privatization funds financed by the conversion of official debts or blocked funds they can be useful devices to trigger investment activity of a type and magnitude which might not otherwise occur. This and other issues are discussed at length in later chapters. We turn our attention now to examining the background of debt crisis management and the case for further DDSR.

The Need for Further Debt & Debt Service Reduction (DDSR):

Background and Justification

As the Craxi Report observes, there have been three phases in debt crisis management since 1982: (i) from 1982-85 when the emphasis was placed on involuntary commercial bank and Paris Club reschedulings organized under the aegis of the International Monetary Fund; (ii) from 1986-88 when the Baker Plan was ostensibly in effect; and (iii) post-1989 when it was acknowledged that debt reduction through write-downs and debt conversions was an essential part of the strategy and enshrined in the construction of the Brady Initiative for commercial debt and in the Toronto Terms agreed by the Paris Club. Each of these phases and their effects is discussed briefly below by way of background to establish the case for further debt and debt service reduction (DDSR).

Phase I : When the debt crisis broke in late 1982, the total disbursed and outstanding debt (DOD) of developing countries was estimated to be just under $840 billion. Outstanding obligations of severely indebted developing countries (SIDCs) i.e. those which were experiencing acute problems in meeting their annual debt service payments, were estimated to account for $480 billion, or roughly 57% of the total owed by developing countries. After three years (1983-85) of intensive debt crisis management through IMF-supported involuntary concerted lending, associated with the rescheduling of official bilateral as well as commercial bank debt, the outstanding obligations of the developing world had risen to $1.04 trillion with the debt of SIDCs having risen to nearly $585 billion. These increases occurred despite cumulative debt service (over the three years) of $366 billion by the developing world as a whole and $205 billion by the SIDCs.

During this period SIDCs suffered an economic contraction with a cumulative loss of $100 billion in output while, at the same time, transferring nearly $48 billion in real resources (net financial transfers over three years) to creditors. Based on the mistaken view that the debt crisis was one of liquidity rather than solvency, the international community remained reluctant to consider measures which, on a case by case basis, or on a global scale, would result in a permanent reduction of debt burdens. Proposals advanced by various sources for debt and debt service reduction (DDSR) were regarded by creditor governments and banks as irresponsible at best and dangerous at worst. In keeping with their diagnosis, the creditors' preference was for providing temporary relief through debt service deferral for short periods of time. As events turned out, this approach added to and exacerbated future debt burdens.

Phase II : By 1985 it had become clear that measures to contain the debt crisis had averted the threat to the international financial system but had seriously damaged the economies of debtor countries and could no longer be politically sustained. Peru had declared a public policy of limiting debt service payments to an affordable proportion of exports. In an effort to prevent that contagion from spreading, the Baker Plan was announced with the intent of reducing debt-service take-outs, partially refinancing the exposure of commercial banks and the IMF (which had become dangerously overexposed) with money from the multilateral development banks and lengthening maturities and grace periods for official and commercial debt reschedulings.

Debt reduction remained an unacceptable concept though experimentation with debt-equity swaps, which were emerging as a technique to induce foreign investment, repatriation of flight capital and debt reduction, was not discouraged. The Baker Plan was a failure. Instead of declining, debt service outflows from SIDCs between 1986-88 amounted to over $215 billion while their outstanding obligations grew by $129 billion to nearly $715 billion. Cumulative negative net transfers (from SIDCs to creditors) amounted to a further $65 billion during this period. By 1987 a number of countries were falling into arrears (Brazil and Argentina being the largest), sparking a round of unprecedentedly large provisioning by commercial banks and export credit agencies (ECAs). Outstanding interest arrears of SIDCs, which were less than $9 billion at the end of 1985, rose to nearly $26 billion at the end of 1988.

Actual, Real & Scheduled Debt Service Ratios : Between 1983-88 SIDCs (as a group) were exporting about 6-7% of their GDPs by way of debt service with negative net transfers on debt accounts amounting to 2-3% of cumulative GDP. Viewed against overall export performance (for all SIDCs), debt service took up an enlarged share of export earnings between 1982-86 as aggregate exports fell from $190 billion in 1982 to $150 billion in 1986 before rising again to $225 billion in 1990. The average debt service to exports ratio (DSR) for all SIDCs thus fell from a peak of 42% in 1986 to just over 25% in 1990 though there were wide differences in the DSRs for SILICs vs SIMICs, the ratios for the former being lower than the latter between 1985-88 and then reversing to becoming much higher between 1988-91 reflecting the greater impact of DDSR in the private debt of SIMICs but not in the official debt of SILICs. But that improvement was illusory. Had interest and principal arrears not been incurred the debt service ratio would have been over 60% of export earnings! To underline that important point the arrears of SIDCs have continued to climb rapidly, exceeding $45.2 billion in 1990 and (an estimated) $53.4 billion in 1991 though with the Brady agreements concluded after 1991 there should be a significant reduction in overall SIMIC (and therefore SIDC) arrears at the end of 1992. The following table dramatizes that point:

Following their adoption of different and more realistic provisioning policies in mid-1988 and thereafter, commercial banks began more aggressive programmes of portfolio adjustment through discounted debt swaps and sales. Consequently, secondary markets for trading developing country debt became wider and deeper, though they remained relatively thin compared to the volumes of debt outstanding. Trading volumes in those markets, barely $5 billion in 1985, climbed to $45-50 billion by 1988 indicating that commercial creditors were coming to accept market reality in adjusting their own portfolios at discounted prices though still reluctant to pass the benefit of the discount directly to debtors on grounds of moral hazard. Market volume was estimated to have increased to $120-150 billion in 1991 in the aftermath of the Brady deals for five countries which have resulted in more marketable paper emerging for commercial claims.

Phase III : It was clear that with the breakdown of the Baker Plan in early 1988 another debt initiative was necessary which would legitimize the objectives of DDSR while meeting the demands of creditors that the measures taken should be: voluntary (on the part of creditors), market-based, and applied on a country-by-country basis. Also, in 1988 the special difficulties being experienced by the low-income distressed countries, particularly in Africa, were explicitly acknowledged by creditor governments resulting, in the emergence and application of the Paris Club's Toronto Terms. These, for the first time, permitted creditors to reduce debt stocks (by one-third of eligible maturities during the consolidation period) and debt service through either interest rate reductions or revised grace periods and maturities stretched out to 14-25 years.

TABLE 1: DEBT SERVICE RATIOS AND ARREARS

(Amounts in US $ billions)

	1985	1986	1987	1988	1989	1990	1991
SILICs							
A. Total Debt Service (TDS):	10.77	9.03	6.75	9.09	10.01	11.11	11.48
B. Interest Arrears:	3.09	4.81	6.04	7.99	10.06	10.78	12.89
C. TDS + Arrears	13.86	13.84	12.79	17.08	20.07	21.89	24.37
D. Exports	36.35	29.27	30.29	32.52	34.24	42.35	36.72
E. Debt Service Ratio (DSR) Actual (A/D):	29.6%	30.9%	22.3%	27.9%	29.2%	26.2%	31.3%
F. Real DSR (C/D):	38.1%	47.3%	42.2%	52.5%	58.6%	51.7%	66.4%
SIMICs							
A. Total Debt Service (TDS):	57.55	53.55	51.21	60.53	52.44	47.00	51.47
B. Interest Arrears:	4.81	6.72	13.27	15.59	24.00	34.48	40.50
C. TDS + Arrears	62.36	60.27	64.48	76.12	76.44	81.48	91.97
D. Exports	145.14	120.83	136.12	149.59	164.61	183.05	173.51
E. Debt Service Ratio (DSR) Actual (A/D):	39.7%	44.3%	37.6%	40.5%	31.9%	25.7%	29.7%
F. Real DSR (C/D):	43.0%	49.9%	47.4%	50.9%	46.4%	44.5%	53.0%
SIDCs							
A. Total Debt Service (TDS):	68.32	62.58	57.96	69.62	62.45	58.11	62.95
B. Interest Arrears:	7.90	11.53	19.31	23.58	34.06	45.26	53.39
C. TDS + Arrears	76.22	74.11	77.27	93.20	96.51	103.37	116.34
D. Exports	181.49	150.10	166.41	182.11	198.85	225.40	210.23
E. Debt Service Ratio (DSR) Actual (A/D):	37.6%	41.7%	34.8%	38.2%	31.4%	25.8%	29.9%
F. Real DSR (C/D):	42.0%	49.4%	46.4%	51.2%	48.5%	45.9%	55.3%

Note: Source: WDT1991-92. The "real DSR" figures actually understate the ratio since amortization payments in arrears are not included in the arrears base. Including these figures (on which consistent information is not easily available) the real DSR would be 3-8% higher than the figures shown.

After a confused interregnum of a year in which arrears began building up rapidly the Brady Initiative emerged in March 1989. Its initially vague shape and form was defined gradually in the context of support measures for DDSR (using $30 billion in resources from the IMF, World Bank and a special

Japanese fund) and a structure which tackled the particular problem of Mexico. It was also apparent by then that the innovative private debt reduction initiatives taken by Chile (quite independently of Baker and Brady) in 1985 were succeeding in reviving investment and growth on a sustainable basis[1]. Unfortunately, the Brady Initiative has proven to be more complex and cumbersome to apply than earlier hoped, the Craxi Report noting that:

".......experience with the Brady Plan has raised a number of problems related to the long duration of negotiations, the lack of resources and the use of guarantees. .... The presence of (sharing and negative pledge) clauses and the collusive behaviour of creditor banks have made the negotiations ... excessively lengthy and sometimes less effective than expected. ... The financial resources available for the Brady Plan are probably not adequate to bring about sufficiently large debt reductions quickly enough to stimulate the flow of new financial resources towards the countries that are carrying out economic adjustment programmes. The limitation of interest guarantees to no more than 18 months greatly curtails the intended enhancements of the (Brady) bonds. .... Another difficulty of the Brady PLan arises from differences among national systems of taxation, accounting and bank surveillance rules covering loans to developing countries. .... Those differences cause distortions and delay negotiations on debt reduction. "..

By September 1991 only five "Brady deals" had been done -- in Costa Rica, Mexico, the Philippines, Uruguay and Venezuela. The total change in indebtedness resulting from them amounted to an aggregate $17.4 billion.[2] Fifteen other SIDCs eligible to benefit remained unaffected as of then. In the Philippines the benefits of the first Brady debt reduction package (arguably the worst negotiated so far) were not discernible. However, the positive economic impact of these arrangements in Costa Rica, Mexico and Venezuela have been greater than suggested by the amount of debt reduction alone. In these countries the reactions of foreign investors, creditors and holders of flight capital to the post-Brady economic regime have been instrumental in spurring impressive economic recovery unhampered by previous concerns about the debt overhang impeding sustained progress.

The 1989-91 period has seen debt stocks stabilize. Total DOD for developing countries (SIDCs showed much the same trends) grew by 24% between 1983-85, by a further 23% between 1986-88, but by only 5% between 1989-91, suggesting that the ethos of DDSR has taken hold although it has not yet achieved the objective of debt stock or debt service reduction to manageable levels. Arrested growth of <u>total</u> debt stocks obscures the reality of private (mainly commercial bank) debt reduction accompanied by continued growth in bilateral, and more disconcertingly, multilateral debt obligations owed to preferred creditors; the latter now posing a particularly intractable problem in SILICs. In the severely indebted low-income countries (SILICs) debt stocks continue to grow much too rapidly despite the application of Toronto Terms, which have not proven to be particularly efficacious. The Trinidad Terms proposed in late 1990 would have represented a major breakthrough in reversing this trend and reducing bilateral debt stocks to serviceable levels. But as observed earlier they have been substantially diluted by the consensual approach of the Paris Club. Growth in the total debt stock of SIDCs is portrayed in Table 2 on the following page.

Total DOD in the SILIC group has grown from over $74 billion in 1982, to nearly $117 billion in 1985, $161 billion in 1988 and $165 billion in 1990. <u>The debt stock of SILICs is now more than twice as large as when the debt crisis began indicating that the rescheduling approach applied to debt crisis management in these countries has been seriously flawed</u>. Total DOD amounted to 33% of the aggregate GNP and 200% of the aggregate exports of SILICs in 1982; it now accounts for nearly 120% of GNP and nearly 500% of aggregate exports. Successive Paris Club reschedulings have resulted in unanticipated, counterproductive outcomes as arrears have mounted and interest has been capitalized continuously, resulting in bilateral DOD levels which are structurally unserviceable and in need of cancellation (and conversion) to a much larger extent than the enhanced Toronto Terms envisage.

The Outcome of a Decade of Debt Crisis Management : As Table 2 shows, bilateral and multilateral debt have risen sharply throughout the 1982-91 period while growth in interest arrears has been dramatic since 1985 and even post-1988 suggesting that the DDSR measures taken so far have not been adequate. Private guaranteed and unguaranteed debt (apart from short-term debt in which fluctuations are often difficult to explain on trade-related or creditworthiness grounds), on the other hand, rose modestly between 1985-88 and has subsequently shown a declining trend since then in all SIDCs, but particularly in the SIMICs, reflecting the impact of Brady deals as well as other unrelated debt conversions (into equity and other kinds of local currency uses)[3].

TABLE 2: GROWTH IN DEBT STOCKS OF SIDCs

(Amounts in billions of US dollars)

	Phase I	Phase II	Phase III		
	1982	1985	1988	1990	1991(E)
SILICs:					
Total DOD:	79.12	116.74	160.91	165.01	175.35
Interest Arrears:	1.25	3.09	8.00	10.78	12.89
Bilateral DOD:	32.06	49.45	75.10	76.33	80.43
Multilateral DOD:	10.61	16.76	26.77	31.45	34.73
IMF:	3.23	5.56	5.83	5.53	6.30
Private Guaranteed:	18.32	24.11	32.24	30.35	29.18
Private Unguaranteed:	2.90	3.33	3.09	2.86	2.88
Short-Term Debt:	12.00	17.53	17.88	18.48	21.83
SIMICs:					
Total DOD:	346.15	418.46	485.13	505.58	486.54
Interest Arrears:	4.53	4.81	15.59	34.48	40.50
Bilateral DOD:	35.23	62.58	90.58	108.27	99.59
Multilateral DOD:	15.94	24.35	41.71	50.41	53.87
IMF:	6.97	12.99	14.71	18.11	17.54
Private Guaranteed:	183.49	223.00	255.34	230.01	220.69
Private Unguaranteed:	61.70	50.96	29.17	24.10	23.10
Short-Term Debt:	48.82	44.57	53.62	74.68	71.76
Other SIDCs:					
Total DOD:	55.00	50.00	69.00	70.00	65.00
Memo: All LDCs					
Total DOD:	846.00	1,046.00	1,282.00	1,355.00	1,351.00
Interest Arrears:	6.10	8.67	25.64	48.75	55.50

Source: WDT 1991-92.*

DDSR has thus begun to affect private debt largely because commercial bank creditors themselves (along with a few proactive debtor governments such as Chile and Mexico where much of the pioneering experiments have been done) have taken the initiative in exploring different avenues and inventing new instruments and techniques to adjust their portfolios. In recent years, they have accepted the need for debtor countries to capture part of the discount. Private creditors now extract about half the amount of debt service ($2.7 billion annually) from SILICs than at their peak in 1985 ($5.2 billion) while in SIMICs the drop has been of about a third from the peak in 1988 ($34 billion) to $23 billion in 1990 with the interest burden on their private debt having been cut to about a half (from $21.5 billion in 1988 to $11.8 billion in 1990).

Despite bilateral cancellations of ODA debt amounting to over $9 billion between 1983-91 for SILICs, and the successive application of Toronto, Venice, Houston terms and now enhanced Toronto terms in Paris Club rescheduling agreements for SILICs and SILMICs (severely indebted lower middle-income countries), the total stock of bilateral debt has risen relentlessly in all SIDCs. The increase has been due principally to the effect of exchange rate changes since 1985[a] and to the interest capitalization practices of the Paris Club. Indeed in some instances, the extent of interest capitalized upto now exceeds by a significant factor the original value of the debt incurred. As a result, most SILICs are now servicing a much smaller proportion of bilateral debt obligations (less than 20% of contractual amounts due even after rescheduling). Constrained resources oblige them to service preferred multilateral creditors first and (to keep their trade lines open to the extent possible) private creditors next before allocating resources to bilateral debt service. Nevertheless bilateral debt service payments by SILICs have grown from about $1.2 billion in 1982 to around $3 billion now. SIMICs generally reflect the same debt servicing priorities, though as a group they are servicing about 60% of the bilateral debt service obligations due after rescheduling; such obligations in their case have risen from about $3.5 billion annually at the beginning of the 1980s to around $5.3 billion at the beginning of the 1990s.

The Need for Further Action : These trends clearly suggest the urgent need for <u>bilateral</u> DDSR well beyond that envisaged through enhanced-Toronto Terms for SILICs and the original Toronto Terms for SILMICs. <u>Export credit agencies (ECAs) and other bilateral non-concessional creditors now need to accept the same reality that commercial banks have been obliged to recognize and engage in cancellation or conversion options on a scale which would reduce bilateral DOD to realistically serviceable levels</u>. The steep rise in <u>multilateral</u> DOD provides the most significant source of concern especially in the cae of SILICs. Incurred to help finance debt servicing to commercial lenders (and later to the IMF) as an integral component of adjustment financing packages, the outstanding debt obligations of SILICs to multilateral creditors have risen steadily from over $10 billion in 1982 to $35 billion in 1990 while those of SIMICs have risen from $16 billion to $54 billion. These obligations involve debt service requirements which are unamenable to rescheduling or deferral on the same basis as either bilateral or private obligations. Debt service to multilaterals by SILICs has thus risen from $600 million to $2.7 billion between 1982-91 and by SIMICs from $2 billion to $9.5 billion.

It is not clear what can be done to achieve multilateral DDSR without impairing the credit-worthiness of these institutions in international capital markets; thus reducing the invaluable leverage which these institutions have been able to exert in using publicly financed capital funds to raise nearly ten times more by way of private funds from markets. Some steps are being taken by multilateral institititions to refinance the debt service due from SILICs on their high cost facilities with compensating inflows from their soft loan windows and with interest rate subsidies funded out of their profits. But these are isolated measures and inadequate. If the present trajectory of growth in SIDC indebtedness to multilaterals continues, more radical solutions may need to be contemplated if the servicing of these obligations is not to fall into egregious and prolonged arrears. Given the pre-emptive nature of multilateral debt service, bilateral creditors (who are indirectly responsible for multilateral credit as well through their uncalled guarantees) will be under even greater pressure to effect a sufficient amount of DDSR on the outstanding bilateral debt portfolio in order to avert a generalized problem emerging with multilateral debt servicing.[6]

The ruthless logic of numbers indicates unambiguously that the internal dynamic of continuing bilateral debt accumulation, through the compounding effects of interest capitalization, has already become unsustainable. But there are other powerful and compelling reasons to justify the case for further (and swift) debt stock and debt service reduction. As the Craxi Report on Debt adds:

> "Debt is closely intertwined with war, poverty and environmental degradation. Drug trafficking, immigration from countries with stagnant economies, environmental hazards, trade imbalances, and political instability are all exacerbated by the frustration of development and the debt paralysis of recent years.

Initiatives Taken towards DDSR

The debt strategy employed by the creditor community since 1989, for official as well as private debt, has explicitly acknowledged the need for DDSR, although considerable dissension and conroversy surrounds: how much DDSR is needed in each SIDC; what the burden sharing among different types of creditors should be in achieving such reductions; and what techniques should be used for further DDSR. The initiatives taken thus far are perhaps best characterised separately for the SILICs and SIMICs recognizing, of course, that special problems have been detected in the case of the in-between category of severely-indebted lower middle-income countries (SILMICs).

<u>DDSR in the SILICs</u> : In the low-income debtor countries, mainly in Africa, measures taken by the creditor community to provide DDSR recognize that these countries are characterised by serious long-term structural problems whose resolution is being thwarted by exceptionally high debt stock ratios (in excess of annual GNPs and four time exports) and a declining ratio of actual to scheduled debt service. The lead in providing relief through DDSR has been taken by the Paris Club of bilateral creditors with agreement on the Toronto Terms in October 1988. Consensus was reached that instead of every OECD creditor in the Paris Club applying standard terms universally, creditors could for the first time choose among a menu of options in rescheduling the debts of the poorest countries. Under Toronto Terms, rescheduled ODA concessional debt could be cancelled in full or in part and/or the balance to be repaid with a 25-year maturity including 14 years of grace. Enhanced Toronto Terms (ETT) which were agreed for Nicaragua and Benin in December 1991 involve rescheduling ODA debt over 20 years with 10-years grace. Moratorium interest charges would be at least as low as the interest rates charged on the loans at the time of original signing. For non-concessional bilateral debt, three supposedly equivalent rescheduling options were defined by the Paris Club and adopted, at the World Bank-IMF Annual Meetings in Berlin later that year, by creditors:

> <u>OPTION A. PARTIAL WRITEDOWNS</u>: One-third of eligible maturities could be cancelled and the remainder rescheduled over a 14 year period with 8 years grace. Moratorium interest would be based on market rates in different creditor countries. Under ETT the amount cancelled is increased to 50% with the remainder consolidated at market rates, to be paid over 23 years with 6 years grace.

> <u>OPTION B. EXTENDED MATURITIES</u>: A 25 year maturity with 14 years grace could be applied to all reschedulable debt with base moratorium interest being charged at prevailing market rates. Under ETT this option remains the same though it is now called Option C and is selected by creditors not wishing to participate in debt cancellation or its equivalent.

<u>OPTION C. REDUCED INTEREST RATES</u>: Moratorium interest rates on rescheduled debt could be charged at either 3.5% below, or one-half of, the prevailing market rate in the creditor country concerned, whichever gave the smaller reduction, with repayment maturities of 14 years and 8 years grace. [The provision referring to "3.5% or half" appears to have been watered down since to "somewhat below market rates"]. Under ETT the full amount is consolidated at concessional rates so as to reduce payments due by 50% in NPV terms to be repaid over 23 years with 6 years grace.(this is now Option B under ETT).

The Toronto Terms and ETT were applied by the Paris Club only to low-income, debt-distressed countries that had agreed to an acceptable ongoing Fund or Bank supported adjustment programme. Upto March 1992, 24 SILICs had rescheduled $6.5 billion with the Paris Club on TT or ETT. These reschedulings saw creditor choices almost evenly distributed among the three options. France, Finland and Sweden usually chose Option A, Belgium, Japan, the Netherlands, Spain and the US have usually chosen Option B while Australia, Canada, Germany, Italy, Norway, Switzerland and the UK have exercised Option C. Though these option are intended to be "equivalent" in their debt relief effects, they are not.[7] Option B (or 'C' under ETT) is clearly inferior to the other two in offering much less real relief.

The impact of Toronto Terms has been to reduce scheduled debt service by nearly $1 billion on a present value basis compared with standard reschedulings but less than $400 million when compared to the extended Venice Terms which had been agreed in the previous year. The cash flow savings in <u>actual</u> debt service as a result of these reschedulings have amounted to $120 million annually. The impact of Toronto Terms has been limited because: (a) its concessions do not apply to the entire stock of debt but only to maturities falling due within a consolidation period of generally no more than 18 months; (b) the Venice terms already allowed the rescheduling of all principal and interest on a prolonged basis; (c) criteria for cutoff dates and for previously rescheduled debt are sufficiently strict as to inhibit the full extent of intended relief from being realized; and (d) they do not apply to Nigeria which is a low-income severely debt distressed country nor to some some middle-income countries (like Cameroon, Cape Verde, Congo, Cote d'Ivoire, Senegal) where there is a strong case for more generous treatment by the Paris Club.[8] Calculated against <u>scheduled</u> debt service burdens, had the original contractual terms been honoured, the relief is much greater -- probably over $6 billion

-- but it is hypothetical to look at savings from scheduled levels for most of these low-income countries. Also with more than one-third of the total amount being rescheduled using Option B the reduction in the present value of future debt obligations on restructured debt is about 15% instead of the 33% that would result if creditors chose one of the other two options.

The World Bank has calculated that if creditor countries chose the same options as before, and if Toronto terms were to be applied repeatedly as future maturities fell due then: (i) projected debt service savings for SILICs would amount to $310 million in the year 2000; (ii) the present discounted value of debt service savings for the period 1989-2000 would amount to under $1.85 billion; (iii) annualized as a share of 1988 debt service this would result in a saving of under 2.5%; and (iv) the total amount of debt reduced by 2000 would be just over $2 billion. Assuming that Toronto terms were also adopted by other non-OECD creditors then the discounted value of savings would rise to $2.7 billion (or an annualized 3.4% of debt service saved) with total debt reduction by 2000 of nearly $3 billion.[9] These amounts, though seemingly large, do not make much of a dent in the debt problem of SILICs -- a point which was recognized in the two proposals tabled to carry the impact of DDSR further.

The first of these was introduced by British Prime Minister John Major (when still Chancellor of the Exchequer) at the meeting of Commonwealth Finance Ministers in Trinidad in September 1990.[10] Known as the Trinidad Terms (referred to earlier) they suggested: (a) rescheduling the entire stock of debt instead of renegotiating it tranche by tranche for maturities falling due in 15-18 month intervals; (b) increasing from one-third to two thirds the amount of relief provided by cancellation of debt stock; (c) capitalizing all interest payments (at market rates) on the remaining one-third debt stock for a period of five years and requiring phased repayment with steadily increasing payments of princiapl and interest in line with export and output growth in the debtor economy; and finally (d) stretching repayments of the remaining one-third debt stock over a period of twenty-five years with a flexible repayment schedule.[11]

As indicated above the consensus reached in the Paris Club in December 1991 (and applied to Benin and Nicaragua) diluted the Trinidad Terms considerably representing inferior treatment for SILICs relative to Poland and Egypt. The new terms, (depicted alongside the Toronto options above), are not being applied to debt stocks but to maturities falling due and arrears for consolidation periods of upto 30 months. The new rescheduling agreements (RSAs) do, however, include a "goodwill clause" which gives creditors the option of considering further debt relief on eligible maturities falling due after the expiration of the consolidation period and to consider applying ETT to the entire debt stock within 3-4 years providing the debtor country has fully implemented the terms of the RSA, made comparable arrangements with non-OECD bilateral creditors and maintains continued access to IMF resources by adhering to adjustment programmes. If the remaining debt stock is restructured on terms which are no less favourable than the first ETT arrangements the new terms will enable Paris Club creditors to "exit" in three stages: i.e. two Paris Club agreements covering relatively short consolidation periods followed by a third and final agreement dealing with the remaining debt stock, thus requiring debtors to jump through three hoops when one would have done.

Though ETT represent progress over what presently prevails they represent another opportunity missed by the creditor community to achieve a level of DDSR reduction in bilateral debt service obligations which aligns scheduled obligations with the actual capacity of SILICs to repay. The Trinidad terms created expectations on the part of many SILICs that a meaningful step was to be taken in resolving their bilateral debt problems. In the current circumstances the next round of Paris Club reschedulings will probably continue to result in broken agreements and further build-up of arrears because the DDSR offered is insufficient to recognize the absolute limits which constrain servicing of bilateral obligations by SILICs.

On the multilateral debt front, SILICs which are pursuing Bank-Fund monitored adjustment programmes have been assisted by the World Bank in two ways: (i) through an interest subsidy fund which subsidizes 90% of the interest payments on outstanding IBRD obligations; and (ii) an implicit policy of expanded IDA flows to cover amortizations of IBRD principal, ensuring that positive net transfers are maintained by the World Bank group as a whole. These arrangements need to be replicated by the regional development banks and other multilateral creditors. The IMF has also attempted to relieve the burden of debt service from SILICs to the Fund through its concessional Structural Adjustment Facility (SAF) and its enhanced successor (ESAF). For SILICs which are in egregious arrears, the IMF has developed the "rights approach" under which outstanding arrears to the IMF are frozen over 3-4 years while the country concerned earns "rights" by pursuing a Fund-monitored "shadow" programme. If the programme targets are met through-out the period, the Fund disburses an ESAF credit against the rights earned in an amount sufficient to refinance the arrears due. In the meantime the SILIC concerned is expected to keep current on debt service on maturities falling due during the shadow programme period and to pay interest on the frozen arrears. The Fund's performance on relieving SILIC's debt burdens through its own actions have not proven particularly effective and its DDSR options need reconsideration.

In contrast to the several measures (even if partial and not yet fully responsive) taken by official creditors to provide relief through DDSR to SILICs, progress in renegotiating commercial bank debt reduction packages has been desultory. Between 1989-91 only Madagascar, Nigeria and Zaire have reached restructuring agreements with commercial creditors employing debt conversion and swap options. SILIC arrears on commercial obligations have risen from $2.5 billion in 1988 to over $4 bilion in mid-1991. Although private debt typically accounts for a very small share of total debt in SILICs (around 10-15% including accumulated arrears) it exerts a debilitating influence because of its: non-concessionality; the inhibiting impact that arrears have had on flows of short-term trade credit and on preventing the normalization of creditor relations. Prolonged, large arrears on commercial obligations has also undermined investor confidence and prevented adjustment measures aimed at galvanizing investment from taking hold. The reduction (preferably elimination) of these private claims at a deep discount (reflecting the price of such debts on secondary markets) would have a salutary effect. For that reason the World Bank created a Debt Reduction Facility which provides eligible SILICs with grants of upto $10 million for commercial debt buybacks. To date the operations of that Facility have been disappointing.

As of now only two countries - Mozambique and Niger - have benefitted from the DRF . In March 1991 Niger completed the buyback of its commercial bank debt (of $108 million) with resources provided by the DRF ($10 million), and supplemented by Switzerland ($3 million) and France ($10 million). But the price at which its commercial debt was bought seemed unjustifiably high suggesting that scarce resources were unwisely used.[12] The same appears to be true in the case of Mozambique. Out of the several SILICs that had applied to use DRF at the end of 1990, negotiations are underway for Senegal and Tanzania. The fact that only two buybacks have actually been completed 30 months after the establishment of the DRF suggests that something is seriously wrong with the execution of what was, and still is, a good idea. The Bank observes that:

> "... Much of the delay in drawing the resources of the facility is due to the reluctance of banks to participate, in part to avoid setting precedents for other countries where their exposure is larger..".

If that is the case there is considerable justification for regulatory and tax authorities in the home countries of these banks to adopt measures such as the clawback of tax relief already provided against specific and general provisions for developing country debt and considerably less exertion of pressure on behalf of commercial banks in their negotiations with middle-income debtors -- as for instance was exerted by OECD governments in pressing the case for commercial arrears clearance by Brazil. But the reluctance of banks is not the only reason. Private discussions with several governments of the eligible countries which have applied for DRF use suggest that the Bank's own internal guidelines, procedures and its bureaucracy are at least as responsible for the absence of movement. Whatever the reasons for the DRF not being used to its full potential the Bank's management and its shareholders should be enjoined by the international community to exert maximum efforts in removing present obstacles for wider DRF use before the terminal date for (June 30, 1992) expires and the balances of its unused resources revert to IDA.

<u>DDSR in the SIMICs</u> : In the SIMICs, and until the two extraordinary reschedulings agreed by the Paris Club for Poland and Egypt in 1991, the weight of DDSR effort has focussed on the reduction of commercial rather than official debt and debt service burdens. Since the emergence of the Brady Initiative in May 1989 several commercial bank DDSR operations have been undertaken (many outside the framework of Brady arrangements) in SIMICs and SILMICs employing a variety of techniques. These range from the use of: temporary coupon reduction bonds, exchanges of debt for exit bonds with recapture clauses; expanded debt-equity swaps (DES) and debt-for-development swaps (DDS) and phased market buybacks. These "deals" have been financed by using resources for DDSR support from the reserves of debtor countries themselves (where such use could be justified) as well as the World Bank, IMF, the regional banks, Japan and private voluntary organizations for DDS.

As indicated earlier nine SIMICs have completed formally organized Brady debt restructuring packages (DRPs) as of now. The most successful private debt reduction programme has been Chile's and that was executed outside the Brady framework. Brazil and Argentina have launched extensive DES programmes related to their privatization efforts. Initial Brady DRPs have proven to be cumbersome involving protracted negotiations (particularly where arrears are concerned) though the momentum of deals seems now to be picking up; free-rider problems have been minimal.[13] In these DRPs commercial banks have eschewed opting for new money or providing downside contingency risk clauses. The creation of large quantitities of collateralized Brady bonds has had a salutary impact on secondary market trading volumes and improved market liquidity for the debt of countries where DRPs have been agreed. It has also resulted in the implicit buyback price (i.e. the ratio of the debt reduction funds used to the NPV of contractual debt reduction) reflecting broadly the prevailing secondary market price for traded debt. Five other SIMICs and SILMICs have launched negotiations with commercial creditors for DRPs. Most of these countries confront a difficult situation with growing arrears, inadequate reserves and increasingly limited access to official funding for DDSR which may slow down their negotiations.

The overall financial and economic impact of the DDSR measures taken to reduce private debt obligations in SIMICs so far is impossible to capture in a single index. The outstanding private debt stock of SIMICs as a group has been reduced by about $43 billion (or 16%) between 1987-91 with reductions averaging $10 billion in annual debt service between 1988-91, representing a saving of 15% in debt service outflows. These net reductions are, of course, far less than the gross face value of cancellations and DES/DDS conversions which have been undertaken since 1985 as they have been offset by capitalization of arrears and very modest new lending during the period. The entrenchment of developing country debt trading in global markets which are becoming increasingly large and robust suggests that, in the aggregate, private debt reduction in the SIMICs will continue to grow through the 1990s with an even wider range of techniques and instruments being applied across a wider range of SIMICs, even if official support for these operations is constrained. In countries like Chile, however, the process is coming to a natural halt because the secondary market price of Chilean debt (over 93¢) is prohibitive and militates aganist the economics of DES/DDS. That may happen before too long in Mexico and Venezuela as well.

Prior to 1990, official bilateral creditors did not resort to permanent DDSR in any form for SIMICs. In September 1990 the Paris Club agreed on the extension of different rescheduling terms to SILMICS. The 'Houston' terms resulted in rescheduling maturities for (a) export credits being extended from 10 to 15 years and grace period from 6 to 8 years; and (b) concessional debt being extended from 20 with 10 years of grace. Post-Houston rescheduling agreements for SILMICs also includeda debt conversion clause on a voluntary basis for upto 100% of concessional debt stock but limited to 10% of non-concessional debt stock or $10 million whichever is higher. Between 1990-March 1992, thirteen SILMICs and Nigeria (a SILIC) have benefitted from Houston terms covering consolidated debts of $17 billion though no official debt conversions have yet occurred in these countries.

In 1991 creditors departed from normal rescheduling practices for SIMICs in the cases of Poland and Egypt. The Paris Club agreements for these two beneficiaries entailed tranched reductions amounting to a total of 50% of outstanding bilateral debt stocks[14]; with the next tranches depending on the fulfilment of conditions on adjustment performance and on these countries obtaining similar treatment from their other bilateral and commercial creditors. If followed through, these two arrangements will result in the forgiveness of nearly $29 billion in bilateral claims. The Poland and Egypt agreements also permit conversion on a voluntary basis for upto 20% of the residual non-concessional debt stock or $20 million whichever was higher. Both countries have requested creditors to exercise this option. In the case of Poland the local currency proceeds of conversion are to be used for an 'environment fund' while in Egypt the intended purpose is for a 'social fund'. The US has agreed in each case but other creditors are reluctant and their intentions still unclear. The Paris Club has emphasised that these two cases are to be considered exceptional (that is to say, these agreements were politically rather than economically justifiable) and has underlined that point by agreeing to worse ETT for the SILICs.

In September 1991 the Paris Club rescheduling of a consolidated $6.6 billion for Peru deferred all of the moratorium interest on eligible debt for 15 months contingent on Peru's performance under the IMF's "rights accumulation programme".

In addition to initiatives undertaken in the Paris Club, the US launched its own bilateral Enterprise for the Americas Initiative (EAI) in 1990 which contained specific debt relief provisions for developing countries in the Western Hemisphere which met certain eligibility criteria. With very few SILIC exceptions the EAI applies mainly to SIMICs. Under EAI, part of the outstanding PL480 and USAID concessional debt can be cancelled (the proportion depending on the circumstances of the country concerned) with the balance exchanged for a new, restructured obligation at a concessional interest rate not subject to further restructuring or cancellation. Amortization payments on the exchanged debt continues to be paid in US dollars but interest payments can -- for those debtor countries which have entered into Envirnmental Framework Agreements with the US -- be made in loal currency deposits to an Environment Fund for supporting environmental projects approved jointly by the debtor government and US.

Legislation for the conversion/cancellation of PL480 had been obtained by the end of 1991 but legislation for converting AID loans is still pending in Congress. Agreements with Bolivia, Chile and Jamaica on PL480 conversions had been signed by the end of 1991 which resulted in debt reductions of $264 million. EAI also provides for the sale, reduction, cancellation or conversion of EXIM bank debt and CCC (Commodity Credit Corporation) debt in transactions with private investors for DES and DDS operations. Legislation on this aspect is also pending. Hence, like the earlier Caribbean Basin Initiative, the EAI is not yet living up to its original promise. In the unlikely event (in an election year) that the Administration succeeds in obtaining the necessary legislative actions EAI could have a significant impact on some SILMICs in the Western hemisphere which have particularly high official to total debt ratios (e.g. Jamaica).

In summary, a considerable advance has been made since 1988 with DDSR initiatives. But their net impact on SIDCs as a whole (with the exceptions of Poland and Egypt) has yet to be felt in any significant way. The largest impact of DDSR so far has been in reducing the burdens of private debt and debt service in SIMICs. In part this is because in a small, selected group of SIMICs, commercial creditors and debtors with the support of official lenders have been willing (with varying degrees of enthusiasm in different countries) to take imaginative steps through a wide variety of techniques to accept market valuation of their debt portfolios and to adjust them accordingly on an increasing scale.

The burdens of official bilateral debt in SILICs and SILMICs are being coped with through the repetitive cycle of increasingly generous but still inadequately effective reschedulings and arrears. Though substantial cancellations have been made of concessional bilateral debt in SILICs between 1983-91 these have not prevented a rise of over $40 billion (or over 120%) in SILIC bilateral debt stocks during that period although the rate of growth in such stocks has moderated considerably since 1988. Apart from isolated initiatives such as the EAI and the two cases of Poland and Egypt, there have been no significant reductions of bilateral obligations owed by SIMICs. The bilateral debt stocks of SIMICs have grown by nearly $75 billion between 1983-90, though 1991 will register a decline because of the Poland/Egypt reductions.

Further cancellation of bilateral debt coupled with aggressive and imaginative conversion of the residual uncancelled balances (using the debt conversion clauses which are now featuring in rescheduling agreements) is the immediate priority for the next few years. The burdens of multilateral debt remain extraordinarily onerous and are emerging, in the 1990s, as the most difficult problem to address.

Objectives of Further Debt & Debt Service Reduction

In considering the case for further DDSR, the objectives for the creditor community should be to:

(a) reduce debt stocks and debt service decisively to levels which are sufficient to restore confidence in sustainable recovery in debtor economies;

(b) combine debt reduction initiatives with other concomitant initiatives aimed at promoting economic restructuring and restoring economic efficiency;

(c) avoid unforeseen consequences of debt reduction measures, either through moral hazard or through measures which impede macroeconomic stabilization;

(d) act in a manner which eschews continuing with a partial, piecemeal approach which accomplishes little and vitiates the wider objectives of structural adjustment and economic reform by compromising the integrity of the "financing packages" designed to support such efforts; and

(e) reinforce equivalent action on the part of all creditors to the extent that circumstances permit.

This set of aims is, of course, easier to embrace as a general set of principles than to act upon. The first two of these objectives require further elaboration which is provided below.

Extending DDSR sufficient to restore long-term economic viability : The evidence available upto now from the cases of Costa Rica, Chile, Mexico and Venezuela in particular, suggests strongly that DDSR of a meaningful magnitude can provide a critical impetus to recovery and long-run economic viability. In these countries debt reduction appears to have led to a surge in direct and portfolio foreign investment, the repatriation of flight capital, increased domestic saving and investment and, in some cases restored access to voluntary lending by private creditors (banks and securities markets). DDSR is obviously therefore a necessary, if by itself insufficient, condition for re-attaining economic viability. It needs to work in tandem with sufficiently strong adjustment performance to inspire the confidence of creditors and investors (especially capital flight holders) in the quality of economic management and the sustainability of adjustment measures; timed properly, DDSR can contribute significantly to "fiscal consolidation" (as in the case of Mexico) and actually reinforce the process of adjustment by reducing fiscal and monetary pressures.

The precise impact of DDSR in debtor countries is difficult to measure quantitatively partly because: DDSR has not been applied for all that long (barely two years); secondly, because its impact is inextricably interwoven with the effects of other economic events and variables; and third because it is impossible to be certain about the counterfactual prospect i.e. what would have happened and what would <u>actual</u> debt service have been in the absence of DDSR. In the case of Mexico controversy still rages about whether it really benefitted significantly from the content of the Brady deal or from its extraordinarily fortuitous timing, coming at a time when oil prices began an upward surge in anticipation of the Gulf conflict, the North American Free Trade Area (NAFTA) negotiations were announcedwhich changed perceptions of Mexico's economic prospects radically, and the fact that earlier policy changes were beginning to bear fruit. Whatever the reasoning it is usually unwise to argue with success. Our own conclusion is that the Mexican DDSR unquestionably helped at the margin and its effects were buoyed by other events. In the Philippines exactly the opposite happened so that any impact that the first DDSR package might have had was overwhelmed by other factors. Nevertheless some preliminary conclusions are emerging. First, debt reduction may actually cost creditors very little in cash terms i.e. when measured in terms of actual vs contractual debt service by debtors. Second, the importance of eliminating a structurally unserviceable debt overhang, which exacerbates investor uncertainty over macroeconomic instability (and therefore in the stability of exchange rates, interest rates and tax rates) caused by external shocks, has been seriously underestimated as a policy objective on the part of creditors. There can be little question that when successful structural adjustment depends so heavily on domestic savings and investment behaviour, and especially on the investment behaviour of private agents, the perception that a debt overhang is being eliminated and that future gains from growth and exports will not accrue entirely to creditors, can be a critical factor in sustaining and bolstering effective adjustment and reform. Where the opposite is true, i.e. when the amount of DDSR is too insignificant to change investor perceptions that the debt overhang has been dealt with adequately, the opposite results also accrue: private confidence is not restored investment does not take off, flight capital is not repatriated and adjustment does not take hold.

The key issues for creditors are how much DDSR is necessary and where should it come from? In the case of SILICs those questions are relatively easy to answer. The extent of DDSR aimed for should attempt to realign debt stocks and debt service schedules to meet existing levels of debt service, allowing a small margin of headroom for servicing new borrowings on concessional terms and incremental trade finance facilities (including restored export credit cover) of a size sufficient to generate a sustainable increase in exports and output. Clearly the main areas to look at for DDSR in SILICs are: (i) reducing the stock and cost of bilateral debt along with stretching out extant repayment schedules on IDA type terms; and (ii) the refinancing on stretched out concessional terms of multilateral debt including, in particular, IMF debt. Private debt is not as large a problem in most SILICs (with a few notable exceptions such as Nigeria and Zambia) though its remaining on the books remains a serious impediment to trade. Deep discount conversions of private debt or outright buybacks need to be pursued much more competently than they have upto now.

There is much more controversy over how much DDSR is necessary in the case of SILMICs and SIMICs and what the pattern of burden-sharing among different groups of creditors should be. These controversies have been heightened by the problem of arrears in Argentina and Brazil and by the unwillingness of commercial creditors to be as generous as bilateral creditors were to Egypt and Poland. It is clear, for instance from the Jamaica case study, that significant further reductions are necessary in bilateral and commercial debt and the introduction of greater concessionality and stretch-outs in its multilateral obligations is a matter deserving serious consideration. In Mexico there was considerable criticism that the level of debt reduction achieved by the Brady DRP was insufficient though ensuing events and outcomes seem to suggest otherwise. The same criticism in the case of the first Brady package in the Philippines has, however, proved to be correct. In Costa Rica the general consensus is that the Brady DRP resulted in much more reduction and relief than was really necessary, though that view has yet to be borne out by experience.

These examples suggest that attempts to determine with any precision the exact amount of DDSR that a country needs are perhaps ill-advised; the final outcome is inevitably the outcome of subjective judgement and negotiation. The quest for a mathematically clean and simple set of heuristics to determine how much DDSR is necessary is an understandable one. But the examples in which DDSR has been undertaken so far do not provide instant formulae except to suggest that the net result of DDSR should be to achieve a total debt service profile of no more than around 2% of GDP, 20% of total exports, with a trajectory which either approaches zero negative transfer on debt account or enables the residual net negative transfers to be financed by sustainable inflows of long-term capital on the equity account. The next stage of DDSR in SIMICs must aim to broaden the number of countries in which the various options in a market-based menu of debt reduction possibilities are exercised by private creditors (banks as well as suppliers) whether this is done within (as in Mexico) or outside (as in Chile) a formal Brady framework. The main countries in which progress must be made to achieve a turnaround in managing the debt crisis are now Brazil, followed by Poland and the USSR/CIS.

A second front which must be opened in the next phase of DDSR is the <u>reduction of official bilateral debt</u> through: (i) exercising the limted conversion option that recent SILMIC rescheduling agreements have opened up; and (ii) expanding the limits of that option beyond 10% of the non-concessional stock of debt outstanding. The prospect of bilateral creditors resorting to debt sales and conversions on any significant scale raises interesting and difficult issues about whether such sales should take place within the expanding and established secondary debt trading markets for private debt, whether they should be traded in a separate segment of that market and whether official creditors should be competing with private creditors in the same segments of investor and trading demand for SIDC paper.

Combining DDSR with other Initiatives : Unlike private creditors, official creditors are in an unusual and unique position in working closely with debtor governments to orient their debt reduction programmes towards achieving specific economic objectives which support the process of structural adjustment. For example, given the difficulties that many DES/DDS programmes already confront by way of IMF imposed ceilings which are tightly monitored, bilateral DDSR programmes could be tied exclusively to privatization programmes involving public asset swaps which, if properly designed, could avert any inflationary dangers.

Indeed, the case studies for Jamaica and Zambia suggest that well-designed programmes for bilateral DDSR aimed specifically at accelerating the privatization programmes these countries are anxious to launch or maintain the momentum of could be a crucial ingredient in the mix of policy and institutional measures to revive these economies in conditions where private investors are as yet unwilling to take the initial risk. In other indebted countries bilateral DDSR programmes could be targeted for environmental and social expenditures provided that the local currency released through debt swaps was mobilized from the market (i.e. it did not add to money creation pressures) or was offset by equivalent public deficit reduction action.

The last three objectives of DDSR noted above obviously do not require much elaboration. To the extent possible DDSR measures should be designed so as to reinforce rather than hamper the adjustment process by reducing fiscal and monetary pressures rather than fuelling inflation (as some debt conversion programmes have done). Official debt reductions should not result in commercial creditors getting a "free ride" as threatens to be the case in Poland and Egypt. Nor should official bilateral debt reductions absolve the multilateral creditor comunity from its responsibility of continuing to find ways in which its own debt and debt service claims can be reduced or deferred. Second, the tendency on the part of creditors to adopt piecemeal approaches to DDSR conditioned on their inherent antipathy toward "giving away too much too soon" has resulted in the debt crisis being prolonged for much longer than was necesssary with higher costs for both debtors and creditors. That tendency needs to be forcefully countered. Continuing difficulty in proceeding more swiftly with Brady deals in more countries and the dilution of the Trinidad Terms in order to reach consensus in the Paris Club suggests that official and private creditors have a long way to go in changing their mind sets before more productive outcomes can be achieved. The Poland and Egypt cases demonstrated quite clearly that DDSR measures are now more influenced by political thinking than by economic imperatives when the measures applied to these two countries would have been much more justifiable in other contexts. Rather than treating them as exceptions the creditor community ought to use them as a platform from which to launch a different debt strategy aimed at definitively ending the crisis before the middle of this decade.

Finally, the DDSR effort has to be one in which all creditors perceive the burden as being equitably shared. To a large extent the shareholders of banks and private suppliers have already been adequately protected and insulated from the consequences of further portfolio losses and write-offs on SIDC debt. In the final analysis the main brunt of further debt reduction falls on the shoulders of creditor governments whether they take the necessary losses: (i) directly, by way of write-downs of the assets and capital of their export credit agencies (ECAs) or of their aid agencies;

(ii) indirectly, in that they are also the principal owners and underwriters of the capital of multilateral creditor institutions; or (iii) through tax revenue losses caused by the provisioning and writing down of a greater amount of commercial debt.

Where the debt strategy goes from here in effecting the further reductions in debt stocks and debt service claims which are clearly justified depends much more on the political judgement and willingness of OECD governments to relegate the debt crisis to history than it does on presenting the economic rationale and justification for DDSR, which in virtually every SIDC, are too obvious and well-known to bear repetition.

In the following chapters this Report deals with debt conversions. More specifically, it focusses on <u>the reduction of official debt through conversion</u> as a means for achieving debt and debt service reduction. So far debt conversions have been undertaken primarily in the case of private debt. In undertaking research for this Report we discovered that a limited amount of conversion activity involving official debt has occurred though it is not much publicized. The success of private debt conversions as key elements in DDSR packages, in bringing about an impressive turnaround in Chile, Mexico and Argentina, as well as the emergence of debt markets which now make such conversions far easier, beg the question as to why such a powerful technique should remain confined to private debt. If such a technique could be applied more widely to official debt it would provide a powerful additional tool towards achieving meaningful DDSR, especially in the SILICs where private debt is relatively less significant. Indeed the door to using such a tool has been opened by the inclusion of optional conversion clauses in recent Paris Club agreements for SILMICs and now even for SILICs.

In examining the prospects, opportunities and difficulties involved in converting official debt either into equity or into local currency for developmental purposes, this Report examines the cases of Ecuador, Jamaica, Tanzania and Zambia in some detail. Chapter II reviews experience with actual debt conversion so far. Chapter III highlights the issues which have emerged in examining the prospects for official debt conversions while Chapter IV examines, in a preliminary fashion, the scope for such conversions. Chapter V evaluates the implications of official debt conversions on creditors while Chapter VI considers the financial and economic impact of official debt conversions on debtor economies. The final chapter (VII) concludes with a summary of recommendations and outlines what a second phase of this Study might wish to focus upon and achieve.

[1] Chile's debt to commercial banks had escalated from $5.3 billion in 1983 to $11.8 billion in 1986. Its debt-equity swap programme enabled that debt to be reduced to $5 billion in 1989 and to less than $4 billion by 1991 with debt service to private creditors being reduced by $1 billion annually and with creditworthiness being restored sufficiently for voluntary lending by banks to resume in 1990. However, Chile's total debt stocks and total debt service have not been reduced that dramatically with large increases in multilateral and bilateral debt replacing reductions in commercial bank debt. Chile's total debt obligations rose from $18 billion in 1983 to a peak of $21.5 billion in 1987 but have declined since to $19 billion in 1990 (and about $17 billion in 1991).

[2] See pg 38, Table 3.2 of the 1991-92 World Debt Tables which, along with previous WDT's in the series provide the source for the data contained in this Chapter. Since September 1991 Brady deals have been negotiated for Argentina, Morocco, Nigeria, and a second arrangement for the Philippines. Not all of these deals have been put fully into effect as yet. These four arrangements together are expected to result in further SIMIC debt reductions amounting to about $14 billion in commercial debt.

[3] Estimated to have grown from around $1 billion in 1985 to around $15 billion annually between 1988-90.

[4] The WDT has been used as the basic data source for this and other tables. The estimates provided for 1991 for the SILICs in this Table are higher than those projected in WDR because available data from other sources suggests that WDT has underprojected the 1991 DOD (it has consistently underprojected the latest year's estimates in the past). The 1991 estimates for SIMICs remains unchanged. The SILIC-SIMIC breakdowns do not unfortunately include DOD for countries which do not report to the World Bank, but whose debt the WDT estimates in aggregate form (see Table 1.1 pg 13 of WDT 1991-92). These include countries such as Afghanistan, Albania, Cuba, Iraq, North Korea, Libya, Mongolia, Namibia and Vietnam along with some 30 other island micro-states in the Caribbean and South Pacific. Data for these nine large non-DRS countries (excluding Libya and Namibia which are not SIDCs) provide the basis for the "Other SIDC" line shown above. No further breakdown is available for these countries to conform with the categories of debt shown above. Also there has been considerable movement of countries between the SILIC and SIMIC categories between 1982-91 with several former SIMICs now classified as SILICs (e.g Egypt and Nigeria).

[5] These have increased the dollar value of bilateral debt denominated in currencies which have appreciated significantly relative to the dollar since 1985.

[6] It is often (but wrongly) asserted that the multilateral institutions are the only net providers of liquidity to the SILICs and thus on a net basis the multilateral debt service burden is alleviated by net inflows of resources. That is only true on the debt account. Between 1982-91 the multilaterals have on average accounted for a positive net transfer to all SILICs of about $1.3 billion annually. By contrast bilateral creditors have provided an average net transfer of about $1.4 billion

annually in the same period though the net transfer on bilateral account turned a negative $815 million in 1990. But, taking into account grant capital flows from bilateral governments (which are also provided to cover debt service to themselves and other creditors) which multilaterals do not generally provide, the net transfer from bilaterals was on average a positive $12 billion annually for SILICs, dwarfing the miniscule amount of net liquidity provided by multilateral creditors. Moreover much of the exposure of multilaterals to SILICs is from their soft windows (financed by donor contributions) which enables them to be more flexible than if it was from their hard windows which are financed by borrowings on global bond markets.

[7] See "The Problem of Official Debt owed by Developing Countries", by Percy S. Mistry, op cit. para 3.14.

[8] See World Debt Tables (WDT) , 1990-91, Vol. I. pg 94.

[9] See WDT, 1989-90, Vol. I; pp 47-48 for these calculations.

[10] The second, and more far-reaching proposal, was made by the Dutch Development Co-operation Minister Jan Pronk at the Second UNO Conference on the Least Developed Countries in Paris in September 1990. It suggests that all creditor countries collectively cancel all bilateral official debt (concessional as well as non-concessional) to those least developed countries which are severely debt-distressed and other low-income countries pursuing acceptable economic reform programmes. Applied in its strictest sense (only the LLDCs) the Pronk proposal would result in the cancellation of about $40 billion in outstanding debt stocks and save on scheduled annual debt service of $3-4 billion; but actual debt service savings would be in the region of about $1.5 billion.

[11] Adopted unchanged, the Trinidad Terms would have meant a reduction in the eligible debt stock of the poorest sub-Saharan SILICs of about $18 billion. That would have been increased to $34 billion if all low-income African countries were to become eligible. It could have resulted in lowering scheduled debt service payments to levels approaching the present level of actual payments on bilateral debt service depending on the flexibility that was applied in phasing the repayment schedule. The proposal would have been substantially enhanced if it reduced interest rates applied to the residual rescheduled debt stock to intermediate, below market levels for the lowest income countries, with some flexibility for higher rates to be applied to countries less distressed.

[12] Niger's debt was purchased at 18 cents. The buyback offer was made in January 1991 contingent upon acceptance by creditors holding at least 70% of outstanding commercial debt of $111 million. In the event, 97% of that amount was cleared. The buyback included interest arrears as well as principal (which meant that creditors probably recovered 40-50% of their principal). There were two options offered to creditors: (i) an exchange of 60 day notes equal to 18% of the face value of debt plus interest arrears tendered; and (ii) an exchange of debt for long-term zero coupon notes guaranteed by US Treasury zero coupon bonds with the maturity of such notes being adjusted so that their price at the time of exchange would be 18% of the dollar amount tendered. Both types of notes were guaranteed by the BCEAO (the West African Central Bank for states in the CFA franc zone) -- the recipient agent of the grant aid

which financed the buyback. The 1986 Bolivian buyback was executed by the IMF at 11 cents when, just previously, Bolivian debt had been trading for between 4-7 cents; resulting in a few arbitrageurs making a very substantial profit on the transaction at the time. The Brady deal for Costa Rica resulted in a buyback of commercial debt and arrears also at 18 cents. Compared to these two deals, a price of 18 cents for Niger represents very poor value for money.

[13] In part because of the market-based menu approach but also because of: (i) much clearer accounting, regulatory and tax treatment for these deals and (ii) legal devices, such as novations and the use of short-term promissory exchange notes rather than cash, which have overcome the problems posed by negative pledge and pari passu clauses in syndicated loan agreements.

[14] In both Agreements creditors can choose one of three options which are supposed to be equivalent in their NPV debt reduction effect: (i) outright cancellation of 50% of principal outstanding; (ii) reduction of interest on outstanding stock to an extent equivalent to effect the same NPV reduction; (iii) reduce and partially capitalize interest (on which no further interest is applied). The resructuring for Poland is divided into two stages with the first tranche NPV reduction of 30% becoming effective in April 1991 and the second for the remaining 20% in April 1994. In the case of Egypt the first tranche for a 15% NPV reduction becomes effective in July 1991, the second for 15% in January 1993 and the third for 20% in July 1994.

CHAPTER II: EXPERIENCE WITH ACTUAL DEBT CONVERSION: A REVIEW

As part of debt management techniques, conversions of private commercial bank debt have been extensively used during the last several years in a number of developing countries as a means of reducing debt, promoting foreign investment, encouraging privatisation and furthering the achievement of other development objectives. However, swaps of official bilateral debt (ODA, other government loans, and commercial loans guaranteed by creditor governments or their export agencies) have been very rare, till recently; this was partly due to prohibitions on part of the Paris Club against selling official debt; as we shall describe below, these prohibitions have been recently lifted and a number of decisions taken to allow such conversions.

First, we will review the experience of commercial debt conversions; then we will examine the until now more limited official debt conversions. Finally, conclusions and policy implications will be drawn.

COMMERCIAL DEBT CONVERSIONS

A. Debt-for-equity swaps

As can be seen in Table 1, according to IMF calculations the estimated total volume of commercial debt extinguished through official ongoing commercial debt conversion programmes in the 1985-1990 period reached US$ 33.6 billion; this represents around 15% of the total commercial debt of all heavily indebted countries, and of the total commercial debt in 1985 of the countries listed in Table 2 (other sources, e.g. World Bank, with a broader coverage, give higher amounts). Though debt conversions clearly did not lead to overcoming the debt overhang of most HICs (with the exception of Chile, whose debt conversion programme was a major factor in eliminating the country's debt overhang, as via this mechanism almost 70% of 1985 commercial was converted, see Table 2), they did make a meaningful contribution to such debt reduction in several of the heavily indebted countries. As can be seen in Table 2, in both Argentina and Philippines, debt conversions represented over 30% of those countries' 1985 commercial debt stock; for the other countries listed in Table 2, 1985-90 debt conversions represented less than 20% of 1985 commercial debt stock.

Since Chile established the first institutionalised debt-equity programme in May 1985, many highly indebted countries (most of them in Latin America) have adopted similar debt conversion schemes. In terms of volumes swapped, in the 1985-1990 period, the largest amounts of conversion have occurred in Chile ($10.0b), Argentina ($9.1b), Brazil ($4.4b), Mexico ($4.3b), Philippines ($2.7b), Venezuela ($1.4b), Nigeria ($0.5b) and Ecuador ($0.5b).

TABLE 1:

VOLUME OF DEBT CONVERSION BY COUNTRY, 1985- 1990[1/]

(US Millions)

	1985	1986	1987	1988	1989	1990	TOTAL
ARGENTINA	469			764	1180	7038	9451
BRAZIL	537	176	336	2095	942	483	4569
CHILE	323	974	1997	2927	2767	1096	10084
COSTA RICA		7	89	44	124	17	281
ECUADOR			127	261	31	42	461
HONDURAS			9	14	47	32	102
JAMAICA			4	5	16	23	48
MEXICO		413	1680	1056[2/]	532	435	4116
NIGERIA				70	304	217	591
PHILIPPINES		81	451	931	630	378	2471
URUGUAY				104	53		157
VENEZUELA			45	49	544	716	1354
TOTAL	1329	1651	4738	8320	7170	10477	33685

SOURCES: Central Bank of Argentina, Central Bank of Brazil, Central Bank of Chile; Mexico, Ministry of Finance; Central Bank of the Philippines; Bank of Jamaica; Central Bank of Venezuela; and IMF.

1/ Face value of debt converted under official ongoing schemes. Figures do not include large-scale cash buy-backs and debt-exchanges.

2/ Does not include an estimated $6-8 billion related to prepayment at a discount of private sector debt since August 1987 signing of an agreement to restructure FICORCA debt.

In the context of this study it is interesting to emphasise the evolution of volumes of debt conversion through time. After a rapid expansion of debt conversions in 1987 and 1988 (see again Table 1), some countries began slowing down or suspending such conversion in the face of concerns such as domestic monetary implications of these operations and the possible lack of additionality of associated investments. In other countries (especially Chile) debt conversions grew rapidly, till their very success reduced the stock of available debt to sell. The revival of debt equity swaps in countries like Argentina, Mexico and Philippines was largely linked to privatisation efforts in them. This was partly in response to the potential adverse inflationary effects of debt conversion programmes in those countries; the advantage of using debt conversions for privatisation is that such operations do not lead to the monetisation of foreign debt. Thus both the fiscal and monetary expansionary impact of conversions is avoided if publicly-owned enterprises are privatised and the equity of the privatised enterprises are then swapped for debt. Furthermore if privatisation leads to increases in efficiency in loss-making enterprises, the debtor government would gain from a reduction both to its external debt and in the need to subsidise the public enterprise. However, if the government swapped debt for equity in currently profitable enterprises, the reduction in the central government's income from those enterprises could have a future negative fiscal impact, the latter case perhaps being less frequent.

Another factor explaining recent expansion of debt conversion programmes is that several recent bank debt restructuring agreements (especially in the context of the Brady Plan) contain (usually due to pressure from creditor commercial banks), commitments of debtor countries to engage in debt-equity swaps; increased efforts by many heavily indebted countries to attract foreign investment has also been a recent factor in increased used of debt-equity swaps.

The increased use of market-based debt reduction techniques (and especially debt-equity swaps) has been facilitated and in turn, has contributed to, a marked growth in the size of the secondary market. According to the data presented in Figure 1, total volume of trading of LDC debt reached in 1990 around $100 billion in 1990. (NMB, the largest European traders, real figures of trading volumes reached at least $150 billion in 1990). This is in sharp contrast with levels in 1983 or 1984, when total trading in LDC debt reached on 0.5b; thus the volume of trading has increased 200 times in 7 or 8 years.

TABLE 2:

DEBT TO COMMERCIAL BANKS; CONTRIBUTION TO ITS REDUCTION BY DEBT-CONVERSION PROGRAMMES (US$b)

	(1) STOCK OF COMMERCIAL BANK DEBT, 1985	(2) VALUE OF DEBT CONVERSIONS 1985-1990	(3) (2)/(1)*100
ARGENTINA	25.3	9.5	37.5
BRAZIL	67.1	4.6	6.9
CHILE	14.8	10.1	68.2
MEXICO	71.4	4.1	5.7
NIGERIA	4.9	0.6	12.2
PHILIPPINES	7.6	2.5	32.9
VENEZUELA	23.6	1.4	5.9
TOTAL	214.7	32.8	15.3

(1) Refers to long-term commercial bank debt; Source: World Bank, World Debt Tables 1990-1991.
(2) Based on Table 1.

Besides a dramatic increase in volume of trading, and closely related to it, there has been a streamlining and simplification of procedures; in particular, the documentation for carrying out swaps has been significantly simplified and standardised. The fact that all post-Brady bonds are really perfectly tradeable and assignable documents has played a major role in facilitating - and expanding volume of - transaction.

The LDC Debt Traders Association Inc., created in December 1990, seeks to further improve the secondary market's efficiency by adoption of standard procedures. Indeed, procedures and documentation has by now become so simplified that trading can be done over-the-counter (by telephone and/or computer). Given that deals were initially so complex to arrange on the commercial debt secondary market, (and there were so many sceptics about the market's future), its impressive development since the mid-1980s may show important potential for official debt trading to increase significantly (and to become operationally simple) especially for swapping debt for equity or development, as is discussed in future chapters. Furthermore, the precedents set and the experience with commercial debt should facilitate operations with official debt.

A review of the different country experience with commercial debt conversion and of the literature[1] on the subject seems to lead to the following three broad conclusions:

1) The economic effects of debt conversions are very heterogeneous amongst countries, and sometimes in different periods within the same country. Factors which seem to contribute to more positive results include: a) stable macro-economic environment, with low fiscal and quasi-fiscal deficit, b) the existence or parallel development of domestic capital markets, which can attenuate or eliminate monetary effects, (this is particularly well illustrated by the Chilean experience), c) clarity of objectives pursued with the programme, d) carefully designed debt conversion programmes which gear it to meeting objectives (e.g. debt reduction, encouraging additional foreign direct investment) and controlling problems, e.g. excessive monetary expansion, misuse for round-tripping of funds. For details of the debt conversion programme characteristics in different debtor economies, please see Appendix 1.

2) Debt-equity swaps have, if the policy framework, the circumstances and the programme design are right, yielded some valuable positive results. These have included:

a. <u>Major reductions in commercial debt</u>, so significant that they contributed in the Chilean case in a very important way to reducing the debt overhang, and thus helped the country's return to international capital markets; in all other cases however, the reduction of debt has been far less meaningful. In the case of countries like the Philippines, (but especially Brazil) the role of debt conversion in debt reduction has been far less significant than in the Chilean case (see Table 2). However, in the Mexican case, the country has (like Chile) now returned to the international capital markets, which was an important objective of its debt strategy; it could be argued that debt conversions played some (though not a major) role in achieving this objective. It should be stressed that other factors (besides debt reduction in the Brady context and debt conversions) played an important role in Mexico's return to the international capital markets; these include domestic policies, such as the pursuit of prudent macro-economic policies, and external events such as the likely creation of NAFTA (North American Free Trade Area).

b. Investment promotion and return of capital flight, an important bonus resulting from debt-equity conversions has in several cases been its contribution to help attract foreign direct investment and the return of previously fled domestic capital. There is debate in the literature about how much FDI generated is additional, because the answer depends on the assumptions upon which a counter-factual is based, that indicates how much foreign capital would have entered in the absence of the conversion programme. However, especially in some countries (and here again Chile and, to a lesser extent, Mexico are leading examples) there is ample evidence to suggest that conversions have contributed, both directly and indirectly, to accelerate the pace of foreign investment. Furthermore, the country origin of FDI flows have become more diversified. Naturally the subsidy granted had an important influence on persuading particular investors to come into those countries, who may otherwise not have come. Policy-makers[2] in countries like Chile stress that the favourable publicity concerning the country's economic performance, favourable business climate, and economic openness generated by Chile's early adoption of debt conversion played an important indirect role (via for example favourable exposure in international financial press) in promoting FDI flows to that country. Similarly, Mexico's more limited debt-equity swap programmes reportedly[3] also helped attract FDI.

This "kick-starting" of FDI flows to countries where previously both foreign and domestic investment was depressed was a very valuable bonus of some debt conversion programmes in middle-income countries, which could be replicated hopefully in other, relatively poorer, countries. Three caveats are important here. First, debt conversion will be effective in helping catalyse FDI and possibly other private flows (e.g. portfolio flows) if they are part of a policy package that make the country attractive to such flows. Second, there may be some trade-off between applying selectively criteria to enhance the positive development and macro-economic effects (e.g. demanding new flows to accompany debt conversion, as was done for example in Argentina, and/or restricting the sectors for which debt-equity swaps can be used as was done for example in the Philippines) and the magnitude of the debt conversions carried out. Thus, if less selectivity and pre-condition are placed by the local government (as in Chile), then a greater volume of debt conversion (and FDI via that mechanism) is achievable, though its development and macro impact may have some flaws. Greater selectivity may on the other hand limit the magnitude of operations, the additional FDI generated, even though its development impact may be enhanced. If an initial qualitative change in perception of the country is desired, perhaps a more liberal approach may be desirable, especially for the first stages. Finally, as is discussed in Chapter VI, it is not sure whether the indirect effects of debt conversion/debt reduction on attracting foreign direct investment will occur to the same extent in low-income countries as it did in middle-income ones.

Debt conversion can also be used as a vehicle to facilitate the return of capital flight by nationals of the country. In that aspect the Chilean experience is also interesting, as a special window (Chapter 18) was opened, which residents were allowed to use; this facility gave a smaller subsidy than that for foreign investors but offered an implicit tax and legal amnesty. The programme was very successful in attracting returned capital flight.

c. Export promotion and import substitution To the extent that the additional FDI attracted by debt conversions goes into tradeables sectors (and especially if they bring with them know-how, additional markets, more efficient technology), this will help promote production of foreign exchange earning and/or saving activities. There is some evidence that an important share of FDI entering through debt conversions has gone into such activities.

d. Privatisation, as pointed out above, debt conversion programmes have increasingly boosted privatisation programmes by providing an additional source of demand for equity in the companies involved. Also of importance is the fact that in some countries (e.g. Chile) the debt conversion programme reduced the debts of state-owned enterprises, making such companies more attractive to potential private shareholders. Debt conversions in this field need to be properly structured, so as to avoid biasing privatisation towards foreign ownership, and avoiding excessive subsidies going to foreign investors in companies being privatised.

e. Strengthening private sector finance, in countries like Chile, Brazil and Ecuador, the debt crisis coincided and largely caused financial problems and/or crises for the domestic private sector, especially the financial sector. Debt conversion programmes helped strengthen the private sector particularly by lowering excessive levels of debt. This strengthening of the private sector (and especially the banks) seems to have contributed to a recovery of domestic private investment.

As regards the positive effects described in d. and e., an important caveat should be made. It is important that there is a high degree of transparency in such operations (with public disclosure of operations, and possible monitoring of operations by an independent commission or by Parliament). This is to avoid excessive subsidies going in a hidden way either to, for example, foreign investors buying shares of privatised companies or to the domestic private sector, including cases where no subsidies were needed, as was reportedly the case in Ecuador, Brazil and also Chile.[4] Transparency and supervision also avoid open corruption, and make the programmes domestically more attractive, and therefore increase the likelihood that they will remain. Continuity of debt conversion programmes seems to yield better results, especially on private sector confidence, than stop-go-experiences, such as have occurred in countries like Costa Rica, Jamaica, etc.

3) Though debt conversion programmes have important beneficial effects for debtor economies, they also have problematic effects, which can however be partly or totally counteracted by efficient programme design and implementation. The potential problems include:

a) Monetary and fiscal effects, with inflationary potential. These are meaningful if the swaps are large, if debt is exchanged against local currency, if this issue is not regulated carefully in time, and if compensatory measures (fiscal and/or monetary) are not taken. If the scale of conversion is small (in relation to the money supply the problem is not meaningful, especially if the rate of expansion of the money supply and the magnitude of the fiscal deficit are small, the inflationary impact can be controlled. However, experiences like the Brazilian one illustrate that in a context of high inflation, and high budget deficit, conversions can accentuate an already serious problem. If the conversion is made against bonds, placed in the domestic capital markets, the monetary impact is diminished, but there may be a negative effect on increased interest rates. As discussed in Chapter VI, conversion against instruments such as bonds is only feasible in countries that have or are in the process of creating fairly deep domestic capital markets.

b) Net effect of conversions on Balance of Payments: There is a risk that the net effect on Balance of Payments could be negatively accentuated if the debt was previously not serviced in its totality, if there was considerable round-tripping and/or the foreign investment is not "additional", and if the flow of profit remittances and capital is higher (on a net present value basis) than the interest and amortisation payments saved by the conversion. In designing programmes and evaluating applications debtor governments need to evaluate these factors, so as to ensure at a very minimum a zero effect on the Balance of Payments.

c) Subsidy Effects: Debt-equity conversions normally imply an important subsidy, either to a foreign investor or less frequently to a resident; this could lead to an inappropriate allocation of resources, unless the operation is considered to imply important net efficiency gains. Furthermore, the magnitude of the subsidy can be regulated by the Central Bank, either through a market (via an auction, as is done for example in Chile, for Art 18, used by residents), and/or through administrative measures, such as fixing a lower value for the local currency swapped per unit of debt (called redenomination rate).

B. Debt-for-development swaps.

The resurgence of debt-equity programmes, discussed above, has been accompanied by increased interest in other forms of conversions, which can be broadly called debt-for-development swaps. Most publicity and a large share of the operations have been focussed on debt-for-nature swaps, largely reflecting priorities in developed countries and active lobbying by Northern environmental NGOs. However, some pioneering operations in broader debt-for-development swaps have been carried out; for example, six banks, from three industrialised countries, donated to UNICEF their outstanding debt obligations in the Sudan valued at more than $20 million. These operations allow for funding of high priority social spending (from a developing country perspective).

Commercial debt-for-development swaps can also be classified, depending on whether they originate in purchases or donations. Most frequently, international charitable organisations, or developed-country governments purchase commercial debt on the secondary market at a discount, which are then converted into local currency instruments, either at par or at a discount less steep than that prevailing in the secondary market. In other cases, banks have donated debt to an international charity or NGO, with the condition that the debt be "paid" in local currency, in a previously agreed programme, for conservation or social purposes.

Either in a purchase or a donation of debt, there are at least three parties participating; the commercial bank (whose debt is involved), the international NGO or charity (buying or receiving the debt) and the host government. Frequently, other parties are involved, such as financial intermediaries trading the debt and local NGOs implementing the deal. Experience indicates that the number of parties involved and the differences in their objectives implies that the process is complex and often costly in administrative and other efforts.

This may be one of the important factors in explaining the fairly limited scale of commercial debt-for-development swaps. As can be seen in Table 3, the total face value of commercial debt-for-development transactions identified reached around US$ 485 million by April 1992. If one assumes that some of these transactions have not been identified, the total could reach around US$ 500-600 million. This sum could be increased fairly significantly, given increased interest in these transactions. However, the scale of total commercial debt-for-development swaps is not only incredibly small in relation to the total commercial debt of developing countries, but also in relation to debt-equity swaps (see Table 1), which have accumulated a total of around $38b by early 1992. The magnitude of commercial debt-for-development swaps only represent 1-2% of total commercial debt-for-equity swaps.

Commercial debt for development swaps have clearly, at least until now, not made a meaningful contribution to reducing the external debt overhang and cannot be expected to. However, they have contributed marginally to such a reduction (which is positive) and have had a number of other positive effects (and some costs). Their greatest value lies in highlighting areas of high priority in social and environmental spending and shifting resources to such areas.

Before briefly outlining these, it is interesting to stress that debt for development swaps have been heavily concentrated (in terms of magnitude of swaps) in two countries: Mexico (mainly for social purposes) and Costa Rica (for the environment). (For details of some deals reached there and in other countries, see Appendices 2 and 3, with more details in the latter). Both countries governments have (during different periods) given strong support to such operations. In the case of Costa Rica, the largest swaps for a total face value of debt of ($57 million) have been arranged by donations made by the Dutch and Swedish government directly to the Costa Rican government. In the case of Mexico[5] the government has facilitated and streamlined procedures <u>and</u> provided technical assistance to NGOs as to make such deals easier. Though Mexico and Costa Rica dominate debt for development volumes, a large number of countries have or are trying to arrange swaps.

It is also noteworthy that the cost of purchasing the debt for these swaps is far below their face value, and that the average rate of redemption (at 85%), though below face value, was well <u>above</u> the cost of purchasing or receiving the debt.

As regards the benefits and costs of debt-for-development swaps, a review of the experience indicates that perhaps the main benefit of such deals is that it can place emphasis - both within the country and internationally - on high priority cases, such as social spending. By attracting attention (via usually highly publicised operations), to particular high priority programmes, these swaps may serve as a catalyst for larger shifts, in debtor government priorities and/or in donor and other international agency priorities. Particularly where such high priority areas have been relatively neglected, this will imply important efficiency gains from a broad development perspective. Furthermore, given favourable publicity, the multiplying effect in local currency of donor or creditor effort, and the assurance that the international agent's contribution will be channelled to high priority spending, debt-for-development swaps may encourage additionality of foreign exchange flows, which would otherwise not have entered the country.

The direct net foreign exchange flow effects of debt-for-development swaps tend to be far more favourable than debt-equity swaps, as in the former there is no outflow of profit remittances and capital amortisation to offset the reduction in debt service payments, as occurs in the latter.[6] This assumes that D-D-S operations are also carefully regulated by Central Bank authorities to avoid attempts at abusing such operations for "round-tripping".[7] It should be stressed that from a debtor country perspective, debt-for-development swaps are more favourable <u>if</u> there is a clear net foreign exchange saving. This occurs particularly <u>if</u> the country <u>was or</u>

was about to start servicing that debt. If the country was not, and was not about to start, servicing that debt, then the main gain occurs in a shift of spending to high priority sectors; this latter option is illustrated by the commercial bank donations made to UNICEF for increasing social and environmental spending in Sudan. In the latter case, (if the debt is not being serviced) it is important the debt is either donated by the banks or funds given by external agencies are additional to existing aid or other flows.

However if debt-for-equity swaps engender the kind of indirect secondary effects such as repatriation of flight capital, a substantial inflow of portfolio and equity investment, etc. (as they seem to have done in Chile and Mexico) their foreign exchange effects could be quite favourable for a considerable period of time before net foreign exchange outflows from dividend of capital repatriation assume significance.

Given the relatively small magnitude of most commercial debt-for-development swaps so far, risks of undesirable inflationary impact have been relatively marginal. This is particularly true where inflation and budget deficits are low, and where local currency proceeds from debt-for-development swaps are regulated in time (e.g. via issue of bonds, as in the case of Costa Rica). Furthermore, if there is a net foreign exchange saving from the D-D-S, this will generate a contractionary effect on the money supply, when such foreign exchange is used for higher imports.

It can be concluded that D-D-S are more attractive from a macro-economic perspective for countries with relatively low inflation, and which are servicing (and planning to service) most of the type of debt being swapped. For countries with high inflation, special efforts need to be made, to compensate or sterilise the additional fiscal and/or monetary effects, if these are meaningfully large.

Finally, the above analysis has assumed that D-D-S are geared to high priority development objectives, from the debtor country perspective. However, it has been suggested* that some debt-for-nature swaps tend to finance internationally prestigious environmental conservation projects (e.g. protect exotic flora and fauna), in which a large part of the returns are externalised to the rest of the world; in such cases, the benefits to the debtor's population are small, and may not compensate undesirable monetary or other effects. This problem can be overcome, if international conservation groups broadened their agenda to environmental projects with direct benefit to local populations, such as those that remedy urban air pollution, contamination of rivers and seas, soil erosion in and around farming zones. If the latter include reforestation, this may both benefit the local population and have positive international effects. More broadly, it is important that among creditors, donors, international NGOs, debt-for-development swaps are not identified just with debt-for-nature swaps; the concept should also include debt-for-social spending, either linked or not to improvements in the natural environment; this again would allow a better reflection of debtor's domestic welfare functions and development needs.

Besides debt-for-equity and debt-for-development swaps, other interesting operations (though usually on a one-off basis) have been carried out with commercial debt. One such type of operation is that of debt-for-exports, which was, for example, carried out in Peru. Such operations are interesting for the debtor country to the extent that the exports generated are non-traditional ones, and that therefore the country is using export proceeds (which it would not have otherwise received) to service the debt.[9]

There have indeed been several attempts by both debtor countries and certain creditor banks to put in place a formal procedure through which interest on foreign debt would be paid for with exports, which the creditor institutions would then market. Reportedly,[10] one of the problems in the past has been the fear that such schemes may run counter to the pari-passu and sharing clauses included in most syndicated commercial loan agreements. As a result of this, and also of the complexity of arranging debt-for-exports deals with commercial banks, it has not been possible to formally set up such a scheme in any major debtor country.

As pointed out above, the only important exception reportedly is Peru. The first such "debt-for-goods" deal was announced in September 1987, when First Interstate Bank and Midland Bank announced they would cancel a total of $96 million of short-term debt in return for Peruvian exports. Since then, the programme was extended to cover several formerly socialist East European creditors, American Express, Chase Manhattan and other commercial creditors. The system reportedly required banks to pay $2 in cash for every $3 worth of goods. The $1 difference then goes to retire short-term

TABLE 3:

<u>COMPLETED DEBT-FOR-DEVELOPMENT TRANSACTIONS</u>

(As of April 1992)

COUNTRY	COST	FACE VALUE	LOCAL BONDS	AVERAGE PRICE	AVE RATE OF REDEMPTION
BOLIVIA	$100,000	$650,000	$250,000	0.15	38%
BRAZIL	Donation	$2,000,000	n.a.		
COSTA RICA	$12,515,474	$79,853,631	$41,972,904	0.23	64%
DOMINICAN REPUBLIC	$616,400	$2,582,000	$2,582,000	0.23	100%
ECUADOR	$3,372,000	$22,000,000	$18,500,000	0.18	71%
GUINEA	$500,000	$1,000,000	$1,000,000	0.50	n.a.
MADAGASCAR	$1,395,891	$3,030,475	$3,030,475	0.47	100%
DEBT-FOR-EDUCATION	$2,000,000	$3,500,000	$3,500,000		100%
MEXICO	$2,350,000	$7,900,000 (300,000,000)[1]	$6,500,000	0.52	88%
NIGER	$500,000	$1,000,000	$1,000,000 (cash)	0.48	n.a.
NIGERIA	$1,000,000	$3,500,000	£3,050,000 (cash)	0.35	n.a.
PANAMA	$700,000	$30,000,000	$30,000,000		
PHILIPPINES	$638,750	$1,290,000	$1,290,000	0.50	100%
POLAND	$11,500	$50,000	$50,000	0.23	100%
SUDAN	0	$20,000,000	$20,000,000 (cash)	n.a.	n.a.
ZAMBIA	$454,000	$2,270,000	$2,270,000	0.21	100%
LATIN AMERICA (B of A)	$6,000,000	$6,000,000	$6,000,000	1.00	100%
PARAGUAY (IFC)	$2,000,000	$7,000,000	$7,000,000	n.a.	100%
TOTAL	$34,154,015	$193,626,106 ($485,000,000)[1]	$147,995,379	0.34	85%

[1] Though not registered in published statistics, <u>Mexico's</u> completed debt-for-development transactions (in April 1992) reach $300 million. (Based on interview material, with Lic. Angel Gurria, Mexican Under-Secretary of Finance). This would bring the <u>total</u> of face-value for debt swapped to $237 million.

Sources: World Bank. W. Sung and R. Troia <u>Recent developments in debt conversion programmes</u>, Informal Financing Note 42; UNICEF Debt Relief for Children; personal interviews and experience.

debt owed to foreign banks by Peruvian financial institutions. The goods eligible for treatment tend to be "non-traditional" exports, though fish and farm products are also eligible.

Provided technical (e.g. pari-passu) problems can be solved (and these are increasingly easier to handle), these schemes are of interest to the debtor only if the exports generated are non-traditional exports that otherwise could not have been sold in normal transactions.

OFFICIAL DEBT CONVERSIONS

As pointed out above, initially debt conversion efforts were focussed on commercial debt, with swaps of official bilateral debt practically non-existent; indeed, there were prohibitions against creditor governments selling their debt.

However, the balance of emphasis is rapidly shifting towards bilateral official debt conversion, both for equity and for development. Such operations potentially open debt conversions for other categories of countries (low-income and low-middle-income), for deals whose scale could be large, and which could be negotiated more easily and quickly with creditor governments.

The Paris Club 10% Clause

In September 1990, the Paris Club decided to allow, for heavily indebted lower middle-income countries, that "creditor countries can on a voluntary basis swap part of the claims for debt-equity swaps, debt-for-nature swaps and other swaps, for up to 10% of bilateral or officially guaranteed commercial loans, and (where relevant) for up to 100% of ODA loans; there is also a value limit ($10 million or $20 million), which can be used if it is higher than the 10% of total debt".

In late 1991, the Paris Club extended this facility to heavily indebted low-income countries.

At the time of writing (late April 1992), amongst the countries that had had this clause already approved in their Paris Club rescheduling were: Ecuador, Morocco, Congo, Cameroon, Honduras, Salvador, Bolivia, Ivory Coast, Jordan, Nigeria, Egypt, Poland, Philippines, Jamaica, Peru, Nicaragua, Senegal, Tanzania and Benin. Relatively limited activity had actually taken place in finalising official debt conversions in the framework of the "10% clause". However, a number of transactions are reportedly being considered or about to be implemented.

- Poland has presented a detailed request to its creditors for funding of a $3bn Environment Fund, with the "10% clause". Reportedly, the US and France have made commitments to such a Fund. (For details, based on speeches made by experts at the Seminar on Poland's Debt-for-Environment Swap, held in Poland, 20 November 991, see Appendix 4).

- In Egypt, the French government is reported to have accepted to convert up to $10 million of its bilateral debt, and use it for co-financing (with the World Bank), the Social Emergency Fund. France and other creditor governments (e.g. Japan) are reportedly considering a programme of official debt-equity conversions.

- For Morocco, the Netherlands and other creditor governments are considering the possibility of debt-equity swaps with their Paris Club debt.

- For Nigeria, different creditor governments are reportedly considering using D-E-S conversions to support privatisation.

- Canada is examining the possibility of converting official debt for funding additional UNICEF high priority spending in some heavily indebted Latin American country.

It should be noted that certain creditor governments have, even before September 1990, been selling (or converting) their Paris Club debt, with the aim of improving the balance sheet of their export credit agencies. Because these operations were not allowed in the Paris Club framework, they were not publicised. However, they are interesting because they pioneered D-E-S with official debt, showing that it is feasible for an export credit agency both to take equity in LDC companies and/or to sell official debt to private investors. It is interesting to note that Belgian official bilateral debt was sold at a somewhat higher price than that of commercial bank debt traded in the secondary market for that country. Another country that carried out such operations was the US, though apparently on a smaller scale; EXIMBANK converted its debt claim on Mexico into equity in a private steel company, which it later sold, recovering full face-value of its pre-converted debt claim.

The US Enterprise for the Americas Initiative

Slightly before (June 1990) the multilateral "10% clause" initiative was launched by the Paris Club, President Bush proposed a US Initiative for the Americas. This Initiative had three pillars; trade, investment and debt reduction.

As regards debt, the US Initiative proposes - for Latin American and Caribbean eligible countries - that stocks of concessional debt (PL-480-and AID) be significantly reduced; interest on the remaining debt in this category can be paid in local currency into an environmental fund, if an eligible country has entered into an Environmental Framework Agreement; otherwise interest will be paid in US dollars. Thus, this programme encourages a commitment to allocate domestic resources to the environment in exchange for debt reduction. Initiatives have recently been approved in the US Congress to broaden the local use of interest payments, more generally to development purposes, and specifically for child development.[11]

Within this clause (already approved by the US Congress) the US government has started both cancelling portions of PL-480 debt, and allowing that interest on residual stocks be collected in local currency. ECLAC[12] reports cancellation of a large portions of US bilateral debt, for Bolivia (whose US bilateral debt is mostly concessional), as well as smaller (in percentage terms), cancellations of Jamaica's and Chile's bilateral debt obligations, in the context of the Enterprise for the Americas Initiative. Implementation of the environmental fund is gradually beginning; thus, Chile - the first country to be granted this concession, in June 1991 - was, at the time of writing, in the process of defining its environment framework agreement.

As regards non-concessional debt, owed by eligible LAC countries to the EXIMBANK and Commodity Credit Corporation, the Initiative for the Americas contemplates that sale of a portion of this debt would be undertaken to facilitate debt-for-equity, debt-for-development or debt-for-nature swaps; these swaps would imply both a conversion and a reduction of such debt. Legislation to approve such operations has been seriously delayed.

Potential problems may also arise, for approval of new appropriations to fund new reductions in PL-480 debt.

Thus though the potential for both debt reduction and debt conversion of the Enterprise for the Americas Initiative is fairly large - especially for those countries whose share of US bilateral debt in total debt is large, as occurs with several small and relatively poor countries - the actual volumes forgiven and converted may be both delayed and constrained by difficulties with US Congress approval and by other internal US political and economic considerations. Another factor constraining the application of debt reduction and debt conversion is the large number of conditions that LAC countries have to meet, so they can become eligible. These include: the country should have in effect or making significant progress towards an IMF stand-by or IMF monitored programme (and if appropriate World Bank SAL), have in place IDB loan for promoting investment; and (if large part of debt owed to commercial banks), have negotiated a satisfactory financing programme with commercial banks, including debt and debt service reduction.

Even if constrained in magnitude, these Enterprise for the Americas operations may provide valuable precedents, experience and support grass-roots conservation (and hopefully social development) efforts.

Other official debt conversion initiatives

Outside the framework of the Paris Club, interesting deals with bilateral official debt have been carried out or are being considered.

First, some developing countries, and especially Mexico, have pursued an active strategy as creditors to reduce official claims via debt conversions on Central American and Caribbean countries. Some of these operations were used for example, by Mexican investors to purchase a privatised company in Honduras, to lease land on which to grow grain in Nicaragua, and to build new hotels in Costa Rica. These operations have been quite sophisticated financially, as they have involved both debt-for-debt swaps (e.g. Mexican with Honduran) and debt-equity swaps. As these operations can provide useful lessons for developed country creditors, they deserve further study, in the context of Phase II of this study.

Second, the official debt claims of Central and Eastern European countries and the ex-USSR against developing countries can be converted. An example is provided by the sale of ex-German Democratic Republic claims on developing countries to commercial firms engaged in importing raw materials, so as to help fund the large German public deficit. Surprisingly, the commercial firms are reported as recovering full face value through imports of raw materials, from countries such as Zambia; this seems very undesirable from the LDC perspective, as it implies full pre-payment of official debts, in circumstances that Zambia is not even servicing the rest of its bilateral debt in full.

Other operations are reportedly being discussed with a prospective sale of ex-USSR claims on Mozambique to private investors from South Africa for D-E-S operations.

These deals, with ex-Comecon countries' debt, are of interest in themselves; it is important to study them from and LDC perspective, to ensure that they are structured in a way that contributes (and does not damage) their development and macro-economic objectives; it is also important to evaluate the extent to which they imply equal treatment for all official creditors, and do not discriminate either in favour or against ex-Comecon creditors.

SUMMARY AND CONCLUSIONS

The experience of debt conversions (especially of commercial debt) reviewed above, leads us to the following conclusions:

a) Particularly in some countries, there has been considerable scope for debt-equity swaps. This is particularly so when the programme of debt conversion has coincided with a large programme of privatisation and with the development of a domestic capital market, as both these aspects helped to control excessive monetary expansion resulting from such programmes. To the extent that privatisation is also conducive to greater efficiency of enterprises, then debt-equity swaps can be assumed to generate significant efficiency gains, and a positive supply response.

b) The scope for clearly non-inflationary debt-equity swaps is thus much larger if the country has a large public sector, which the government wishes to privatise (e.g. recently Argentina); in other countries, where the state sector is relatively small, in relation to the total of the economy (e.g. Ecuador), and/or where the government does not have any or a large privatisation programme, the scope for debt-equity swaps may be far smaller.

However, in the latter case debt-equity swaps could still be used to attract foreign direct investment or return domestic capital into new activities; the potential problematic monetary effects can be controlled if the swaps are placed in the context of a multi-year macro-economic programme, consistent with low levels of inflation.

Indirect effects of debt-equity swaps, such as helping the kick-starting of foreign direct or portfolio investment, have been especially positive in countries such as Chile and Mexico, though it is again uncertain whether such effects would occur to the same extent in far poorer, less diversified and smaller economies, such as the Sub-Saharan ones.

c) As regards debt-equity swaps vs. debt-for-development swaps, in the case of commercial debt we can clearly conclude from the above evaluation of experience, that it is not a case of one being more benefitial than the other, but that the likely scale of debt-equity swaps tends to be much larger, both because creditors prefer to sell rather than donate debt, and because debtor governments prefer debt-equity swaps, if they involve privatisations, as this avoids inflationary impact. A similar trend is likely to arise for official bilateral debt, even though the proportion of debt-for-development swaps may be somewhat higher than in the case of commercial debt, as some bilateral creditors may well seek to find either public goods in the debtor country and/or international public goods, via official debt conversions.

[1] For useful analysis of the issues, see, for example, M. Blackwell and S. Nocera "Debt-equity swaps" IMF Working Paper, February 1988, Washington, DC; and several articles in Analytical Issues in Debt, op. cit.; for a review of debt-swap programmes and policy lessons, see, for example, UNCTC "Transnational banks and debt-equity conversions. Report of the Secretary General" Economic and Social Council, February 1991, EIC 10/1991/1; R. Ffrench-Davis and R. Bouzas (ed.) Conversion de deuda externa y financiacion del desarrollo, Grupo Editor Latinoamericano 1990, Argentina; M. Mortimore "Debt-equity swaps" CEPAL Review, September 1991, Santiago; for an analysis of the Chilean experience and lessons therefrom, see, for example, Larrain, F. and Velasco, A. (1990) "Can swaps solve the debt crisis? Lessons from the Chilean experience Princeton Studies in International Finance; M. Williamson Chile's Debt Conversion Program, CEPAL/CET, August 1990, mimeo; R. Lagos (1989) "Debt Relief through Debt Conversion: A Critical Analysis of the Chilean Programme" M.Phil thesis, IDS, Sussex; J. Aravena (1991) Debt Reduction Schemes, Theoretical and Empirical Issues for Chile, CIACO, Louvain.

[2] Interviews with senior government officials in Chile; see also, M. Williamson, op. cit.

[3] See, for example, M. Mortimore, op. cit.

[4] Interview material; see also, M. Mortimore, op. cit.

[5] Interview material.

[6] M. Occhiolini "Debt for Nature Swaps" WPS393. World Bank, March 1990.

[7] Interview material.

[8] See, for example, R. Devlin "Debt-for-Nature Swaps: A New Agenda". International Economic Insights, September/October 1991.

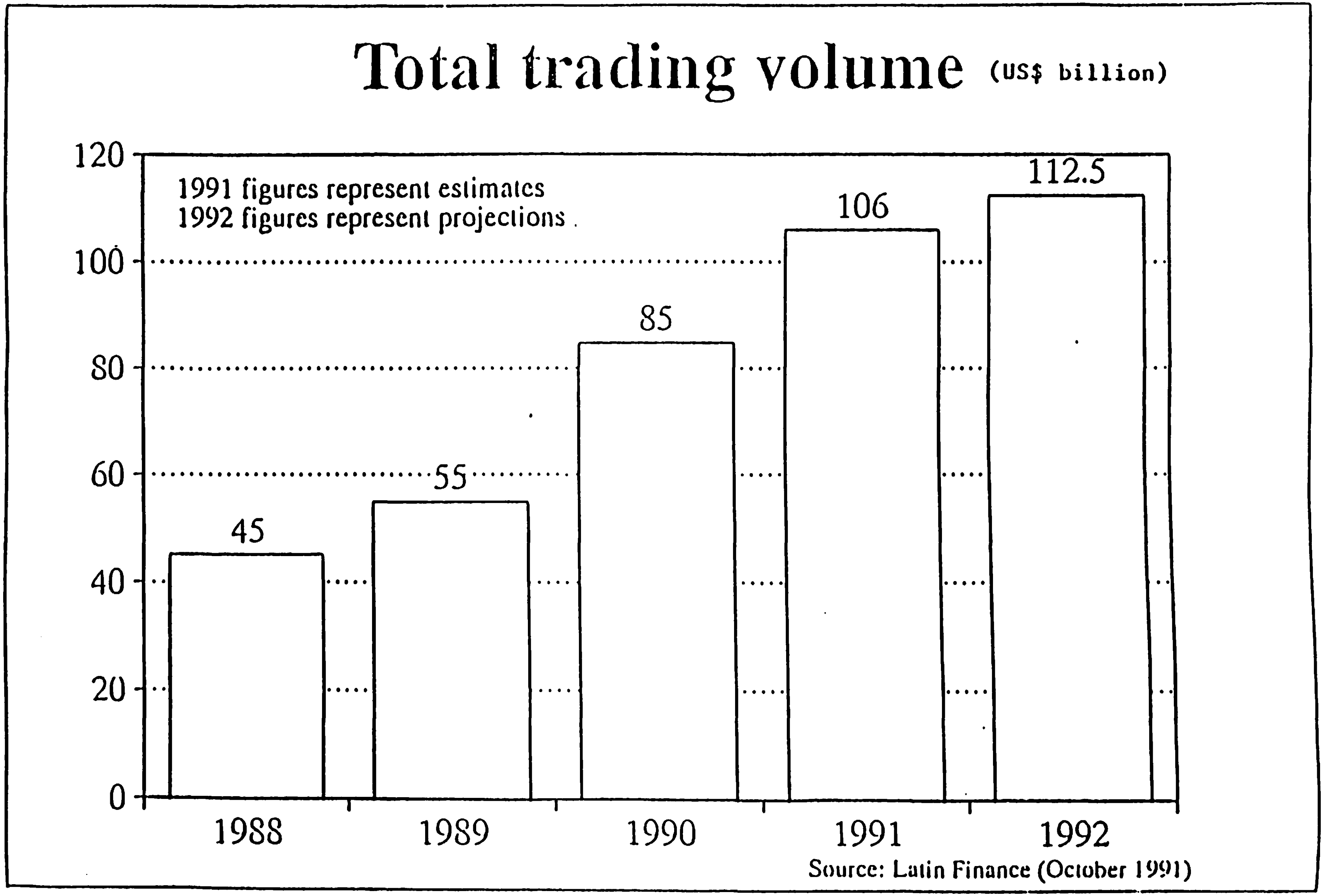
[9] I thank V. Monaldi for emphasizing this aspect, and for valuable discussions on it.

[10] "UNCTC Debt Equity Conversion. A Guide for Deciosion Makers ST/CTC/104. New York, 1990.

[11] Based on an Amendment of Congressman Dod. Based on interview material.

[12] ECLAC Preliminary Overview of the Economy of Latin America and the Caribbean 1991. Santiago, December 1991; also interview material.

F I G U R E 1


Total trading volume (US$ billion)
120
100
80
60
40
20
0
1991 figures represent estimates
1992 figures represent projections
45
55
85
106
112.5
1988
1989
1990
1991
1992
Source: Latin Finance (October 1991)

Appendix Features of Selected Debt Conversion Schemes

	Argentina	Brazil[1]	Chile	Costa Rica	Ecuador[2]	Honduras	Jamaica	Mexico	Nigeria	Philippines	Uruguay	Venezuela
Eligible investors												
Nonresidents												
Any creditor	x	x	x	x	x	x	x	x	x	x	x	x
Original creditor only												
Residents	x		x	x	x	x		x		x	x	x
Eligible external debt												
Public sector	x	x	x	x	x	x	x[3]	x	x[4]	x	x	
Private sector	x	x	x							x		x
Exchange rate for conversion												
Official exchange rate		x	x	x	x	x	x	x	x	x	x	
Parallel exchange rates	x[5]											x[5]
Valuation of debt for conversion												
Face value		x[6]			x	x[7]	x		x[8]			
Below face value	x	x	x[9]	x		x[7]		x[10]	x[11]	x	x	x
Eligible domestic investments												
Equity												
Parastatal enterprises		x	x			x	x	x		x		x
Private companies	x	x	x	x	x	x	x	x	x	x	x	x
Original obligor only	x[12]											
Debt												
Public sector		x[13]	x	x					x			
Private sector			x									
Repayment of domestic obligations		x	x		x						x	
Restrictions on eligible investments												
Restrictions on capital repatriations	x	x	x	x	x	x	x		x	x	x	x
Restrictions on profit remittances												
Same as for all foreign investment		x									x	
More restrictive than the above	x		x	x	x	x	x			x		x
Other features												
Limit on value of conversions	x	x	x	x		x	x	x	x	x	x[14]	x
Auction system	x	x	x[15]			x	x	x	x	x		x
Conversion fees							x[16]		x			
Additional foreign exchange required			x				x[17]					

Source: IFC, International Capital Markets, May 1991. Washington, D.C., [illegible]

~~Sources~~: Argentina, 1987 Refinancing Plan; Brazil, Foreign Investment Law (Law No. 4.131 and Decree No. 55.762) Central Bank of Brazil, Resolution 1460, February 1, 1988; Central Bank of Chile, *Compendium of Rules on International Exchange*, Chapters XVIII and XIX, and Decree Law 600; Central Bank of Costa Rica, *A Guide for Converting Foreign Debt Securities Issued by the Central Bank of Costa Rica into Colones*; Central Bank of Ecuador, Monetary Board Circular Nos. 395-86 and 408-87; Mexico, National Commission on Foreign Investment, *Manual Operativo para la Capitalizacion de Pasivos y Sustitucion de Deuda Publica por Inversion*; Central Bank of Philippines, Revised Circular No. 1111; Venezuela, Office of the President of the Republic, Decrees Nos. 1259 (Nov.15, 1990) and 1418 (Dec. 27, 1990), and Central Bank Resolution 89-8-04 of August 31, 1989, and Ministry of Finance Resolution 2401 of September 4, 1989; Central Bank of Honduras Circular D-036/89, July 6, 1989; Central Bank of Uruguay, Disposicion del 8 Diciembre 1987; Bank of Jamaica, *Programme for the Conversion of Jamaican External Debt into Equity Investments*, July 1987; Nigeria *Guidelines on Debt Conversion Program for Nigeria*, July 5, 1988 and 1988 Rescheduling Proposal.

[1] In November 1987, the authorities announced a new debt-equity swap scheme. The description in this table corresponds to this scheme.
[2] Introduced in February 1987 and temporarily suspended in August 1987.
[3] Debt rescheduled under the A tranche of the June 1990 rescheduling agreement with commercial banks.
[4] Rescheduled debt only.
[5] Free market exchange rate.
[6] The June 1988 rescheduling agreement allows for conversion of exit bonds and new money at face value.
[7] Depends on type of investment and on discount in secondary market.
[8] Applies to debt-bond conversions.
[9] Conversions of public sector debt are subject to a small discount; conversion terms of private sector debt are negotiable.
[10] A minimum discount of 35 percent applies.
[11] Applies to debt-equity conversions.
[12] Private sector debt only.
[13] Exit bonds can be exchanged for Treasury securities.
[14] Conversion rights will be administratively allocated if the offers tendered for debt conversion exceed the established annual limit.
[15] Chapter XVIII investments only.
[16] A fee not exceeding 10 percent of the face value depending on priority of investment.
[17] Fees depend on the share of investment funded with foreign exchange.

APPENDIX 2

COMPLETED DEBT-FOR-DEVELOPMENT TRANSACTIONS

As of April 8, 1991

COUNTRY	ORGANIZATION	SECTOR	DATE	COST	FACE VALUE	LOCAL BONDS	PRICE	RATE OF REDEMPTION
BOLIVIA								
	Conservation Int'l	Environment	Aug-87	100,000	650,000	250,000	0.1538	38%
COSTA RICA								
	Nat'l Parks Foundation of CR	Environment	Feb-88	918,000	5,400,000	4,050,000	0.17	75%
	Holland	Environment	Jul-88	5,000,000	33,000,000	9,000,000	0.1515	30%
	The Nature Conservancy	Environment	Jan-89	784,000	5,600,000	1,680,000	0.14	30%
	Sweden	Environment	Apr-89	3,500,000	24,500,000	17,100,000	0.1429	70%
	TNC/WWF/Sweden CABEI	Environment	Mar-90	1,953,474	10,753,631	9,602,904	0.1817	89%
	TNC/Rainforest Alliance	Environment	Jan-91	360,000	600,000	540,000	0.6	90%
DOMINICAN REPUBLIC								
	Nature Conservancy	Environment	Mar-90	116,400	582,000	582,000	0.2	100%
	MUCIA	Education	Jul-90	500,000	2,000,000	2,000,000	0.25	100%
ECUADOR								
	World Wildlife Fund	Environment	Dec-87	354,000	1,000,000	1,000,000	0.354	100%
	RNC/WWF/Missouri Bot Gardens	Environment	Apr-89	1,068,000	9,000,000	9,000,000	0.1188	100%
	CARE (AID)	Ag/Tech Asst/ Environment	Apr-89	500,000	2,000,000	3,500,000	0.1429	57%
	World Mercy Fund	Health	Apr-90	700,000	5,000,000	2,500,000	0.14	50%
	Harvard	Education	Jul-90	750,000	5,000,000	2,500,000	0.15	50%

COUNTRY	ORGANIZATION	SECTOR	DATE	COST	FACE VALUE	LOCAL BONDS	PRICE	RATE OF REDEMPTION
GUINEA								
	IFESH (AID)	Self Help	Mar-90	500,000	1,000,000	1,000,000	0.5	
MADAGASCAR								
	World Wildlife Fund (AID)	Environment	Jul-89	950,000	2,111,112	2,111,112	0.45	100%
	World Wildlife Fund	Environment	Aug-90	445,891	919,363	919,363	0.485	100%
MEXICO								
	Conservation International	Environment	Feb-91		4,000,000	2,600,000		65%
	Rockefeller/Min. of Health	Health	Feb-91	350,000	1,000,000	1,000,000	0.35	100%
	Harvard/Fundacion Mexico	Education	Apr-91	2,000,000	2,900,000	2,900,000	0.69	100%
NIGER								
	IFESH (AID)	Self Help	Mar-90	500,000	1,000,000	1,000,000 (cash)	0.475	
NIGERIA								
	IFESH (AID)	Self Help	Mar-90	1,000,000	3,500,000	3,050,000 (cash)	0.35	
PHILIPPINES								
	World Wildlife Fund (AID)	Environment	Jan-89	200,000	390,000	390,000	0.5128	100%
	World Wildlife Fund (AID)	Environment	Aug-90	438,750	900,000	900,000	0.4875	100%

A P P E N D I X 3

Established debt-for-nature agreements and debt for development agreements

Date agreem. established	Date debt exchange executed	Debtor country	Debt exch. ceiling, face value US$ million	Secondary market price cents/$	Cost US$ million	Face value of debt acquired US$ million	Redempt. price % face value	Conservat. funds generated US$ million	Conservation investor	Local fund adm.	Participating banks and credit institutions	Donors	Terms and aims
07/87	07/87	Bolivia	0.65	15.3	0.10	0.65	39	0.25	CI	Bolivian Academy of Sciences, Ministry of Agriculture and Peasant Affairs	Citicorp Investment Bank	Frank Weeden Foundation	The US $650,000 debt was cancelled in exchange for full legal protection of the Beni Biosphere Reserve and a $250,000 management fund in local currency. The Bolivian government also agreed to establish four buffer zones in connection with the Beni Biosphere Reserve (ref: Conservation International 1987, Conservation International 1989).
08/87	12/87 02/89	Costa Rica	5.40	17.0	0.92	5.40	75	4.05	NPF	NPF in consultation with the donors	Costa Rican Cooperative Bank (financial intermediary), City Bank, Swiss Bank	TNC, WWF-US, Pew charitable Trust, Jossie Smith Noyes Foundation, Asociacion Ecologica La Pacifica, John D. and Catherine T. MacArthur Foundation, Swedish Society for the Conservation of Nature, W. Alton Jones Foundation, Organization for Tropical Studies	The programme was proposed by the Costa Rican Ministry of Natural Resources, Energy and Mines, and was approved by the Central Bank in August 1987. Donations from various donors were given directly to the National Park Foundation which purchased the debt and exchanged it for monetary stabilization bonds, with maturation periods of up to six years paying an average interest rate of 25%. The goal of the programme is to fund conservation, environmental education, ecological tourism, sustainable forestry and land purchases (ref: Umaña Quesada 1989).
10/87	12/87 (part I)	Ecuador	10.00	35.4	0.35	1.00	100	1.00	FN/WWF-US	Fundación Natura	Bankers Trust, Citicorp	n.a	Fundación Natura signed the agreement with the Ecuador government under which Fundación Natura was authorized to exchange $10 million in debt for monetary stabilization bonds denominated in sucres. In December 1987, WWF-US reached an agreement with the foundation to provide financial support and to arrange for purchase of the debt. WWF-US bought the first million of debt in March 1988. The interest payable on the bonds is used by Fundación Natura in connection with the maintenance and conservation of Ecudaor's national parks. The interest rate was 31% the first year and is thereafter tied to the interest paid by Ecuador's five largest banks. The bonds mature in nine years. The principal will become an endowment for Fundación Natura.
	04/89 (part II)	Ecuador		11.9	1.07	9.00	100	9.00	FN/WWF-US, TNC/MBG	Fundación Natura	Morgan Guaranty Trust, Bankers Trust, American Express Bank	n.a	The second part of the programme was executed in early 1989 by WWF-US and the Nature Conservancy. The bonds received in exchange for US $9 million of debt pay interest every six months (the rate is set as on the first bonds) and the principal is amortized in seven years, starting in 1990. Income from the bonds will be invested by Fundación Natura in management and conservation programmes in protected areas (ref: World Wildlife Fund 1987, World Wildlife Fund 1989a, Nature Conservancy 1989)
06/88	07/88	Costa Rica	33.00	15.1	5.00	33.00	33	9.90	Gov. of the Netherlands	Costa Rican Ministries of Natural Resources and Planning	n.a	Government of the Netherlands	The primary objective of was reforestation operations and sustainable development activities in co-operation with various local interest groups like peasant organizations and co-operatives. The allocation of the interest payments (4 year maturation and 15% interest rate) is determined by the Costa Rican Ministries of Natura. Resources and Planning in consultation with the Dutch Government (ref: Umaña Quesada, 1989).
06/88	01/89 (part I)	Philippines	2.00	51.3	0.20	0.39	100	0.39	WWF-US	Haribon Foundation	Bankers Trust	n.a	The US $2 million swap package was developed by the Philippine government, WWF US and the Haribon Foundation. The first exchange following the agreement was made by WWF-US exchanging US $390,000 in debt for funds contributing to implementation of a conservation strategy, protected area management, strengthening of conservation groups, and training (ref: World Wildlife Fund 1988).

Source: Dogsé 1990.

Date agreem. established	Date debt exchange executed	Debtor country	Debt exch. ceiling, face value US$ million	Secondary market price cents	Cost US$ million	Face value of debt acquired US$ million	Redempt. price % face value	Conservat. funds generated US$ million	Conservation investor	Local fund adm.	Participating banks and credit institutions	Donors	Terms and aims
07/88	01/89	Costa Rica	5.60	14.0	0.78	5.60	30	1.68	TNC, NPF	NPF	American Express Company	n.a.	The Nature Conservancy bought the debts from the American Express Company and then sold them to the National Parks Foundation for 11 cents on the dollar. The bonds pay an interest rate of 15% and will mature in four years. The income will help build up the National Biodiversity Institute, support NPF and the Neotropian Foundation, protection of endangered species, and management of national parks (ref: Umaña Quesada 1989).
12/88		Sudan	0.80	Bank donation	-	0.80	-	0.80	UNICEF	UNICEF	Midland Bank	Midland Bank	Debt-for-development swap: Midland Bank donated US $800,000 of Sudanese loans to UNICEF which had a deal with the Sudanese government that local money, in exchange for the loans, would be spent in providing water wells with hand-pumps in ten villages (ref: The Economist 1987).
04/89	04/89	Costa Rica	24.50	14.2	3.50	24.50	70	17.10	Gov. of Sweden	NPF	Salomon Brothers	Swedish government, Swedish students and private conservation groups	The swap proceeds will be used for expansion and protection of Guanacaste National Park. The bonds mature in four years and pay an interest rate near 15% (ref: Umaña Quesada 1989).
05/89	04/90 (part Ia)	Costa Rica	45.00	18.2	0.91	5.00	100	5.00	NPF	NPF	Salomon Brothers, Lafisse	Swedish government, WWF-International, TNC (loan)	This three year programme (which could be classified as a debt-for-development programme) adopted in 1989 allows that US $15 million face value of debt is exchanged per year for conservation, education and micro-enterprises projects. Costa Rica's National Parks Foundation exchanged in April 1989 US $ 10.75 million face value debts for conservation bonds. US $5 million were swapped for 20 years local currency bonds with 8% annual interest rate at 100% face value. These incomes will be used mainly for land compensations in La Amistad Biosphere Reserve. The WWF-International donation (US$ 100,000), administered by WWF-US, will be used as a management endowment for La Amistad.
05/89	04/90 (part Ib)	Costa Rica		18.2	1.04	5.75	80	4.60	NPF	INBIO	Salomon Brothers, Lafisse	Swedish Government, Pew Charitable Trust, W. Alton Jones Foundation, US-AID	The second part of the deal, US $5.75 million, were exchanged for dollar denominated 20-year bonds with 3% interest and 80% face value, the income from which will support the National Biodiversity Institute of Costa Rica (ref: Umaña Quesada 1989, Janzen 1990).
07/89	No transactions ?	Peru	10-20.00	Bank donation	-	(5.00)-	100	(5.00)	IFESH	IFESH	American Express	American Express	Peru adopted a debt-for-development law in July 1989. The law provides a framework for debt-exchanges for various activities: micro-enterprises, nutrition, health, family planning, conservation, education, agricultural development, and historic preservation. American Express donated US $5 million in Peruvian debt paper for the first projects approved (but so far not executed) under the programme, which includes training activities and teaching for the very poor (Lagniappe Letter 1989).
04/89	06.89 (part I)	Madagascar	3.00	45.2	0.95	2.10	100	2.10	WWF-US	WWF-US in co-operation with the Government of Madagascar	Bankers Trust Company, National Westminster Bank PLC, Dresdner Bank, Amro Bank, Banque de l'Union Européenne, Crédit Commercial de France, Société Générale	US-AID	Using the official exchange rate, the debt will be exchanged for local cash. US-AID will cover up to US $1 million of the costs and provide US $300,000 for hard currency expenditures in relation to the swap agreement. This agreement aims at supporting conservation work built on education, sustainable development methods, and conservation, in priority protected areas. WWF-US plans to exchange the remaining US $500,000 under the agreement before 1992 (ref: World Wildlife Fund 1989b).

Date agreem. established	Date debt exchange executed	Debtor country	Debt exch. ceiling, face value US$ million	Secondary market price cent	Cost US$ million	Face value of debt acquired US$ million	Redempt. price % face value	Conservat. funds generated US$ million	Conservation investor
08/89	08/89	Zambia	2.27	20.7	0.47	2.27	100	2.27	WWF-Netherlands-
10/89	No transactions	Ecuador	50.00	-	-	-	50	-	
11/89	01/90	Poland	0.05	23.0	0.01	0.05	100	0.05	WWF-Internat., WWF-Sweden
12/89	No transactions	Argentina	60.00	-	-	-	-	-	-
03/90	03/90 (part I)	Dominican Republic	80.00	20.0	0.12	0.58	100	0.58	PRCT, TNC
05/90	No transactions	Madagascar	5.00	-	-	-	100	-	CI
TOTAL			337-347.3	-	15.42	96.01	-	58.16	
AVERAGE				16.1			61		

Date agreem. established	Local fund adm.	Participating banks and credit institutions	Donors	Terms and aims
08/89	Government of Zambia in consultation with WWF.	NMB Bank	Anonymous Swiss donor	The debts were exchanged for local currency which will be used for conservation and management of wetlands, education programmes, support to local conservation institutions, alleviation of soil erosion, and protection of rhino and elephant populations (ref: World Wide Fund For Nature 1989).
10/89	n.a	n.a	n.a	The government of Ecuador approved in October 1989 a US $50 million debt exchange programme. The Central Bank will allow that commercial Ecuadorian debt be exchanged (50% of face value) for monetary stabilization bonds paying interest in local currency, to support social, cultural, environmental, and education programmes. The Ecuadorian swap programme has, therefore, expanded beyond debt-for-nature into debt-for-development. The Government agreed in February 1990 that the Rotary Club may buy and exchange debt (US $5 million, which is the maximum amount allowed per investor) for financing of a malaria eradication programme (ref: Junta Monetaria del Ecuador 1989).
11/89	n.a	NMB Bank	n.a	The exchange was set up as a first experimental exercise in what is hoped to be a large-scale Swedish-Polish project aiming at cleaning up the River Vistula. The revenue from the exchange will support the development of Biebrza National Park.
12/89	Neuquén Foundation, Lorenzo Parodi Foundation	n.a	n.a	Argentina's National Development Bank (BANADE) approved that up to US $60 million in debt is exchanged for special BANADE conservation bonds, paying interest either in US dollars or local currency (depending on project needs). The bonds will benefit two national ecological groups: the Lorenzo Parodi Foundation (US $30 million and the Neuquén Foundation (US $30 million). Programmes envisaged include watershed protection and management of national parks and reserved areas (ref: Orme 1990).
03/90	PRONATURA Fund	MG-First Boston	PRCT	The PRONATURA Fund, which consists of 11 of the Dominican Republic's conservation and development groups, reached an agreement with the Central Bank under which within four years up to US $80 million of the country's external debt may be exchanged, at 100% face value, for conservation projects. The US $80 million represents 10% of the Dominican Republic's commercial debt. The first exchange under the programme of US $582,000 (funded by the Conservation Trust of Puerto Rico) will support four conservation projects developed by the Nature Conservancy and PRONATURA, which also administrates the proceeds (ref: Orme 1990, Nature Conservancy 1990a).
05/90	n.a	n.a	n.a	The Government of Madagascar has agreed that Conservation International exchanges US $5 million of the nations commercial bank debt and trade credits, at 100% face value, over the next five years. The swap proceeds may be deposited in private Malagasy banks as an endowment fund paying interest in local currency. The fund is intended to support conservation activities, including inventories of endangered species, environmental, and education programmes (ref: New York Times 1990).

Appendix 4

Environment Fund:
A new source of project finance

Poznan Environment Fair
November 20 1991

John E Marrow
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This paper summarises the proposed activities of the Environment Fund - what it will do and how it will do it.

The purpose of the Fund is to implement a cost-effective programme that addresses international environmental problems. Four key areas of concern have been identified:
(a) transboundary SO_2 and NO_x pollution;
(b) pollution of the baltic;
(c) greenhouse gas emissions; and
(d) biodiversity and nature conservation.
Allocation of finances among these four areas will reflect creditor preferences.

The Fund's programme will be one that Poland alone cannot finance. Projects will be additional in the sense that, without the assistance of the Fund, they would have either not proceeded at all or only proceeded at a substantially later date despite their international importance.

Secondary objectives of the Fund will be to stimulate efficiency and professionalism in environmental agencies and to encourage the private sector's contribution to environmental objectives. The latter concerns not just financial assistance with pollution abatement but also financial assistance for private sector companies meeting environmental needs.

The Fund will be created as a new organisation sufficiently distinct from existing environmental agencies to facilitate accountability and demonstrate additionality. Nonetheless, the Fund will work closely with existing agencies to ensure clear coordination with domestic programmes.

Disbursements from the Fund will take the form of grants. Projects offering no financial return will be eligible to receive support up to 100 per cent of the project cost. On the other hand, projects offering some financial return, albeit insufficient for the project to be viable, will be eligible to receive support for a limited proportion of the project cost or an interest rate subsidy. In all cases the guiding principle will be to provide a level of financial support sufficient to render the project viable taking account of other sources of external aid.

The programme will support various types of project including those that:

- clean up existing sources of pollution;
- introduce new clean plant;
- stimulate a domestic environmental protection industry; and
- educate and train.

However, the bulk of the Fund's expenditure will be on projects that provide direct environmental benefits.

Examples of likely priority projects include:

- flue-gas desulphurisation and low-NO_x burners at existing power plant;
- gas supply to all sectors;
- energy efficiency in all sectors;
- forestry;
- methane recovery from coal mines and landfill sites;
- municipal water treatment plant;
- sewerage systems; and
- industrial waste minimisation.

Operations of the Fund will concern all phases of the project cycle: identification; preparation; appraisal; approval and monitoring, together with disbursement administration and general administration to support all of the foregoing.

The Fund will develop strategies in each of its areas of activity and will identify projects to implement those strategies. Thus, project proposals might arise from an initiative of the Fund to invite bids for a specific project - solicited proposals. Alternatively proposals might be put forward on the initiative of a project sponsor - unsolicited proposals. The Fund's policy will be to welcome unsolicited proposals. If a project sponsor is interested in making an unsolicited proposal, it will be encouraged to discuss its proposal at an early stage with the Fund. The potential proposer is warned that the Fund might decide to invite competitive proposals for the project.

Formal responsibility for project preparation will rest with the proposer. Nonetheless the Fund will have an active role in, for example, making sure that proposers with the capability and resources to prepare projects themselves understand the Fund's requirements and standards; and helping other proposers to find the financing or technical assistance necessary for preparatory work. In certain cases the Fund may provide financing through a Project Preparation Facility.

For those projects meeting some simple screening criteria, a formal appraisal report will be produced, which will match the normal expectations of banks and aid agencies for project investment. The report will address the following:

- assessment of benefits;
- assessment of costs;
- environmental impact assessment;
- technical method;
- financing plan;
- project management; and
- monitoring and reporting.

A successful project will demonstrate both cost-effectiveness in meeting its environmental objectives and value for money in respect of the Fund's expenditure. The latter will be influenced by the availability of leverage through cofinance. The terms of the Fund's participation in the project will be confirmed at this stage.

Possible sources of cofinance include:

- corporate funds;
- bank borrowing;
- domestic environmental agencies; and
- international agencies.

The amounts that may be raised by way of leveraged funds will clearly depend on a number of factors including the willingness of agencies to cofinance and the ability of the Polish private sector to become financially involved. The expectation is that cofinancing from overseas agencies and the international private sector will be equivalent to the foreign currency component of project costs.

The approval process for project finance will include acceptance by the Supervisory Board of both the appraisal report and the terms of the Fund's participation. Further requirements will apply where cofinaciers are involved. A formal agreement will then be signed by the project sponsor and the chief executive of the Fund.

The Fund will monitor project implementation, procurement and disbursement against agreed schedules, will identify and facilitate correction of any problems arising, and will ensure timely availability of funds for ongoing projects.

Finally, the timetable for establishing the Fund is short. The Fund will commence operation early in 1992.

The Polish government has a responsibility to ensure that the arrangements for the swap programme will not impose an impossible strain on its budgetary position and jeopardise its ability to meet the conditions of its IMF facility. To the extent that expenditure within the swap framework is matched by reduced debt service there will be no incremental budgetary demand imposed by the programme.

The proposed arrangements would allow Poland to reduce its payments into the Bank for International settlements to the extent that documented eligible expenditure, in either local or foreign currency, has taken place. Expenditure in Zloty will be converted on the basis of the prevailing official rate of exchange. The arrangements will require a relatively simple agreement overlaying the arrangements already in place under the Paris Club agreement.

The mechanism for matching expenditure with debt forgiveness would work on the basis of a cumulative rolling total so that eligible expenditures would match the profile of the debt forgiveness, as would be the case for example during the start up of the administering Fund's operations before the first projects were at the point of implementation, then the unused entitlement would be paid into an escrow account bearing the appropriate market rate but would be available to be drawn upon subsequently by the Polish side, against eligible expenditures. In this way the escrow account will ensure that Poland's debt-for-environment swap is not just an excuse for a "free lunch" as far as Poland is concerned.

With a debt-for-environment programme, creditors' contributions to the programme (made by the Polish Government in consideration of debt canellation) would be leveraged in two direct ways: First, cofinance of specific projects by multilateral agencies (EBRD, World Bank, IFC, NEFCO etc) and bilateral agencies; and second, private sector finance complementing partial project financing from the Fund administering the swap programme.

Appendix 4.

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November 1991

THE PARIS CLUB DECISION ON DEBT-FOR-ENVIRONMENT OPTION FOR POLAND

As already mentioned, in April 1991, Paris Club members agreed in principle to provide for exceptional debt relief for the Government of Poland. The agreement, which was in recognition of the unique challenges facing Poland as it moves toward a market economy, provides for a reduction of 50% in net present value of debt service to be implemented in two tranches; in addition the agreement includes a provision for participating creditor governments to cancel a further 10% through debt swaps on a voluntary basis.

The Polish Government wishes to take up the 10% provision to institute a debt-for-environment swap programme funding investments specifically aimed at alleviating Poland's contribution to regional and global environmental problems and achieving the most cost-effective environmental improvements.

If all the Paris Club members accede to the proposed debt-for-environment swap programme, the value of the resources available to fund the programme would amount to about $3.1 billion in net present value terms. The swap would provide a facility which has a value each year of equal to 20% of the debt service stream following the Paris Club Agreement (equivalent to a 10% reduction, in net present value terms, of the level of debt prior to the Agreement). This will make possible an initial annual expenditure of approximately $120 million which will increase in time in line with the annual debt service profile agreed with the Paris Club.

While the funds provided for in the framework of a debt-for-environment programme may be relatively small in relation to Poland's overall environmental needs, they would nevertheless constitute a significant injection of additional resources which would otherwise be not available at this time due to the period of austerity accompanying Poland's structural adjustment programme. This in turn will enable Poland to contribute to environmental solutions in ways which would not be possible if Poland had to rely on its own unaided efforts. Furthermore, a debt-for-environment programme will likely trigger supplementary co-financing by other agencies, in particular the official multilateral financial institutions.

The Polish Government's debt-for-environment initiative has aroused considerable interest amongst the Paris Club creditor countries. Several governments have signalled that they are seriously condidering participating in such a programme, and the United States has already availed itself of the possibility of the further 10% debt swap provided for in the Agreed Paris Club minutes.

The Polish Government understands that there are difficulties for some member countries to participate in the initiative at this time. To accommodate these difficulties the debt-for-environment swap programme is so designed as to leave the door open for countries to join when they are ready to do so. The Government is also anxious not to unilaterally impose its own vision of how the debt-for-environment programme should operate. Accordingly, the specific details as to the form and mechanics of the swap programme are being worked out in close consultation with creditor countries. These consultations are ongoing. As a result, some of the institutional, financial and technical arrangements of the programme have yet to be finalized.

Having said that, there are some basic principles which are at the heart of the Polish debt-for-environment swap proposal.

BASIC PRINCIPLES OF THE SWAP PROGRAMME

The first is the principle of ADDITIONALITY: A primary objective of the programme will be to channel additional resources to projects which adress regional, international and global enironmental problems. The environmental projects selected will be additional in the sense that, without the assistance of the swap programme, they would have either not proceeded at all or only proceeded at a substantially later date despite their international importance.

Thus not only will the funds be used to increase the expenditure on projects of international and global significance, but the expenditure will represent an increase in the total environmental spend so that resources are not diverted away from projects which adress environmental priorities in Poland.

In practice it is very difficult to asses additionality on a project basis since this presumes the existence of a clearly identified baseline programme with a specific timetable for each individual project over what will be a twenty year time horizon. For this reason under these circumstances the more relevant concept of additionality is defined in terms of total expenditure on environmental projects.

In short, the essence of the principle of additionality is that Poland is not seeking a soft option. Debt swap funds will not be used as an easy means of covering the financial burden of the domestic agenda for environmental expenditures. Nor will debt-for-environment be an easy way out of debt repayments. The fundamental objective is to achieve real and measurable additional environmental improvements, and to be able to demonstrate thereby to the international community that their trust and confidence is not misplaced.

A second principle at the heart of the Polish debt-for-enviroment proposal is the issue of COST-EFFECTIVENESS of fund expenditure in relation to achievement of the programme's objectives of adressing international environmental problems. The cost-effectiveness approach is the the most efficient way

of spending the fund's resources and the most acceptable to potential co-finacing multilateral institutions.

The cost-effectiveness principle also underpins our view on how the allocation of available money be best achieved. The Polish government believes that it is important for this to be done on a "club" basis. By this we mean that each participating country would be able to indicate their preferences between the different (four) areas of environmental activity and that the individual preferences would then be added together to create an overall allocation of fund resources. In other words, if the size of debt forgiveness for a particular participant in present value terms is $X million then they might allocate two thirds of X to, say, SO2 abatement and the other thirds to biodiversity. The total split between the areas would emerge from the sum of these allocations across all participating countries.

There are several reasons for doing this on a club basis. First, to achieve the maximum result for a given spend requires the potential projects be assessed against each other and then implemented in order of the best projects first. Selecting projects in isolation and allocating funds on an individual basis would be immensly complicated and would diminish the impact of the funds. One debt-for-environment programme would be far more effective and practical than, say, seventeen separate ones. Second, the availability of funds in relation to each individual country will be relativley small to begin with. Hence it would be unwise to start several projects simultaneously, with the larger projects taking years to complete. A collaborative pooling of resources and concentration of projects would produce more effective results for the money available in a shorter period. Thirdly, the size of the individual projects will not neatly match the size and profile of each individual debt forgiveness, hence a whole series of bilateral deals would be impractical to implement.

The issue of the club approach also affects the question of procurement within the framework of the swap programme. The Polish Government's preference is for an open system of procurement rather than a system of tied procurements. First, a system of open tender ensures maximum cost effectiveness of funds spent and thus an optimal allocation of resources. Second, potential co-finaciers may be reluctant to become involved in tied procurement programmes. A number of multilateral organizationshave indicated to us that the degree of their potential involvement in co-financing is dependent on the implementation of an open procurment system. Tied procurements may, therefore, hinder the flow of co-financing resources.

FINANCIAL MECHANISMS

Finally, some words on the financial mechanisms for the swap programme. These are still in the process of development and are the subject of negotitaion between the Polish Government and the creditor countries.

CHAPTER III: OFFICIAL DEBT CONVERSIONS: THE ISSUES

Debt Reduction: The Case for further Progress

The previous two chapters reviewed the need for further debt reduction and experience with debt conversions to date. Debt cancellations have been confined to the least developed SILICs whose bilateral creditors have forgiven about $8 billion between 1983-91. Most debt conversions have been undertaken in SIMICs and, until very recently, have involved the conversion of private commercial bank debt for both debt-equity (DES) as well as debt-development (DDS) swaps. But, broadly speaking, debt conversions also include debt buybacks and exchanges, various forms of private debt restructurings and debt-debt conversions (which is what debt for bonds swaps effectively are). Taken together all types of debt conversions, including the Brady deals completed so far, amounted to nearly $98 billion between 1985 and March 1992 of which some $38 billion were DES and DDS conversions. Over 85% of such activity is concentrated in six countries Argentina, Brazil, Chile, Mexico, the Philippines and Venezuela. With the recent Brady deals in Nigeria and Morocco the pace of DES/DDS activity is expected to pick up in these countries as well. The rate of debt reduction in individual SIMICs where private debt predominates is now faster than it is in the SILICs where official debt predominates although SILICs need DDSR to an even greater extent than SIMICs. The recent Poland/Egypt arrangements add further weight in favour of the SIMICs with official debt reductions in these two countries likely to amount to $51 billion (face value) when the agreed arrangements have been fully implemented and a further $5 billion if the proposals put forward by Poland and Egypt to persuade creditors to exercise the 10% conversion option are eventually accepted by their creditors.

The largest part of recent private debt reductions have occurred through debt exchanges under Brady debt reduction packages (DRPs) since 1989 which have involved buybacks as well as swapping commercial bank debt for a reduced value of discount bonds; these options have resulted outstanding debt reduction of $41 billion with an NPV of $25 billion. Yet total outstanding debt has continued to climb in both SILIC and SIMIC groups while debt service performance has deteriorated and arrears increased. There are therefore powerful reasons for continuing with DDSR in the interests of reviving sustainable growth in debtor economies and reinforcing adjustment efforts. But there are equally powerful reasons for the creditor community to reduce SIDC debt burdens in its own interests to improve the overall value of its residual portfolio of debt after reduction well beyond that which could be sustained if debt burdens are not reduced.[1]

Debt cancellations in eligible SILICs are not going to be as large as was once anticipated under proposed Trinidad Terms with their dilution in the Paris Club consensus of December 1991. Till cancellations are sufficient to realign debt burdens more realistically, in keeping with the actual debt servicing capacity of SILICs, more extensive use of debt conversion options by official creditors will need to be employed whether for commercial (DES) or developmental (DDS) purposes. Continuing tolerance of a high level of arrears on bilateral and private debt is inevitable if the preferred position of multilateral creditors is to be preserved through their preemptive claims on debt service. In SILICs private debt stocks have fallen from a peak of $32 billion in 1988 to an estimated $27 billion in 1991 (reflecting mainly movements on Nigerian debt) but annual debt service to private creditors has actually increased from $2.6 billion to over $3.5 billion between 1988-91 reflecting higher amortizations in 1991 with interest payments remaining at a level $1.1 billion. Cancellations notwithstanding, bilateral debt stocks of SILICs have continued growing. They are now about $10 billion larger than in 1988 with debt service to these creditors having increased from $2.4 billion to $3.3 billion between 1988-91 of which interest payments account for over a half. Multilateral (including IMF) debt stocks registered a $7 billion increase over the same period with debt service payments rising from $2.9 to $3.5 billion. Given the weak response of SILIC economies to adjustment and policy reform measures these rising debt and debt service levels are a matter of considerable concern as the growing level of interest arrears (from $8 billion in 1988 to $13 billion in 1991) would indicate.

In the SIMICs the impact of debt stock and debt service reduction in private debt burdens is already being felt. SIMIC debt service to private creditors has dropped from a peak of nearly $34 billion in 1988 to an estimated $25 billion in 1991 reflecting a reduction in private debt stocks from a peak of $262 billion in 1987 to $220 billion now. Clearly the net reduction in private debt stocks does not reflect the gross value of debt reductions and conversions that have taken place. But offsetting these private debt reductions official debt stocks and debt service have continued to grow. The bilateral debt of SIMICs is also $10 billion larger than in 1988 with debt service payments having climbed from $4 billion to $5.4 billion in 1991. Multilateral (+IMF) debt has grown even faster from $42 billion to $54 billion in those three years and debt service payments increased from $9.5 billion to $14.2 billion. The rise in official debt and debt service has therefore more than offset the decline in private obligations. As with SILICs, interest arrears of SIMICs continued to grow from $15 billion in 1988 to over $35 billion in 1991 (reflecting to a large extent the arrears of Argentina and Brazil). These will be reduced in 1992, with the arrangements just concluded with creditor banks in the case of Argentina and, hopefully, also for Brazil before year-end.

The general picture which emerges is that although DDSR has been accepted as a legitimate objective in the post-1988 debt strategy the overall results up to the end of 1991 have been disappointing. Overall debt burdens have not been reduced significantly except in isolated cases. And where they have been reduced significantly (as in Chile, Costa Rica, Mexico and Venezuela) their economic impact seems to far exceed the financial debt service savings generated. The need for further progress with DDSR therefore remains urgent. The initiatives which have been launched to reduce private debt have not been extended to as many SIMICs as quickly as had been hoped between 1989-[illegible] although 1992 has so far seen more rapid progress being made The init[illegible] Brady negotiations and arrangements proved cumbersome and protracted requiring greater flexibility on the part of private creditors and the need for more funding support from official sources. With experience in a wider range of countries earlier problems are gradually being ironed out and the increasing sophistication of debt trading markets themselves, coupled with increasing standardization of tradeable paper are now providing an added impulse for more Brady deals to progress. Multilateral debt, of course, remains out of bounds for discussion in the context of debt reduction, although the build-up of this kind of debt throughout all SIDCs is reaching proportions which is bound to raise the same questions in the not too distant future.

The greatest immediate potential in breaking new ground with debt reduction lies in the bilateral debt arena where creditors have upto now been eluctant to face squarely upto the reality that their claims cannot realistically continue to be valued at face. It is now time for bilateral creditors, especially the ECAs, to acknowledge the same reality that commercial banks have done and to apply similar measures and techniques for official DDSR. The recent Paris Club agreements for Poland and Egypt appeared to acknowledge that reality. But since then bilateral creditors appear to have retreated behind the cover of these cases being "exceptional" and not precedents. That position lends a much more emphatic political dimension to the position of creditors on debt reduction than on grounds of economic rationality even as they ask debtors to justify the case for seeking reductions on the latter.

However, with the inclusion of debt conversion clauses in the Paris Club rescheduling agreements (PCRAs) with SILMICs since September 1990, and the requests that Poland and Egypt have made in mid-1991 asking creditors to exercise their debt conversion options, bilateral creditors face new choices in using these clauses to extend debt reduction beyond consensually agreed limits. The use of these conversion clauses, however raises several issues which are discussed in detail below.

General Issues Concerning Official Debt Conversions

Transparency & Competitiveness of Conversions - The Five Price Concept : Five "prices" are involved in undertaking official debt-equity conversions which determine the net gains and losses to debtors and creditors of such transactions: (i) the secondary market discounted price of the debt being converted; (ii) the redemption price i.e. the proportion of face value that the debtor agrees to convert into local currency; (iii) the transaction or conversion fees and taxes which are levied by the debtor government or the central bank to capture part of the market discount benefit; (iv) the price in local currency of the asset to be acquired; and (v) the special sweeteners that are offered by debtor governments to encourage foreign or domestic investment through DES, often accompanied by offsetting repatriation restrictions in the medium-term to avert premature pressures from arising on the balance-of-payments until adjustment has occurred. All five prices influence the NPV calculations on which the cost/benefit outcome of conversions are judged. On the basis of experience it is essential, especially where official debt conversions are concerned, that all five prices be transparent and equitably applied across the board to avoid perceptions of inequitable treatment among creditors which could disrupt bilateral relations, and to avoid excessive subsidies being provided, inadvertently or otherwise, to foreign investors. In the case of official creditors, debt conversions need to conform to clear policies and objectives which are codified and transparent. It has often been suggested that to ensure transparency and competitiveness official debt sales be conducted through auctions in markets in the debtor country themselves. Though attractive in concept this measure does not necessarily guarantee transparency or efficiency. More than in the case of private debtors, official creditors need to act in concert rather than on a voluntary individual basis to avoid free rider problems from arising within the official creditor community.

It is also important for debtor governments to recognize that parties undertaking debt conversions invariably look to the combination of the discount and redemption prices (along with the other sweeteners) in offsetting an overvalued real exchange rate in the debtor country. To the extent that nominal exchange rates are distorted the objective of parties engaging in conversions is to achieve an equivalent exchange rate close to the rate that could be procured in the parallel market. The benchmark set by the parallel rate is usually an important guide for debtor governments in determining the combined effect of these five prices. Where governments have not tracked market discount rates of their external debt carefully, or have not taken parallel rates into account as a guide in setting redemption prices, debt conversions can themselves become sources of exchange rate instability. For example, in Zambia conversions of "pipeline debt" were done at prices which resulted in Zambian holders of flight capital or legally sanctioned foreign accounts to obtain local currency at a multiple of the parallel exchange rate. The debt conversion route was then used to finance several cycles of "round-tripping" and feeding the demand for dollars in the parallel foreign exchange market.[2]

Additionality vs Substitution: Debtors, particularly SILICs, are concerned that debt conversions should be seen not as substitutes for cancellations but as supplements. Conversions of the DES type clearly involve future claims on debtors which may exceed the NPV of expected cash flows on debt service for the unconverted claim; cancellations do not. Their saving grace, however, is that such claims only arise in the event that the projects/enterprises they finance generate positive financial returns (which many undertakings financed by debt did not) suggesting, in the aggregate, an enhanced capacity on the part of debtors to meet those claims. In SILICs the scope for DES is more limited than in SIMICs. Even under the most optimistic scenarios for <u>cancellation</u> envisaged under the new ETT the overhang of bilateral debt stock will remain sufficiently large to make <u>conversions</u> a necessity in achieving necessary levels of DDSR. In these cases conversions will clearly be additional to cancellations. Concerns about substitution of conversions for cancellation are more germane in SILMICs and SIMICs where ECAs remain reluctant to write down claims and see no need to take premature losses in conditions where they believe that recovery is possible. They are especially reluctant to do so when they are also underprovisioned. In some instances creditor governments are reluctant to cancel claims because they believe in maintaining leverage and exercising conditionality over debtor country economic management in the post-conversion phase. Conversions are clearly preferable to cancellations for creditors who believe in the need to maintain that leverage even though their convictions might be (as experience suggests) self-defeating. The examples of the "breakthrough countries" clearly indicate that DDSR is not a zero-sum game. It is a positive-sum game in which creditors stand to gain as much as, if occasionally not more than, debtors as a result of enhanced values of residual claims resulting from improved relative debt servicing performance (as the previous amount of actual debt service can be spread over a smaller debt stock), from secondary effects such as flight capital repatriation, new foreign equity flows and reinvigorated domestic savings, and from generally improved economic prospects consequent to the removal of a debt overhang.

Conversion Preference: In some unusual instances (e.g. Ecuador, Jamaica and Zambia) debtors and creditors might be better served by conversions rather than cancellations if the former resulted in wider efficiency gains that might not otherwise accrue. If DES were to result in the acceleration of privatization resulting in better utilization of productive resources or DDS were to improve the quality of development expenditure, of investment in human capital, and encourage environmental protection and the sustainability of development then the cancellation option, which might not result in debtors (or markets) taking the same measures left to themselves, could be a distinct second best. Clearly the terms on which official DES conversions were done would have a material bearing on whether or not they would result in net welfare gains to the debtor economy and whether those gains would be captured through the design of the programme.

Legal & Technical Problems : Official debt claims are highly varied in their nature and in the contractual agreements involved, much more so than private commercial bank claims. This is not a problem if official claims are to be cancelled as is effectively the case with DDS. It is if the claims are to be converted into equity or any other type of future claim. Official claims are structured differently for each source of credit within and across a wide range of creditor countries. In their present form they are not particularly easy to transform, assign or transfer to third parties. In the case of bilateral claims already rescheduled, especially under TT or ETT, they would be difficult to convert if only because the debtor may not perceive any benefits in doing so. Many Paris Club reschedulings have clauses in agreements whose implications for conversion are not yet fully understood. A detailed understanding of the nature of ECA and other types of claims (aid, military credits, commodity credits, government-to-government loans etc) is essential before the extent of the legal and technical problems involved in conversion can be comprehended. To avert an excessive amount of complexity in the conversion process it might be possible to novate i.e. exchange existing claims for promissory notes with standard features which reflect the maturities and coupon obligations of the existing bilateral claim. The Paris Club could be instrumental in standardizing such exchange instruments in the event that official debt sales in secondary markets and bilateral debt conversions grow in volume.

A particular complication arises in the case of insured ECA claims which usually provide less than 100% indemnities leaving the original policyholder with an unindemnified portion of 5-25% but with full rights and obligations which ECAs are bound to protect in their rescheduling or conversions. In some instances (e.g. Germany) the policyholder remains the titular "owner" of the full claim and has the responsibility of attempting to secure full recovery even when the ECA has paid out the indemnity. Dealing with these "tail" claims has proven to be a major legal and technical problem in circumscribing the flexibility of ECAs wishing to consider debt reduction or conversion. In some instances the "tails" have had to be bought out at full face value, in other instances at negotiated discounts which are generally above the secondary market price (Sweden, Belgium and Switzerland). In the Polish debt restructuring the German government faces the prospect of being sued by policyholders unwilling to accept a 50% reduction on their portions of the claim. There is no easy and general answer to this problem except for creditor governments to provide tax or other incentives to "tail-holders" to sell their claims at discounts either to ECAs or to specialist intermediaries trading in debt. What is clear is that this problem will need to be resolved before ECAs can act with the manouvreability that is necessary to engage more proactively in official debt reduction or conversion programmes. It is an issue which will need to be considered in further detail in Phase II of the present project. Complications also arise in the conversion of official debts which have been previously rescheduled; and aspect which is discussed separately and in more detail later in this chapter.

Monetary Impact of Official Debt Conversions : Many DES and DDS programmes have been slowed down by ceilings imposed by the IMF on debt conversions because of their imputed impact on money supply expansion and inflation. The inflationary effects of official DES/DDS conversions would depend on the nature of the swap transaction and the level of current debt service actually being paid on the obligations to be converted. Several lessons have been learnt from previous experience with DES/DDS programmes in mitigating inflationary influences:

(i) An up-front disbursement of cash at face value can be highly inflationary.[3] Local currency redemption of converted debt should, to the extent possible, be made in the form of debt instruments with medium-term maturities and bear interest at rates which do not pose immediate or long-term threats to budgetary control.

(ii) DES conversions are less likely to be inflationary than DDS because the former contribute to increasing producive capacity and supply thus being generally deflationary.

(iii) Direct swaps of foreign debt into real assets (equity in privatized enterprises, land, buildings, equipment etc) without requiring an intermediate swap into local currency may involve no increase in money supply.

(iv) DES restricted to privatization programmes and properly designed can have either a neutral impact on inflation or even a beneficial impact when revenues accruing to the treasury help to suppress the public deficit and reduce the calls made by government on central bank credit.

Many observers, including several market-makers in developing country debt, believe that the IMF's concerns about the inflationary effects of debt conversions are overplayed and impose an unnecessary and damaging restriction on providing timely DDSR. Specific models developed by financial advisors to debtor countries indicate that there is an immediate monetary expansion effect resulting from debt conversions which can be managed by phasing the rate of actual local currency emission over time. But the expansionary monetary effect declines very rapidly and, after four or five years, debt conversions can actually have a contractionary impact on money supply as a result of reduced future public debt servicing demands.[4] The problem for macroeconomic management however is underlined by these models in that governments and the IMF are more concerned about short-run money supply effects in achieving stabilization and adjustment and much less impressed by longer-run consequences. Nonetheless there is concern in the private creditor community about the IMF's unswerving belief that debt conversions provide debtor governments with a soft option for avoiding fiscal and monetary discipline. This line of thinking seems excessively rigid especially when debt conversion caps are applied indiscriminately to privatizations involving real asset swaps with the proceeds flowing directly to the Treasury. Depending on the financial engineering involved such conversions could be neutral or (in the medium term) even beneficial in terms of their consequences for money creation and should not be ruled out of order on a blanket basis. On the whole the fiscal and monetary implications of DES or DDS operations in most debtor countries are likely to be insignificant relative to other factors which exacerbate fiscal deficits and fuel money growth. As the Chilean example clearly suggests it is possible to have very large debt conversion programmes and manage them sufficiently well to avoid any non-trivial inflationary outcomes. (For more detailed discussions on this point, see Chapters II and VI).

Confusing Development with Debt Reduction Objectives : In instances where DES/DDS programmes are tied in with specific development objectives such as privatization, capital market development, environmental or social funding and the like it often becomes difficult to disentangle the cost/benefit ratio to the country emanating from the debt conversion itself from the other objectives which might be tied into the design of the programme. That makes it more difficult for creditors and debtors to assess clearly what the parameters of the conversion should be, so that both of them gain from it. As noted earlier there are several prices involved in a DES/DDS arrangement which affect debtor, creditor and foreign vs domestic investor perceptions differently. It is essential therefore for official creditors, even as they attempt to tie in their conversion options with measures that would achieve wider efficiency and welfare gains, to be clear about the benefits accruing to themselves and the debtor governments as a result of these conversions. The IMF is concerned that in official debt equity conversions (ODEC's) too many different issues and objectives might easily become confused with the DDSR objective overriding other legitimate concerns involving the five prices referred to above and distorting any or all of them. For example, ODECs focussed on privatizations might result in exacerbating the endemic underpricing of public asset sales which has been observed in many privatization programmes in order to attract public support. Alternatively governments might vitiate fiscal policy by providing tax concessions, price support guarantees or off-take guarantees to privatized enteprises to assure their short-term viability. Given the mixed experiences of private DES programmes across different countries the

IMF (pointing to the limited gains from DES in countries such as Jamaica, the Philippines and Costa Rica) was more cautious and sceptical about debtor countries, and especially SILICs, being able to deal with the more complex issues of ODEC programme design while acknowledging that if well-designed and executed such programmes could have useful secondary spin-off effects, as were evident in Chile, Mexico and Argentina.

Conversion & Conditionality : DES programmes are usually constrained by conditionality monitored by external interlocutors (usually the monetary ceilings monitored by the IMF). They have occasionally provided a canvas for disputes among IFIs on the wisdom and efficacy of particular conditionalities. The IMF is invariably supported by bilateral creditors in the Paris Club who are pursuing their own agenda. The complications arising from these successive layers of conditionality and cross-conditionality [5] are troublesome and need to be resolved differently. Debtor countries clearly need to take the initiative and develop their own independent capabilities, with impartial technical advice, for devising DES programmes. Technical support from the IFIs and commercial sources needs to be obtained and applied in a coherent manner. In devising these programmes debtors need to identify clearly their areas of priority for DDS and their preferred (or excluded) areas of investment for DES operations with a clear sense of the impact that such preferences might have on the debtor's own fiscal and monetary position.

Conditions for Conversion Success : Official DES/DDS conversions would be most beneficial to debtors in conditions under which:

(i) They were already servicing a large proportion of the debt intended for conversion as that would result in immediate forex savings. If only a small proportion of the debt intended for conversion was being serviced then conversion would only achieve its intended objective if the local currency creation impact was small and its emission was regulated over a period of time, especially if underlying inflation was already high and proving difficult to bring under control. If debtors were not servicing the debt being converted, and creditors were tolerant of arrears on the assumption that such debt would eventually be written off, the net effects of conversions would be negative unless, under exceptional circusmtances, other efficiency gains were realized.

(ii) Converted debt was swapped for public assets resulting in conversion proceeds helping to contain fiscal deficits and reducing pressures to increase money supply.

(iii) Any incremental money supply effects were countered by offsetting actions by way of reduced public expenditures in areas being financed by swaps, the enhancement of revenues or by market borrowings of local currency to cover the local currency requirements of conversions.

End-Use of Converted Funds: Controversy persists over whether the proceeds of official debt conversions should be directed in some way or whether their end-use should be determined entirely by market forces. There are strong sentiments in favour of official creditors supporting developmentally oriented programmes such as privatizations and infrastructural investment which complement and support the preferences exercised by private investors through other DES programmes. Similarly there is a difference of view on whether official debt conversions should only be a small adjunct to local currency resource mobilization by government or whether the local currency constraint is sufficiently binding that such conversions should be employed on a wider scale for mobilizing domestic resources within controlled fiscal and monetary parameters. Clearly the situation will vary from country to country with no general prescriptions being applicable to all cases. Official creditors are more inclined (or feel more pressed) to justify their actions in terms of the developmental gains likely to accrue through conversions than are commercial creditors; there is therefore a predilection towards "directing" the end-use of converted funds. The simplest approach, however, would be to utilize official debt in debt trading markets without attempting to pre-determine the efficiency of end-use while leaving open the flexibility to induce particular types of transactions which the market might not normally trigger (e.g. in infrastructural investments).

Funding Official Debt Swaps for Equity or Development : The local currency counterpart of DES (in most debtor countries with conversion experience) is generally funded not with an immediate exchange of cash but with debt instruments (notes or bonds) denominated in local currency which approximate in maturities the original terms of the converted debt. These bonds are convertible in full at the time equity is purchased by the prospective investor. For DDS operations debtor governments have established off-budget trust funds (or endowments) as vehicles for providing local currency aganist converted debt . These are funded either through: (i) annual contributions of local currency over a period of time (e.g. by interest payments on residual debt as under EAI arrangements with Bolivia, Chile and Jamaica); or (ii) local currency non-tradeable bonds with the same features as used for DES operations usually with long maturities for the eventual payment of principal but with annual payments of interest, usually at domestic market rates. If official debt conversions (DES/DDS) are undertaken on any large scale closer attention will need to be paid to the design of local currency emission to ensure that cash flow is controlled in line with monetary targets and that the issuance of large volumes of government debt (for which informal discount markets are bound to emerge if formal ones do not) does not itself result in financial instability.[6]

The Use of Aid for Official Debt Conversions : In considering the prospect of official debt reductions and conversions creditor ECAs and Treasuries have often suggested the use of aid budgets to finance such programmes. Aid agencies have quite rightly resisted such pressures arguing that this would result in a suboptimal use of aid and divert scarce foreign exchange from debtors to creditor ECAs. They have been prepared to assume responsibility for debt transferred from ECAs to aid agencies providing such a transfer is entirely additional and does not result in offsetting reductions in aid appropriations. Even using aid funds for outright debt buybacks is questionable in terms of the benefits it brings to debtors who are not servicing such debt; the net benefit in most such transactions accrues largely to particular creditor agencies.

The debate on this issue, however, will continue for some time especially when creditor government budgets continue to be under considerable pressure and new claimants emerge for official development assistance. ECAs argue that if debt conversions are economically worthwhile then the use of aid resources to finance them are legitimate and justified. Aid agencies (and rational theory) argue that under a set of extremely aid resource-constrained circumstances debt cancellations and/or conversions cannot be seen as aid substitutes particularly for the SILICs. New aid, cancellations and conversions should not be seen by official creditors as mutually exclusive options but as complementary measures, each supporting the other. Under those conditions the continued provision of aid as net new foreign exchange needs to be accompanied (not replaced) by the cancellation of debt obligations which cannot possibly be serviced to the extent that the creditor community can consensually agree, and the conversion of further residual debt which might impose constraints on prospects for immediate stabilization and economic recovery, for medium-term adjustment and for long-term development.

Converting Rescheduled Debt : As observed earlier, creditors (and debtors) have pointed to the substantial technical and legal complexities involved in attempting to convert pre-cutoff date debt which has been rescheduled. For debtors who have received rescheduling terms which are of the Toronto (TT or ETT) varieties there is little immediate benefit in having such debt converted because the actual cash-flow savings would be negligible. As the agreement of debtors would be required before such debt could be converted official creditors should focus on converting post-cutoff debt which may impose real debt servicing budens for debtors but which do not require debtor agreement for creditors to act. There may be complications for creditors in pooling the shorter maturities from several different claims and converting them (to have the maximum immediate impact on debt service savings in the short-run). But those problems pale in comparison to those that debtors are likely to confront in adjusting their own debt records for such transactions. This difficulty may well suggest the need for novation or exchanges of debt instruments between debtors and ECAs which are more amenable to conversion.

Creditors would obviously prefer to convert rescheduled debts if that enhances the value of their claims, enhances prospects for larger eventual recoveries, or enables them to realize cash from debt sale transactions. Debtors would for the same reasons prefer to reschedule post cut-off date debt which imposes the larger debt service obligation. Novations such as the exchange of assignable promissory notes for official ECA claims would be pointless for rescheduled debt, especially on TT and ETT, since the terms of such reschedulings render the NPVs of such promissory notes so low as to make them virtually non-marketable. Hence the real scope for official debt conversions lies with post cut-off date debt which has not yet been rescheduled, unless debtors are willing to agree (for the right price) to waive terms of rescheduling for previously rescheduled debt if they attach particular priority to its conversion. Creditor ECAs, however, are concerned about whether their entry into the debt conversion market is likely to compromise their standing in the recovery of already rescheduled claims or whether large-scale conversion programmes will make the rescheduling option defunct. Having become comfortable through habit with reschedulings (regardless of the consequences for debtors which creditor ECAs do not see as being their concern) ECAs are not anxious to cope with the uncertainties involved in embarking on courses of action whose outcomes, and whose legal and accounting implications, are not yet clear.

Specific Issues Concerning Debt-Equity Conversions

In addition to those discussed above several specific issues arise in connection with official DEBT-EQUITY (DES) conversions. These concern:

Ownership of Converted Official Equity Claims : Several OECD creditors which have through the 1980s undertaken large scale programmes of public asset divestiture in their own countries are reluctant to become shareholders of corporations in debtor economies. Neither are debtor governments particularly anxious to have foreign governments as shareholders in their domestic enterprises. Unlike banks or other private creditors neither creditor governments, nor those ECAs which are government departments rather than independent corporate entities, can directly undertake official DES operations on their own account. They are therefore left with the following three options in converting official debt into equity:

(a) Sell their claims directly in the secondary market and withdraw from further involvement.

(b) Sell their claims on a negotiated basis to their own state-owned entities and have them pursue DES opportunities in SIDCs -- e.g. in France it might be perfectly feasible to persuade French banks, the railway company, the telecommunications company and the coal company, to invest in their counterparts in SIDCs; or

(c) Transfer official claims from the primary creditor source (e.g. ECGD in the UK or Hermes in Germany) to the equity investment promotion arms of these governments (CDC or DEG respectively) which specialize in making equity investments in developing countries.

With the first option the nature of official claims would need to undergo substantial transformation and standardization to be feasible on any significant scale. Many ECAs do not confront as large a problem in transforming post cut-off claims as they would with rescheduled claims. Indeed it was surprising to discover that many ECAs already have clauses in their agreements requiring an exchange of claims for promissory notes at their option. The second option is clearly open to creditor governments but puts those creditors with large SOE sectors at an advantage vs those creditors who do not have such parastatals. It may raise concerns in debtor governments about the indirect involvement of foreign governments in owning visible and strategic utilities in SIDCs. It would trigger the same concerns among the creditor community as the use of mixed-credits has aroused i.e. that these official conversions were being used to obtain an improper competitive advantage (as indeed the case of Iberia's buying Aerolinas Argentinas has done even though that transaction involved commercial rather than official debt). The third option is perhaps the easiest and most practical for almost all creditors. In deploying it creditor governments have two choices. The investment agency (e.g. CDC in the UK) can act on its own account after having the debt claim transferred to it from the ECA (e.g. ECGD) at a mutually agreed transfer price (reflecting either the secondary market price for commercial debt or an internally agreed price) effected through the Treasury. The claim could represent either an equity infusion or subordinated loan to the investment agency from its shareholder government. Alternatively, the investment agency could be asked to act as trustee in managing the government's foreign asset portfolio through equity conversions in SIDCs . The formula chosen would depend very much on the situation in each creditor country. It may pose interesting internal political and bureaucratic problems but is by no means insuperable from a technical or legal viewpoint.

Competition with Private DES: The prospect of official debt conversions has raised the issue of potential conflict or competition between official and private debt conversions. The concern is that official debt conversions executed through secondary markets would add to the difficulties that commercial banks seem to be facing in reducing their private claim portfolios through conversions by expanding the supply of paper on the market, depressing the price and competing for the same group of potential investors. Clearly these concerns would be mitigated to the extent that official creditors chose other options for implementing their conversion programmes. But even if they did not the fears of competition which have been expressed might be overplayed.

There is a large segment of potential market demand for DES which has not yet been tapped through private DES operations. This includes investment by utilities (electricity, gas distribution, water and sewerage) and large transport enterprises (including railways, trucking companies, shipping lines airport and seaport management authorities) in creditor countries to make investments in SIDCs (in the same way that airlines and telecommunications companies are doing). By contrast private DES operations are still heavily concentrated in manufacturing, mining, oil production, airlines, hotels and telephone companies. Official debt conversions can also be used for BOOT (build-own-operate-transfer) projects for toll roads, power stations, tunnels, bridges, export processing zones, industrial estates, mass transit systems and other infrastructural undertakings for which user charges can be levied and the activity operated commercially.

The general feeling on the part of market-makers and debt traders is that -- with perhaps the early hiccups which inevitably accompany any major shift in market supply or demand -- the entry of official debt paper onto secondary LDC debt trading markets would serve to widen and deepen these markets and would, as a result of market forces and innovation by market intermediaries, result in newer segments of demand for official LDC debt paper emerging. This may be an optimistic view expressed by self-interested traders. But developments in other financial markets tend to bear it out. The evolution of secondary markets in LDC debt and the range of innovations which have already emerged in that market have been driven largely by market players. There is no particular reason to suppose that the entry of official debt into secondary markets would simply swamp the supply of debt paper in the face of fixed demand and drive down the price of all types of traded debt. Financial market intermediaries have demonstrated the capacity to "find" segments of demand whose needs will match the characteristics of expanded supply. Obviously the timing and volume of official debt entry into secondary markets will need to be carefully engineered; but that is no different a concern than the care which needs to go into the planning and launching of any major issue of securities in any market. The most encouraging aspect of prospective official debt conversion activity is that the principal market-makers generally tend to see its emergence (which many consider inevitable) as a desirable and overdue phenomenon which they are anxious to accommodate rather than as a threat overhanging the market which they are anxious to avert. Opinions are divided however on whether official debt should be transformed immediately into standardized debt instruments of the post-Brady kind so that they are not diferentiable from other types of traded paper or whether they should be transformed into a different type of claim and traded in a differentiated market segment. The considerations involved in reaching a final judgement on which of these two options would prove more efficacious are technically esoteric and deserve to be looked at further in Phase II of the Study.

An interesting aspect of the public vs private conflict in debt conversions was portrayed by a major creditor bank which saw private DES as a means of exercising certain "rights" acquired (as unpaid creditors) to participate in future gains from real asset ownership through equity claims, or to enjoy immediate realization of cash through sale and transfer of those "rights" to third parties. That bank believed that these "rights" even if unexercised should be capable of being traded openly in a structured manner in same way that common share warrants or rights were traded on stock exchanges. Government creditors could not be put on a par with private creditors in having similar rights because their lending was motivated by considerations other than purely commercial ones; considerations which involved, at the time of lending or guaranteeing, their own broader economic interests (i.e. maintaining full employment, promoting exports etc) legitimately financed by public money. In other words, the self-interest element involved in the official credit transaction automatically resulted in official creditors implicitly surrendering similar rights to private creditors because their motives were quite different; those of private creditors were purely commercial, those of governments or ECAs were not. Official debt conversions into equity would however imply that governments had similar rights to private creditors and could exercise them or trade them. The manner of their engaging in such operations might impinge upon and diminish the value of the "rights" of private creditors providing a good reason why official DES should not be considered. This argument albeit laboured and in some aspects questionable contains provocative thoughts about whether certain implicit "rights" do accrue to creditors when debt contracts are not honoured and how such rights can be valued and exercised, as a different approach to the debt conversion and claim transformation issue.

The Price of Official Debt: Perhaps no issue arouses as much argument, and dispenses with as much logic, as discussions with official creditors on what the present value of their debt claims in SIDCs is. Official creditors have been consistently wrong about repayment expectations and economic recovery in SIDCs for nine years. Yet they appear to be tenaciously unrealistic about the valuation of their own debt portfolios. That tendency is reinforced by adherence to government accounting protocols by most ECAs (which maintain the fiction of face value) rather than corporate accounting conventions which require values to be marked to market and provisioned for. In reality many ECAs employ a hybrid routine and have begun providing against their value-impaired debt following guidelines issued by their regulatory authorities (e.g. ECGD applies the Bank of England matrix). Some European official creditors expressed the view that it would worsen the moral hazard problem if debtors were encouraged, by creditor provisioning practices, to think that their non-concessional debt obligations were formally being recognized as worth less than face value. Such an outcome would cause major public accounting and audit problems within the governments of creditor countries with such audits resulting in curtailing new aid and export credit flows to countries in which conversions or cancellations were made.

Official creditors usually claim that the price signalled by the secondary markets for private debt trades is too low and the markets too imperfect and thin to emit genuine price signals reflecting unconstrained and independent supply and demand functions. They are strangely consistent in their view that the "right" price of their claims is probably at the mid-point between market value (whatever it happens to be at the time) and full face value. They seem curiously incognizant of the non sequitur implied in the belief that there can be a "right" price outside of a market framework which is better derived from bureaucratic judgement than by independent operators in an admittedly imperfect market. While the "genuineness" of the price signal emitted by secondary debt markets continues to be hotly debated, there is no gainsaying that market price signals are often distorted and rendered volatile by commercial bank behaviour which is in turn influenced by end-of-quarter pressures, taxation circumstances, regulatory pressures for capital adequacy and so on as well as sporadic speculative demand and price pressures caused by news of events such as imminent closure on Brady deals, Poland deals, commodity price increases, movements in global exchange and interest rates etc. Many European and American bankers have also expressed the concern that after the Polish debt rescheduling the "political pricing" of debt might prevail over market pricing.

The volatility in price movements of LDC debt traded on secondary markets in 1990-91 was due in large part to the emergence of Chile and Mexico as countries which had re-established voluntary access to capital markets and to the Polish official rescheduling which was seen as increasing the prospects for better debt servicing performance on private obligations. But it was driven by demand for speculative portfolio trading activity and not genuine investor demand for swaps. New portfolio investors (institutional and individual) have now entered the LDC debt market for adding a potential element of additional volatility into price movements which could be dampened by expanding the supply of paper through sales of official debt.

Many observers argue that the secondary market price is too low because it consistently reflects the views of the most pessimistic banks about expected cash flow from debt service payments rather than realistic expectations based on past performance and future trends. Others build an equally convincing case for the view that the market emits price signals which are too high. If they were not, speculative demand pressure from portfolio investors would be much higher than it presently is with sophisticated global institutional investors consistently earning excess risk-adjusted investment returns. The most appropriate view for official creditors to take might well be to use the market price as the best benchmark available and to adjust their own discounts or premia according to hard evidence of past trends and factors likely to affect future performance in the differential servicing by debtors of different types of debt. That approach might yield interesting results in arriving at the conclusion that the market emits price signals which are too high in some cases (e.g. Zambia which has invariably serviced more private debt than bilateral debt) and too low in others (like Mexico which has always attempted to meet rescheduled repayment obligations to bilateral creditors in full because of the importance attached to maintaining full export cover).

Discussions with market traders seem to suggest that as the market becomes wider and more sophisticated it has already discounted these variations in debt servicing patterns. Therefore the real price of official debt might not be that much different from the secondary market price prevailing. Any significant reductions in bilateral debt stock are therefore bound to have a salutary impact on the price of the residual stock. The ability of ECAs to formally recognize and record their claims as having less than face value depends largely on the accounting conventions they employ and the level of provisions they have been required by prudential management or by law to build up.

Reserves & Provisions : ECAs and aid agencies are generally underprovisioned against losses on their SIDC asset portfolios mainly because their accounting conventions and statutory obligations have not required otherwise. Treasuries in almost all OECD creditor countries are under pressure to contain fiscal deficits which does not leave much room for enthusiasm or adventurism in writing down large amounts of SIDC debt if the accrued losses have to be passed through the budget in one way or another.[7] There is no easy short-cut to resolving this difficulty through financial engineering devices (as was done in the case of banks) except to suggest that if Treasuries were prepared to absorb losses as large as those for Poland and Egypt in the same year on political grounds it is relatively pointless to investigate the issue of "affordability" (in financial and economic terms) of debt reductions for other SIDCs on the part of creditors when their proclivities are driven so strongly by political motivations. What may be necessary in the medium-term is the equivalent of a Basle-Accord for ECAs which would establish general conventions for ECA captalization, accounting for portfolio values and provisioning, allowing flexibility for the applicability of national laws and conventions. The statutory configuration of an ECA need not, by itself, be a barrier to the application of more generally agreed international conventions as indeed the hybrid behaviour of many ECAs already suggests.

Use of Intermediaries : An important operational issue for ECAs is whether they should rely mainly on specialized intermediaries in SIDC debt markets in undertaking their conversion operations or whether they should attempt to develop their own in-house capabilities. The answer is -- both. There are concerns on the part of ECAs that use of intermediaries may involve conflict of interest issues since the intermediaries are such large players on these markets. ECAs generally believe that the level of advisory fees and transaction costs levied by financial institutions which become a significant factor in calculating the costs and benefits of conversion programmes to creditors and debtors. Some creditor governments have expressed a strong view in principle that private intermediaries should not get involved in brokering official debt sales and associated conversions to avoid the "benefit of the discount" from being captured by any party other than the primary creditor or the debtor country. The perception gaining currency among primary creditors and debtors is that market intermediaries capture a much larger share of the discount benefit than is often transparent or justifiable. That perception has been bolstered by the posture of IFIs. There is no clear evidence to support such presumptions nor, unfortunately, to dispel them. The real question to be addressed is whether there is a case for the interim development of a specialized sub-market in trading official claims (which need to become increasingly standard and liquid in their structural characteristics). Such a market might involve only ECAs, aid agencies, parastatals undertaking official DES, bilateral and multilateral investment agencies and debtor agencies to start with. Specialized market making, bid-offer pricing, settlement services and transactions knowledge would certainly be required to make the market work. Virtually no ECA has the in-house capacity to develop such a sub-market without help from specialized intermediaries. Such a sub-market could later become a fully integrated part of the private secondary trading market when private and official debt claims became indistinguishable in their trading features. The question is: Would such a sub-market facilitate or impede official debt conversions?

Seniority of Converted Claims: In theory, official creditors would undertake conversion operations through the market if they were convinced that the price obtainable in the market met their expectations in terms of NPV of expected cash flows minus the inefficiencies signalled in the price. They would do so through their own investment arms only if they felt that the probability of future equity returns exceeded in NPV terms what they might get in the market. For the latter condition to hold however they would need to be convinced that the residual stocks of unconverted debt and of converted equity would enjoy seniority and preference over older forms of debt, without which the conversion would be seen as pointless. [a] Seniority in this sense would imply assurance of conversion into foreign exchange and repatriation of dividend streams from converted equity investments; repatriation of capital proceeds and gains from investment sales after a reasonable time period; improved debt servicing on the restructured residual bilateral stock that was not cancelled or converted (which would also result in an upward valuation of the residual debt stock as a consequence of the expected price rise that would follow). Clearly the seniority and repatriation requirements should not impose such stringencies on debtors as to cause them run into balance-of-payments problems and arrangements would need to have some flexibility.

Administrative Costs : Like debtors, creditors are beginning to appreciate the considerable administrative costs involved in repetitive rescheduling exercises with counterproductive results. Outright cancellation, or conversions into local currency claims for DES or DDS would alleviate the administrative costs of rescheduling but would add to portfolio management costs unless these could be covered on an incremental basis because of ongoing portfolio monitoring activity by the investment agency concerned anyway. Such costs would need to feature in any cost/benefit calculation that official creditors might undertake to assess the advantages of the conversion option.

These issues were among the most significant raised during our examination of official debt conversion possibilities and constraints. They are not meant to be exclusive or exhaustive at this juncture but indicative of the areas that need to be looked into in greater depth during Phase II of the Study. Research undertaken for Phase I suggests that the key factors inhibiting faster progress with official debt conversions are:

(a) The surprising lack of financial sophistication on the part of ECAs and decision-makers in governments; by comparison their much more financially sophisticated counterparts in private investment banks have been instrumental in engineering various swap and conversion techniques much more innovatively and aggressively in secondary markets for private LDC debt.

(b) Internal confusion and conflict among different agencies within creditor governments which view opportunities and constraints regarding debt conversion in very different perspectives with no effective inter-agency co-ordination on developing a clear, consistent creditor government position.

(c) Legislative limitations and widespread underprovisioning and inadequate reserves in most creditor countries which act as powerful constraints on conversions which involve sales of official debt at discounted prices.

(d) The reluctance of creditor governments to end up as holders of equity in developing country enterprises.

(e) The immense heterogeneity of different types of official claims which appear to intimidate government officials in tackling the problem through novation.

(f) An unwillingness on the part of OECD creditors to accept the reality that the Paris Club rescheduling process has failed in the SILICs and does not address adequately their DDSR needs.

(g) The absence of any debtor initiatives, other than those by Poland and Egypt, to take creditors up on exercising their conversion options clauses suggesting to creditors that this avenue for debt reduction is not of interest to debtors.

Progress with official debt conversions will depend on tackling all of these shortcomings simultaneously.

1 For persuasive arguments on this point see "Market-Based Debt Reduction for Developing Countries: Principles & Prospects" by S. Claessens et al, The World Bank PR Series No. 16, 1990.

2 We are grateful to Michel Bouchet and Amit Ghose for reminding us of this important point.

3 Such disbursements which used to be prevalent in many African debtors experimenting with DES/DDS can also exceed the value of expected debt service payments on instruments being converted. The inflationary impact can be exacerbated if the debtor is not servicing the debt being converted.

4 For example a major European bank undertook an analysis of the money supply impact of debt conversions on the Polish economy which showed that their effect on reserve money would increase money supply (but by rapidly diminishing amounts) in the first four years and would thereafter exert a contractionary effect.

5 For example, Jamaica recently complained that the IADB was being even more restrictive on money supply growth conditions than the IMF was thus impeding its well constructed and executed debt conversion programme.

6 An interesting situation has arisen in the case of Jamaica which finds that the domestic resource costs of debt conversion programmes is becoming much higher than originally anticipated. This has happened because domestic (variable) interest rates applicable to the Equity Investment Bonds (EIBs) issued by the Treasury in exchange for foreign debt are now very much higher than US dollar rates (35% vs 7%) because of pressure to maintain real positive rates in the domestic market. The result is that holders of EIBs prefer to hold them for the high real yield rather than exchange them for equity investments. As of September 1991 about J$240 million in EIBs remained outstanding with an annual interest bill on these bonds of over J$75 million which was adding to the fiscal deficit.

7 In some major creditor countries (e.g. Germany) exercising the 10% conversion clause, incorporated into post-September 1990 Paris Club Agreements for SILMICs and nor SILICs, would be regarded as equivalent to a debt cancellation for which a specific federal budgetary provision would need to be made. There were no provisions in the 1991 or 1992 budgets to accommodate such conversions nor did existing legislation readily permit the conversion of non-concessional claims, especially for export credits and suppliers' credits. In the US debt conversions and reductions under EAI after FY92 require the Administration to offset these against appropriations for new lending programmes to affected debtor countries. The amount of reduction to be charged against budget authority is not the full face value of the outstanding claim but the difference between what, in NPV terms, the Administration would reasonably expect to collect over the remaining maturities of the claim and the amount of up-front forgiveness.

8 For an excellent discussion of this point see Claessens et al, ibid pp 21.

CHAPTER IV: SCOPE FOR OFFICIAL DEBT CONVERSIONS

Based on the four case studies undertaken during Phase I of the UNCTAD Project the scope for official debt conversions was determined to be extensive and immediate in Jamaica and Zambia but likely to involve considerably more preparatory work in Ecuador and Tanzania. This Chapter is divided into two parts: (i) the scope for commercial debt conversions i.e. debt equity swaps; and (ii) the scope for non-commercial conversions i.e. debt-for-development swaps.

Scope for Commercial Debt Conversions

In Jamaica and Zambia the scope for commercial debt conversions is considerable and these two countries provide ideal conditions in which to follow up on Phase II of the UNCTAD project by offering their governments specific assistance in designing a carefully designed blueprint for official debt conversions (ODC) to present to their bilateral creditors. In both countries there are considerable efficiency gains to be derived from focussing ODCs on their privatization programmes which are different stages in their development and evolution. Large-scale ODCs would represent a well-timed intervention in both countries as they face conditions of flagging investment, high inflation and insufficient external finance coupled with excessively high debt and debt servicing burdens which if alleviated decisively could have a crucial impact on confidence building in the domestic and foreign investor community.

Both countries have suffered serious losses of reputation with private investors, domestic and foreign. The experience of both suggests that the level of savings and investment needed to turn their economies around are not going to be provided quickly by the operation of domestic market forces alone. Jamaica has done everything asked of it by way of adjustment action by its external interlocutors; yet, the results have been desultory and disappointing. Zambiá has been much less conscientous in its adjustment efforts resorting to stop-go approaches and showing considerable irresolution in its pursuit of structural transformation. That has now changed with the election of a new government in October 1991. In both economies, intervention will be required to kick-start their recovery and to engage the resources of the private sector in economic revival. A bilateral debt conversion programme could play an invaluable role in accelerating the rate of privatization in these economies thus enabling their governments to concentrate limited public resources on higher priorities than funding parastatal operating losses. The prospects for moving quickly in these countries are good because both have governments which are now irrevocably committed to market-based policy reforms, adjustment and transformation. Jamaica has a well-designed and impressively executed DECP already (but one which is faltering for reasons described below) along with has a well-designed blue-print for privatization. Zambia is not as far ahead and will need considerable help from external sources to develop more coherent DDSR and privatization plans and to institutionalize the capacity for dovetailing these two efforts.

In Ecuador and Tanzania much more thinking needs to be done on the part of government and its external interlocutors about the role that DDSR and privatization are to play in their economic recovery plans. In Tanzania the "in-principle" acceptance of leaning more towards a market economy has not led to the kinds of political commitments which are essential to move forward in designing specific plans for privatizations and dovetailing them with DDSR initiatives. There is considerable controversy about privatization of parastatals and the role of the private sector in what will still be a large mixed economy with the public sector playing a more prominent role in productive activity than most donors, or the private sector, believe is either practicable or desirable. Movement from establishing wider political consensus towards meaningful action is painfully slow giving the unfortunate impression that Tanzania is neither sufficiently serious enough nor yet politically ready for intensive technical assistance on the privatization and DDSR interface to pay off. Ecuador is in a state of suspended animation which is unlikely to be relieved until elections for a new government are held in August 1992. Till that event occurs it would be premature to make specific suggestions on how movement towards preparing for privatization and DDSR should be made.

The Case of Jamaica

After a decade of continuous adjustment the Jamaican economy has not changed in structure nor diminished its vulnerability to external shocks. Putting Jamaica on a sounder economic footing will require reducing its debt stocks and debt service and restoring the flow of sustainably positive net transfers from the creditor community as a whole until such time that

Jamaica's income and output levels permit affordably negative net transfers. The two main areas in which attention on debt and debt service reduction must be focussed are in reducing stocks of bilateral debt and attendant debt service obligations and stocks of non-bank private credit obligations through conversions.

Part of the reason for Jamaica's failure to respond adequately to strong adjustment discipline is that too large a proportion of the gains accruing from economic liberalization and reform has been exported to external creditors through debt service. A larger portion of the returns, if retained within the domestic economy (through large debt conversion programmes similar to Chile's), would almost certainly have created a more robust base, less vulnerable to external shocks and created genuine popular (political) sentiment in favour of continued liberalization and reform. Appreciating the basis for this assertion requires deeper understanding of the Jamaican debt problem which is analysed fully in Annex 1. Jamaica's external debt in dollar terms quintupled in 20 years but doubled as a proportion of GNP, increasing from less than 65% to over 132%. Its debt to bilateral creditors (mainly OECD countries) of over $2.1 billion in 1990 is now 74 times larger than it was in 1970. The main reason is not additional net external borrowing from bilateral sources for investment but the impact of exchange rate movements between 1985-90 and capitalization through reschedulings. Multilateral debt has ballooned in much the same way with borrowings from the IMF rising to a peak of nearly $700 million by 1985 but diminishing to half that amount by 1990; though this drop was offset by a rise in the outstandings owed to multilateral banks (mainly the World Bank, the Inter-American Development Bank and the Caribbean Development Bank) which largely financed Jamaica's repayments to the Fund.

Long-term debt to private creditors has declined from 95% of the total debt stock in 1970 to just 20% by 1990. Thus the credit risk in financing Jamaica has been shifted in two ways: (i) from private external creditors financing unguaranteed private borrowers in Jamaica to the government, as a result of both large scale nationalizations in the 1970s and the provision of government guarantees for previously unguaranteed debt; and (ii) from private to official creditors over the 1970-90 period.

While unguaranteed long-term private creditors took nearly 80% of the total credit risk on Jamaica's external debt in 1970 that proportion had declined to less than 0.75% by 1990. Equally, while official creditors took less than 6% of the total external credit risk in 1970, this proportion had increased to nearly 80% by 1990 with bilateral creditors alone accounting for 47%. That movement reflects the dramatic deterioration in creditworthiness which Jamaica has suffered over the last two decades. The precipitate reduction in debt owed to private unguaranteed creditors was coupled with a commensurate increase in debt owed to official creditors whose amortization terms were longer and softer. Thus though the interest burden on the increased debt stock increased proportionately (it more than doubled) the debt service effect was ameliorated by a $67 million reduction in amortization payments as a result of substitution. The debt service ratio in 1970 (though the data are somewhat unreliable) was nearly 45% with an interest payments to GDP ratio of 5%. The DSR dropped in 1980 to a healthier 19%, since when it has again risen to 45% in 1990 with the interest payments to GDP ratio rising to over 8%. The latter ratio indicates the extent to which the economy is being sacrificed in terms of current earnings being exported to meet current account payment obligations on debt; the amount exported by way of interest exceeding the 1990 growth in GDP by 5%. In 1990 net transfers on the debt account were negative and large (-$272 million or just under 8% of GDP).

The conclusion which emerges from the growth in Jamaica's debt stocks and debt service burdens especially between 1980-90 is that there is something seriously wrong with the financial design of structural adjustment programmes (and with the financial programming exercise which dictates the design) if the extent of debt servicing, after rescheduling, and substantial negative net transfers remain as high as they do after a decade of remedial action. Under such circumstances profound questions are raised about whether: Jamaica's vulnerability to external influences can indeed be quickly reduced; its economic structure can be transformed, and it can exit the devaluation-inflation spiral in which it seems to be trapped. Clearly the multilateralization of such a large portion of its debt (33%) and an even larger portion of its debt service obligations (45%) as a direct consequence of its adjustment efforts has deprived Jamaica of a considerable amount of flexibility in its ability to manage its debt profile. Until prospects for relief on multilateral obligations become a reality (and such prospects seem remote) the burden of further restructuring and relief must necesarrily, therefore, fall on bilateral obligations and on debt service to private creditors.

In the case of official bilateral creditors the extent of relief already provided is demonstrated by continuous reschedulings which have enabled annual debt service to bilateral creditors to be maintained at around 25% of total debt service; but at the expense of accretion in the share of bilateral debt stock from 33% in 1980 to 47% in 1990. The problem is thus being deferred for a later reckoning rather than being resolved. Six conventional Paris Club reschedulings which continue in the same vein do not appear to be leading to a sensible conclusion. They are only building up Jamaica's bilateral debt stock to a point where, in the absence of timely well-structured programmes of debt conversion, large-scale cancellation will be the only option left open to creditors and debtor alike. Though steps have been taken to reduce private commercial bank debt through a carefully designed and capably managed debt capitalization programme, Jamaica has managed to reduce its London Club type debt stocks to commercial banks by only about $100 million between 1985-90 and by $55 million to suppliers between 1987-90. But it has not managed to reduce its debt service obligations to private creditors between 1980-90 although the interest component of debt service has declined sharply between 1985-90. In 1990 private creditors (long-term, guaranteed) accounted for over 19% of total debt service and 18% of interest service although their stock of debt acounted for only 12% of the total. The scope for further relief (mainly through conversions) on the private debt frontier therefore remains large in theory; in practice it is constrainedby the IMF-imposed cap on debt-equity swaps under tightly controlled targets for money supply expansion.

The net result of Jamaica's bilateral debt reschedulings has been to maintain bilateral debt servicing at around 25% of total debt servicing while ensuring a steady increase in dollar payments to Paris Club creditors. Absent other pressures these relief measures might have been adequate. But, given the imperatives of maintaining full debt service to multilateral and private creditors, the relief provided by the Paris Club has been largely offset and has proven inadequate. Official and private reschedulings as well as net new money flows through the last decade have contributed in small part to helping Jamaica meet debt service obligations without running up arrears until 1990.[1] But this has happened at the expense of incurring further and increasingly unmanageable debt obligations. Between 1983-90, net disbursements of principal from multilateral creditors and bilateral debt reschedulings amounted to about

$744 million (or an annual average over the period of $93 million). But when accumulated interest payments of over $2.1 billion made by Jamaica to its creditors are taken into account, net transfers (on the debt account) have been negative, amounting to a cumulative -$1.4 billion betwen 1983-90. That amount is equivalent to roughly 6.5% of Jamaica's cumulative GDP over the same period. Such a large outward transfer of real resources throughout the 1980s, coupled with the effect of capital flight and the net effect of external shocks (and gains) which Jamaica has experienced intermittently during the 1980s, helps to explain why it has been so difficult to stabilize the economy and place it firmly on a durable growth path. It suggests that though creditors may feel that their debt relief efforts have provided Jamaica with sufficient breathing space to meet its obligations on more realistic lines, the overall impact of these relief efforts in restoring the economy to sound health, despite impressive adjustment and reform efforts, has been negligible.

It is in the context of these developments in Jamaica's economy and external debt that the scope for conversions of official bilateral debt needs to be judged. Clearly, putting Jamaica on a sounder economic footing will require bolder efforts at reducing debt stocks and debt service and restoring the flow of sustainably positive net transfers from the creditor community as a whole until such time that Jamaica's income and output levels permit affordably negative net transfers. The two main areas in which attention on debt and debt service reduction must be focussed are in reducing: (i) stocks of <u>bilateral</u> debt and attendant debt service obligations and (ii) stocks of non-bank private credit obligations through conversion rather than amortization. The estimated bilateral debt stock at the end of 1991 is thirteen times the size of outstanding obligations to private suppliers. Half of it is concessional and can be serviced if amortization ayments are lengthened further. The other half (over $1 billion) is non-concessional and expensive to service. Also the cut-off date for reschedulable official debt goes back ungenerously to 1983 when the bilateral debt stock was 60% of its present level. It is on this large block of accumulated (bilateral non-concessional) debt that attention for conversion ought to be focussed first; although means of reducing the large amounts of annual amortization payments to private suppliers need equally urgent consideration.

Jamaica has a well conceived debt equity conversion programme (DECP) to reduce its private debt stocks. An overall evaluation of the DECP would conclude that the programme stuttered between 1987-89 but picked up steam after the June 1990 rescheduling agreement with the commercial bank creditors. However it has since run out of steam again because: (i) the rising price of Jamaican debt in the secondary market (which has increased from under 40¢ to over 70¢ between 1987-91) has made conversions less attractive as a means of securing local currency vis-a-vis straight forex swaps on the parallel market;[2] (ii) the increasing premium on the parallel market over the "market-determined" exchange rate -- in mid-1991 the premium was over 25%; and (iii) a diminishing amount of early maturities (now amounting to only $100 million) as a result of the 1990 London Club rescheduling and Jamaica's relatively impressive performance in servicing its commercial obligations has perversely reduced the incentive for commercial banks to exercise the conversion option. Somewhat surprisingly, the DECP has not yet been specifically focussed on large-scale privatizations (except in the case of hotel purchases) such as those involving the full or partial sales of shares in a large public commercial bank, the largest cement company and the sale of Jamaica's telephone company, all of which would have enabled debt conversions on a far larger scale, and with careful design, without the monetary expansion effects so opposed by the IMF.

The domestic debt instruments offerred to investors using the DECP have become inordinately expensive for the government to service (and impose much larger budgetary costs than earlier envisaged) because of large, and unforeseen, divergence in the interest rate spread between LIBOR and domestic interest rates caused by rapidly rising, devaluation induced, domestic inflation. Yet, despite these problems, considerable scope remains for carefully designed debt-equity conversions involving the much larger stock of official bilateral debt. Such DECPs could be aimed specifically at accelerating the rate of privatization and of investments now included under the public sector investment programme (PSIP) -- including social sector investments in educational, leisure, retirement and health care facilities -- but which could just as easily be undertaken by the private sector using 'build-own-operate-transfer' (BOOT) financing techniques involving debt swaps. In both instances the DECP could be designed so as to have a neutral or positive budget impact (and therefore monetary impact to the extent that the budget deficit is monetized).

Discussions in Jamaica[3] suggested clearly that there was considerable scope for, and more than 'in principle' interest on the part of the Jamaican authorities, in actively pursuing prospects for an official DECP. No satisfactory reason could be discerned as to why the government had not already pursued with creditors the 10% conversion option included under the June 1991 Paris Club rescheduling agreement which opened the door to a limited amount of such conversions. After all, the official (non-concessional) bilateral debt stock owed to Paris Club creditors amounted to just under $1 billion of which about $700 million was the pre-cutoff date stock providing immediate opportunity for converting between $70-100 million (using the 10% limit) of official bilateral debt into equity or into local currency for designated social and environmental expenditures. The general sentiment on the part of the authorities was that this had not been offered as a 'serious' option by creditors and seemed to be intended more for non-commercial rather than commercially oriented conversions. There was a 'wait and see' attitude on the part of the Jamaican authorities in observing how events materialized with the much larger Polish and Egyptian requests for conversion (for their environment and social funds respectively) which they felt had attracted greater political commitment on the part of donors to achieve something than seemed to be the case for Jamaica. It was also pointed out that the cancellation/interest conversion schematic employed under the PL480 cancellation arrangement agreed under EAI would generate sufficient local currency funds for environmental expenditures for the next 2-3 years unless the scope for despoiled mining land rehabilitation schemes was expanded and investment in this area accelerated.

It was, however, immediately acknowledged by the authorities that an official DECP would have considerable scope and could be quite useful if it was aimed specifically at: (i) facilitating and accelerating remaining privatization initiatives (which require some very large enterprises to be sold in the next 3-4 years); and (ii) substituting private investment for some of the projects presently included in the public sector investment programme. Detailed design work, involving simulations on the budgetary and monetary impact of such conversions, would need to be carried out in Phase II of the UNCTAD Project by expert consultants provided by UNCTAD and/or UNDP in conjunction with staff of the BoJ, the Ministry of Finance (MoF), and the team specifically responsible for the privatization programme in the National Investment Bank of Jamaica (NIBJ).

The scope for an official DECP can be discerned from Annex 1 which lists the enterprises intended to be privatized by the government in the immediate and medium term. While no valuation has been attached to each of these enteprises (for obvious reasons) it can safely be assumed that even if the entire non-concessional bilateral debt stock were to be converted it would account for no more than 20-25% of the total value of the enterprises to be put on the block, and could, in the right market climate, account for much less than that proportion. Hence the absortive capacity for applying such conversions to public asset sales is not a constraint. In addition the 1990-91 PSIP lists public investments in directly productive enterprises in agriculture, mining, manufacturing and tourism (which could be substituted for to the extent of at least 50% by private investment) amounting to J$2.9 billion for the 1991-95 period; investments in economic infrastructure (transport communications, electric power and water supply and sewerage) of J$6.4 billion; and social investments (such as hospital rehabilitation) for a further J$750 million. These programmes also suggest considerable scope for absorbing the local currency proceeds of official debt swaps in a manner which would replace government borrowing and expenditure for the public investment with the involvement of public asset swaps. Clearly, there is also room for other types of recurrent social expenditure; but, unless it can be assured that budget funds thus released are not again redeployed, but used either to close the fiscal gap or to generate a surplus in order to retire existing public debt, (and the attendant future servicing obligations) such substitution could prove problematic.

In considering the prospects for an official DECP the Jamaican authorities were concerned about how the mechanics of conversion would be handled at the creditor end. Obviously, having decided to privatize their own holdings of assets the government would be disinclined to see foreign governments (or even foreign parastatals) become significant holders of equity in Jamaican enterprises. They acknowledge that many bilateral creditors have specific equity investment promoting arms within their institutional armouries (e.g. CDC, FMO, DEG, OPIC etc) which have already take up equity investments in Jamaica and which for all intents and purposes are, despite their ownership, similar to any other private foreign investor except perhaps with a greater developmental orientation and a slightly longer-term perspective. How the debt is transferred from the present holder (e.g. ECGD) to a more appropriate equity investor (e.g. CDC) is not the concern of the Jamaican government nor is the internal price at which such a transfer takes place (though these may of course involve complex issues for creditor governments and agencies themselves to address). What is important is: the likely behaviour of the investor operating through an official DECP; the price at which the debt is to be converted into local currency; the price at which local assets being privatized are to be valued and exchanged; and what 'sweeteners' if any are necessary to induce acceleration of the privatization programme through an official DECP.

Official debt equity conversions could be handled either on: (i) a case-by-case basis in the context of each privatization, which might involve laborious, lengthy and repetitive arrangements between the government and each bilateral creditor in each case; OR (ii) through a more flexibly designed general purpose vehicle such as a Privatization Fund managed on a professional portfolio management basis. Such a fund could be financed by local currency proceeds derived through both debt conversions as well as new (forex) money; though the 'rights and advantages' offered in connection with the new money component might need to be tailored to offer some preferences. For example, a privatization fund could be established in which bilateral creditors (or more specifically their designated equity investment agencies) could pool their converted local currency claims within a structure would enable them to have representation in the management and direction (i.e. Board) of the fund. Such a structure could also accommodate providers of new money (such as the IFC, IIF and CDB along with private professional investor funds in emerging markets such as those run by the major global funds or boutique funds run by ex-IFC staff from Washington) who could bring additional technology and management to the venture. The Privatization Fund could then bid for a significant but limited (to say 25-30%) proportion of any privatization issue under the same types of terms, and with same priorities, as the government's present DECP. This broad idea could be developed in much greater (country specific) detail in Phase II of the UNCTAD Project.

In the absence of a detailed structure for the proposed official DECP and specific targetted ojectives in its operation it is difficult to evaluate its impact except in sufficienctly generic terms to justify pursuing further development of the concept and its application. To begin with, the financial impact would depend very much on how much official bilateral debt creditors were willing to convert in the next 2-3 years. As indicated earlier, the non-concessional component of official bilateral debt owed to OECD creditors amounts to nearly $1 billion with pre-cutoff date debt amounting to $700 million. Assuming official debt conversions were confined to the current 10% ceilings of the entire debt stock this would result in annual debt service savings of about $15 million annually (on average) between 1992-96. The net financial effect in terms of debt service savings would not, therefore, be significant in its own right. But, if this small amount of converted official debt was seen as the first tranche of a privatization fund of the sort outlined above it would have financial leverage effects several times its own size. For example if $100 million in converted debt were to attract a further $30 million in new money from other funders (e.g. IFC, IIC and CDB) and if the privatization fund thus set up were to take up no more than an average of 25% of the total equity of the enterprises being privatized, the potential leverage effect would result in enabling $520 million worth of privatized assets to be financed; not an inconsiderable sum in the Jamaican context.

If, however, the creditors (and the Jamaican authorities) were to be more ambitious and aim to convert 50% of the outstanding official bilateral non-concessional debt stock now with the proceeds being invested over the next five years (i.e. $500 million) then the effect in terms of debt service savings would be substantial (an average of $85 million annually between 1992-96) along with the leverage effects. But the impact of such conversion programmes (as the cases of Chile and Mexico clearly suggest) extends well beyond the mere financial savings involved. If organized in a structured and comprehensive rather than piecemeal fashion such programmes can signal a powerful commitment on the part of creditors and debtor to recovery and growth rather than repeating resched-uling exercises aimed at bleeding the economy, through debt service, of the maximum amount of real resources that can be extracted, with no serious concern on the part of creditors (and no counter-vailing political power on the part of the debtor to exert its preferences) for establishing firmer footings for sustainable recovery.

An official DECP in Jamaica of between $300-500 million could play just such a role in signalling the intent of the creditors to ensure sustainable recovery of the Jamaican economy and to underline that commitment by the preparedness of their agencies to take an equity risk, jointly with other partners willing to provide new money, again on an organized and (in relative terms) impressive scale. It could also signal, on the part of the Jamaican government, its commitment to proceeding with privatization rapidly by overcoming, through such a programme, the natural limits imposed by domestic capital market absorption constraints and the unwillingness on the part of private foreign investors (or holders of flight capital) to put their best foot forward in an environment subject to instant economic destabilization by events such as hurricanes or the Gulf War. Clearly bilateral debt conversion alone would not fully ameliorate concerns on the part of dispassionate observers (and investors) that the Jamaican economy, in terms of its output and export capacity is being squeezed by the international community for much more debt service than it can reasonably afford or sustain and grow at rates of 5-7% at the same time. Conveying that message unambiguously would require action on the multilateral debt front and in debt service currently being extracted by private creditors.

In the final analysis, the objective of the creditor community should be to reduce the annual debt servicing obligations of Jamaica from around $750 million or over 20% of GDP to a level of less than $400 million, which would still represent a very high 11% of GDP but would be more manageable. Such a reduction would need to be achieved in a manner which did not simply defer the ballooning of debt service to five years from now but resulted in a terminal reduction. Achieving that size of reduction, when preferred multilateral obligations alone absorb around $300-350 million a year in debt service, will be extremely difficult unless Jamaica's multilateral obligations can be stretched out and refinanced on intermediate terms at least for the next 5-10 years. But even in the absence of that eventuality materializing an official DECP could play a major role. The availability of a large portfolio of public assets, which could be more productively deployed by the private sector offers a feature which should be seized on swiftly to construct an interwoven debt swap-privatization link which could have profoundly beneficial effects on economic revival and sutained growth.

The Case of Zambia

Unlike the Jamaican case where a sound body of experience has been built up through a structured and well-managed approach to both its privatization programme and the debt-equity conversion programme (DECP) which has been operating for nearly five years, Zambia has resorted to undisciplined ad hocery in both these efforts. Moreover, the debt predicament of Zambia justifies an approach which concentrates first on achieving as much bilateral debt reduction through cancellation as possible before the conversion option is applied to residual balances. Such an emphasis, of course, diminishes the interest of the creditor community in exposing itself to double jeopardy: if creditors can be persuaded to cancel large amounts they are unlikely to be enthused by the option of converting residual balances.

Assumedly the size of the prospective cancellation would be so designed as to to enhance debt-servicing prospects for the residual debt in which case further options would be regarded as superfluous. However, while this type of reasoning may be valid in theory it certainly has not yet been borne out by Paris Club practice. Even so, unless official debt conversions were demonstrably necessary in achieving objectives to which creditors and GRZ attached the highest priority it is unlikely that they would be considered seriously. Fortunately, the case can be made that an official DECP may not only be necessary but indispensable to reviving the Zambian economy. A new government has embraced market-oriented reform and the need for rapid privatization with far greater commitment and enthusiasm than its predecessor. It remains short on administrative capacity and the design-cum-implementation skills that it needs to transfer a large part of the productive structure back into private hands on a sound and equitable basis.

Zambia also remains vulnerable to: fluctuations in the copper and oil price; global volatility in exchange and interest rates; and most importantly, the largesse of the donor community. For those reasons, there remains considerable scepticism on the part of foreign and domestic investors as to whether the government's sound intentions will or can be translated into concrete reality on the basis of past desultory experience in closing the gap which has always existed in Zambia between public rhetoric and private reality. Until the economy stabilizes and exits from the devaluation-inflation spiral in which it has been trapped since 1985 there is little prospect of sufficiently large foreign capital inflows to support the government's privatization and new investment promotion initiatives. Surviving the medium-term with growth prospects enhanced will therefore require extraordinary efforts on the part of the government and the official donor community to underwrite the front-end risks involved in having the Zambian economy turn a critical corner.

The role of a carefully designed official DECP may well prove crucial as an instrument in achieving that difficult objective. In that context key lessons need to be learnt from the past mismanagement of Zambia's "informal" DECP which has, till very recently been characterised by: unclear objectives; poor execution; considerable manipulation by politically well-connected insiders who have used it to legitimately acquire local currency at effective exchange rates well above those prevailing in the parallel market; misapplied proceeds which have not gone into genuine equity investments but into financing parallel market trading transactions, building lavish headquarters for the previously dominant political party, or into capital flight through round-tripping. The way in which debt-equity swaps were managed between 1985-89 resulted in a total lack of transparency in: (i) how much foreign debt was actually converted (with estimates varying between $50-250 million though a recent internal review by BoZ suggests that they were probably less than $100 million); (ii) the secondary market prices at which it was supposedly bought in order to determine a fair sharing of the discount; and (iii) how the purchases were financed by domiciled residents.[4]

Since 1990 there has been considerable tightening of procedures and a firm cap placed under the IMF monitored adjustment programme (of $10 million annually) on debt conversions though there is still no proper follow-through on whether local currency proceeds have been applied for the purposes indicated by applicants. The DECP has so far been concentrated on dismantling the "commercial pipeline" of suppliers credit debt. The BoZ has attempted to look into the use of converted proceeds though ths aspect requires further strengthening. So far no requirements have been imposed on parties undertaking these swap transactions that new forex be an integral component of every swap deal though that requirement is under active consideration.

External claims on the Republic of Zambia at the end of 1990 totalled about $7.2 billion comprising $6.4 billion in disbursed and outstanding debt (DOD) and a further $813 million in accumulated interest arrears (Annex 1). Dramatic changes have occurred in Zambia's debt position between 1970-90. The overall amount of debt has grown nearly tenfold with particularly large increases in the amounts owed to official creditors (both multilateral and bilateral) and in short-term exposure while private long-term creditors have kept a low and constant profile in dollar terms and a rapidly diminishing one in relative terms. Zambia's debt in 1990 was over 216% of GNP amouting to just under $1,000 per capita with a very large portion of the debt portfolio (over $3 billion, including $2.3 billion of amortization payments) being in arrears. That situation has been caused by GRZ's structural inability to cope with debt service payments of the magnitude required even after reschedulings. It points to the urgent need for significant reductions in outstanding debt with restructured residual obligations which are in line with Zambia's debt servicing capacity.

The specific steps recommended to the government at various stages for achieving this outcome have included the following: (i) restructuring debt and arrears owed to the IMF in a manner which meets Zambia's needs for zero net transfers (at worst) from the Fund through the 1990s; (ii) re-paying arrears due to the World Bank Group and refinancing residual hard IBRD debt (or obtaining interest subsidies to help servicing it) with sufficient IDA support to ensure positive net transfers being maintained through the 1990s; (iii) approaching official bilateral creditors to cancel all outstanding concessional credit balances and extend the terms offered under ETT for the non-concessional component to meet Zambia's unique needs; (iv) clearing commercial bank and suppliers' credit obligations through deep-discount buybacks supported by the IDA buy-back facility; and (v) clearing the pipeline of short-term commercial arrears, auction-related LCs, personal remittances and BoZ obligations through initiatives along the lines designed in 1985 but later abandoned due to a shortage of foreign exchange.

Zambia's total outstanding obligations to bilateral creditors exceeded $3 billion at the end of 1990 with nearly $175 million in accumulated interest arrears despite a Paris Club scheduling in mid-1990. OECD creditors accounted for 71% of the bilateral total. - CMEA creditors accounted for 13%, OPEC for less than 5% and other developing countries (mainly China) for the remaining 11%. Between 1989-91 significant steps have been taken towards bilateral debt reduction with cancellations of ODA debt by a number of European countries, the US and Canada. Japan has refused to cancel any obligations preferring to provide offsetting grants from its special debt relief facility to help Zambia meet itsannual debt service. There is some confusion as to exactly how much has been cancelled. The total amount of bilateral debt outstanding increased in 1990 by $505 million as a result of interest arrears capitalization from the 1990 Paris Club rescheduling. The situation for non-OECD creditors is less clear than for OECD especially with respect to full or partial cancellations which GRZ may have negotiated. The largest windfall for GRZ on bilateral account may result if debt to the USSR denominated in roubles can be repaid in that currency.[5]

Of Zambia's OECD creditors, four countries dominate: Germany, Japan, the UK and US. Collectively, they now account for 80% of total OECD bilateral debt. France and Italy are the two next largest creditors, together accounting for another 12% of OECD bilateral debt; almost all on non-concessional terms. Debt reduction efforts need to be focussed on these six donors; both for remaining concessional but, much more importantly, non-concessional bilateral debt. Nearly 85% of all CMEA debt is owed to the USSR on non-concessional terms. China accounts for 72% of the debt due to "other bilaterals"; all its claims are on concessional terms. Also included in this category are Brazil and India. Brazil has joined the Paris Club of creditors in its debt dealings with countries such as Zambia. Along with India it has held its exposure at current levels. A cumulative $2 billion has been rescheduled by the Paris Club in 1983, 1984, 1986 and 1990. A further $390 million in debt owed to East Bloc creditors, India and Iraq was rescheduled in 1989. Total bilateral arrears (after rescheduling in 1990) have already accumulated to nearly $560 million.

Most of the debt buybacks which have occurred in Zambia have been from sales of "pipeline debt" owed to private suppliers in the local secondary market. Estimates of buybacks to date range from $50 million to $250 million; these have not been sufficiently well recorded (despite BOZ's claims to the contrary) for a clear assessment to be made of the extent or impact of such activity on debt reduction. The data provided by BOZ for the 257 individual claims which have been bought back between January 1987-September 1989 is unclear. It does not provide any indication of the overall extent of activity (in dollar terms) or the price or terms on which it has been undertaken.[6]

The actual debt service picture for Zambia is no longer particularly meaningful as an indicator of its debt burdens. It is instead a derivative of ad hoc day-to-day decisions by the BoZ as to what payments can be afforded in response to exigent pressures from one kind of creditor or another, rather than indicative of a clear strategy in meeting Zambia's debt service obligations. In 1990 less than 8% of the interest payments due were actually made and principal repayments were in arrears to the extent with respect to full or partial cancellations which GRZ may have negotiated. The largest windfall for GRZ on bilateral account may result if debt to the USSR denominated in roubles can be repaid in that currency.[5]

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After the eigth breakdown in Zambia's turbulent relationship with the Bank and Fund in mid-1991, the debt and arrears picture has worsened as of the end of that year. Donor grant commitments have not been translated into disbursements and Zambia has again slid back into arrears with the Bank and Fund. Between 1985-90 Zambia's debt servicing strategy Zambia has subordinated the claims of its preferred creditors to those of commercial creditors who have been prepared to lend at large spreads and with substantial collateral to the copper company. Indeed the creditworthiness of the copper parastatal exceeds that of GRZ itself; a uniquely anomalous situation which Zambia's official creditors seem to have been prepared to tolerate for quite a long time. Hence while there has been recognition on the part of creditors that something clearly needs to be done to bring Zambia's debt burdens into line with its debt servicing capacity there has been a reluctance to formalize substantial debt reduction arrangements in the face of repeated failure on adjustment performance.

Zambia has had four Paris Club reschedulings and several cancellations of bilateral debt. The net effect of the three reschedulings prior to 1990 was that Zambia was unable to meet agreed terms almost as soon as its delegation left Paris on signing the Agreed Minute with creditors. They did not provide the kind of relief that was meaningful in Zambia's circumstances. Recognition of that reality led to a series of bilateral debt cancellations between 1988-90 first focussing only on concessional debt but later including selective non-commercial debts as well. Yet despite these cancellations and in the absence of any significant new lending, bilateral debt has still increased by $1billion between 1985-90 mainly because of interest and arrears capitalization when write-offs would have been much the more appropriate course of action. In October 1991 the UK announced unilateral application of Trinidad terms to its claims on Zambia but since then seems to have modified its position to conform with the new Paris Club consensus on enhanced Toronto Terms, resulting in a reduced amount being cancelled. Given Zambia's circumstances it was surprising how many bilateral creditors chose to apply Option B (an inferior option to the other two) rather than opt for debt stock or interest rate reductions. Reschedulings have been agreed with non-OECD governments in parallel with Paris Club exercises resulting in another $420 million being rescheduled.

The concessional component of the bilateral debt stock amounts to $1.53 billion. Despite cancellations it has risen by over $520 million between 1985-90. Zambia's economic circumstances would suggest that the entire concessional stock (80% due to OECD creditors) should be cancelled as the prospects of its recovery are remote. The non-concessional bilateral debt (NCBD) stock is just under $1.3 billion also having grown by about $500 million between 1985-90 largely through interest capitalization. From a dispassionate perspective the most realistic solution to the NCBD stock would be for creditors to apply, as a first step, the enhanced Toronto Terms to the entire stock (rather than simply to eligible consolidated maturities). A second step would be to exercise the option of debt conversion, which has been extended to lower middle-income debtors, to the remaining NCBD stock linking such conversions to acceleration of the privatization efforts which the new government has committed itself to pursuing.

In cash terms, rather than in terms of tenuous political leverage, bilateral creditors are themselves likely to be better off agreeing to the combination of measures proposed above than insisting, as they previously have on imposing unrealistic rescheduling terms. Based on past experience even ETT, whichever choice of options creditors decide to make, are: unlikely to be honoured; likely to constantly threaten the availability of sufficient net external inflows of forex to sustain adjustment if unforessen adversities are encountered; and certain to require donors to supply unrealistic levels of new gross flows to offset unanticipated increases in debt service due to interest or exchange rate movements. Apart from the OECD, the largest NCBD creditors are the USSR, Iraq, Brazil and Yugoslavia with the USSR accounting for by far the largest amount (nearly $300 million at the old fixed rouble exchange rate).

The difficulties involved in reducing outstanding balances (and interest arrears) of Zambia's commercial debt are complicated by: (i) a lack of transparency in establishing the true extent of Zambia's outstanding obligations to commercial creditors; (ii) ad hoc debt buybacks, undertaken in an undisciplined manner without the application of a clear framework or a set of guidelines adding to the confusion;[7] (iii) a distorted discount signal;[8] (iv) the special standing enjoyed by ZCCM whose commercial creditors have invariably been serviced regularly with the unusual situation arising where an instrumentality of government has a higher commercial credit standing than the government itself.

These factors notwithstanding, the following actions on different categories of commercial debt have been recommended to GRZ: (a) personal remittance accounts relating to expatriate contracts to be cleared at face value; (b) suppliers and export creditors with unguaranteed credits outstanding prior to October 5, 1985 to be offered the option of either accepting settlement of claims in local currency promissory notes with a market rate coupon serially encashable over a period of 5 years, or submitting bids for settlement in foreign exchange at a deep discount with GRZ employing a fund of about $10 million to clear all such arrears -- this option would probably result in clearing commercial claims at an average 5¢ on the dollar; (c) London Club debt and other commercial bank creditors should be offered a price of 10¢ on the dollar or less using the resoures of the IDA funded commercial debt buyback facility; (d) ZCCM's private short-term trade lines should be kept current and open by regular servicing; but (e) ZCCM's private long-term creditors should be offered a choice of: (i) 20-year collateralized bonds denominated in US dollars with a fixed coupon of 3%; (ii) an outright buyback at 15¢; (iii) a local currency option of discountable 10-year Kwacha bonds at full face value with a market coupon -- these bonds being eligible for making preferred investments within Zambia; and (iv) enhanced opening up of debt-equity swaps for the purpose of making new investments or buying stakes in parastatals which GRZ would commit itself to privatizing on an announced schedule.

For any major debt reduction or restructuring exercise to succeed, the immediate steps which GRZ needs to take with respect to debt restructuring are: (i) reconciling the large discrepancies which still appear in BoZ's debt records with audited confirmation of outstanding balances by major creditors; (ii) simulated analysis of the impact of applying ETT with the assistance of World Bank staff; (iii) approaching Zambia's four largest bilateral OECD creditors to determine the limits of the possible in going beyond enhanced Toronto terms for non-concessional debt restructuring and conversion; (iv) approaching selected commercial banks to explore prospects for discounted buybacks ; and (v) reviving earlier designs for clearing the commercial pipeline.

Unlike the Jamaican case where a sound body of experience has been built up through a structured and well-managed approach to both its privatization programme and the debt-equity conversion programme (DECP) which has been operating for nearly five years, Zambia has resorted to undisciplined ad hocery in both these efforts. Moreover, the debt predicament of Zambia -- despite the low levels of actual debt servicing which it has been permitted by the creditor comunity to get away with for quite a long time (thus causing fundamental damage to the maintenance of proper debt-servicing priorities and of sound debtor-creditor relationships) --justifies an approach which concentrates first on achieving as much bilateral debt reduction through outright cancellation as possible before the conversion option is applied to residual balances. Such an emphasis, of course, diminishes the interest of the creditor community in exposing itself to double jeopardy: if creditors can be persuaded to cancel large amounts they are unlikely to be enthused by the option of converting residual balances. Assumedly the size of the prospective cancellation would be so designed as to to enhance debt-servicing prospects for the residual debt in which case further options would be regarded as superfluous. However, while this type of reasoning may be valid in theory it certainly has not yet been borne out by Paris Club practice.

Even so, unless official debt conversions were demonstrably necessary in achieving objectives to which creditors and GRZ attached the highest priority it is unlikely that they would be considered seriously. Fortunately, the case can be made that an official DECP may not only be necessary but indispensable to reviving the Zambian economy. A new government has embraced market-oriented reform and the need for rapid privatization with far greater commitment and enthusiasm than its predecessor. It remains short on administrative ability, the design skills and the implementation capacity that it needs to transfer a large part of the productive structure back into private hands on a sound and equitable basis. Zambia also remains vulnerable to: fluctuations in the copper and oil price; global volatility in exchange and interest rates; and most importantly, the largesse of the donor community. For those reasons, there remains considerable scepticism on the part of foreign and domestic investors as to whether the government's sound intentions will or can be translated into concrete reality on the basis of past desultory experience in closing the gap which has always existed in Zambia between public rhetoric and private reality. Until the economy stabilizes and exits from the devaluation-inflation spiral in which it has been trapped since 1985 there is little prospect of sufficiently large foreign capital inflows to support the government's privatization and new investment promotion initiatives. Surviving the medium-term with growth prospects enhanced will therefore require extraordinary efforts on the part of the government and the official donor community to underwrite the front-end risks involved in having the Zambian economy turn a critical corner. The role of a carefully designed official DECP may well prove crucial as an instrument in achieving that difficult objective.

A preliminary proposal (Annex 1) has been made to the Zambian authorities that they also consider establishing a Privatization Fund to be financed through both the conversion of official debt and the provision of new forex by agencies such as IFC along the same lines indicated in the Jamaica case study. The preliminary reactions to this proposal were positive and need to be followed up. Much more work needs to be done in Zambia (than has already been done in Jamaica) on designing a properly identified and sequenced privatization programme before an official DECP can be credibly launched. Zambia, however, offers an unusual opportunity for technical assistance to be provided which could aim at linking these two initiatives from the outset, so that an official DECP could play an integral and supporting role in both helping to design and accelerate the implementation of a privatization programme.

The prospects for official debt conversions for non-commercial developmental purposes (including environmental protection) were also explored though there appeared to be less enthusiasm on the part of the Zambian authorities in using official debt conversions for these purposes. The scope for developmental investments through debt conversions is considerable. Two debt-for-nature swaps have already been done in Zambia. Urgent expenditures for improved urban sanitation, controlling the spread of Aids, reviving educational investment, catering to the health and nutrition needs of children and so on could quite easily be financed through official debt conversions (and a prooportion of converted amounts should be set aside for such uses). The concern in using local currency proceeds for such expenditures, which do not involve an offsetting asset swap in the same way that privatization would, is whether such funding would result in an effective "expenditure swap" in the public budget. To the extent that the money creating effects of the conversions used for social expenditures could be demonstrably offset by public expenditure reductions of one kind or another, thus reducing the fiscal deficit and the calls it makes on central bank credit, such uses could be much more easily justified than they can be under current tightly controlled IMF monitored guidelines and ceilings.

As in the case of Jamaica it is perhaps premature and extremely difficult (indeed impossible at this juncture) to identify with any precision the potential impact of an official DECP on the Zambian economy until some essential parameters became more transparent. There can be little question but that the sales of public assets alone could, over a five year period, easily absorb much more than the conversion of the full residual stock of NCBD after cancellation. The immediate impact in cash flow savings would, of course, be negligible as Zambia has not been servicing more than 10-15% of its scheduled annual bilateral debt service for several years now but simply accruing arrears and periodically capitalizing them when official reschedulings occur. Conversion of 10% of the extant (pre-cancellation) NCBD would amount to about $130 million available for conversions which would yield debt service savings of less than $2-3 million annually in cash terms though it might reduced scheduled obligations (and arrears) by about $25-30 million in principal and amortization payments. Assuming that 50% of the debt stock were to be cancelled (an unrealistically optimistic assumption given the recent practice of the Paris Club) and the remainder were subject to conversion, a 10% limit would result in $65 million being available for conversion. If expectations on the part of creditors were that post-cancellation debt should be fully serviced that would result in savings of about $5-8 million in savings over the first 10 years (basically the interest payments) followedby savings thereafter of annual savings of $30-40 million assuming amortization payments were equalized over the remaining 25 years.

The real immediate and indirect economic impact of these conversions could be much larger if they succeeded in transferring public assets to private ownership, and resulted in inducing associated investment and improving the efficiency with which those assets were deployed. In Zambia it would not be difficult to establish that a change in management and asset ownership, which brought with it sufficient new investment for rehabilitation of existing plant, could easily result in substantially improved prospects for output, efficiency, export diversification and profitability if the process of transfer were well regulated and macroeconomic policy-reforms were sustained with donor financing support at current levels. These are, of course, optimistic assumptions. But they would need to apply in the case of any attempt to proceed with inducing a process of durable structural change. In Zambia it is difficult to envisage such a process being launched and sustained in the absence of interventions such as those of the proposed Privatization Fund. The notional 10% limit applied to the extant stock of NCBD would suffice as a first tranche. Leveraging $130 million with a further $30 million, supplied through the equity investment arms of the major multilateral banks and private portfolio funds aimed at emerging markets, could result in facilitating investments totalling $640-700 million providing that the Privatization Fund were limited to investing no more than 20-25% in any privatized entity. Moreover, the establishment of such a fund would lend structure and discipline to the process of privatization and would provide GRZ with a valuable option for downstream development of the domestic capital market when the Fund gradually sold its own holdings to the public at a later date.

The Case of Tanzania

Tanzania is one of Africa's largest yet poorest countries. In 1990 gross investment of 19% of GDP was financed largely (15%) by current transfers from abroad leaving little scope for expanding investment to needed levels of 25-27% of GDP without attracting much more foreign private investment. This condition is unlikely to be met till the foreign private sector sees a major reduction in outstanding debt claims which are beyond Tanzania's capacity to service. In 1990 Tanzania had a debt to GNP ratio of 270%, a per capita debt to income ratio of 245% with an outstanding debt stock of $5.9 billion which, as a proportion of exports, was over 1000% (see Annex 1 for a detailed analysis). Total debt has grown nearly 30 times between 1970-90 with particularly large increases in official debt, both multilateral and bilateral, which together now account for over 90% of the debt structure. Fortunately, a large proportion of that debt is concessional -- 85% in the case of multilateral bank debt and 62% in the case of bilateral debt yielding an average concessional element of 70% in the official debt structure and 61% in the total debt structure.

Tanzania has 33 bilateral creditors with 11 being owed more than $100 million each with the USSR/CIS being the single largest creditor. OECD countries account for over two-thirds of bilateral debt (the largest creditors being Germany, Italy, Japan, the UK and France). USSR/CIS accounts for a further 17%[9] with the remaining 16% being attributable to OPEC oil exporters (7%) and other bilaterals (9%) among whom China and Brazil are by far the largest. A number of OECD creditors have cancelled all or part of their concessional claims at various times since 1985; but those cancellations have not made a discernible dent in reducing outstanding stocks of bilateral debt which have more than doubled since 1985 largely due to interest capitalization; Tanzania has been unable to meet its annual debt service obligations, except to multilateral creditors, for some time now.

Among the multilaterals, IDA accounts for the largest share (72% of the total multilateral claim) with the African Development Fund being the next largest creditor. Non-concessional multilateral debt is attributable mainly to the IBRD and, to a much smaller extent, the AfDB. Unlike Zambia, the IMF has never been a large factor in Tanzania's debt structure with GoT making minimal use of IMF resources. Private long-term creditors accounted for only 3% of total outstanding debt with short-term debt amounting to another 7%. In the private creditor category suppliers' and uninsured export credits (totalling $177 million) feature much more prominently than commercial bank loans (which amounted to a mere $16 million).

Following peak payments of $183 million in 1983 the Tanzanian government has followed a course of confining its debt service payments only to multilateral creditors. It has sought continuous reschedulings with its OECD and other bilateral creditors but debt servicing to them has not been in keeping with the terms of these agreements despite the concessionality of the arrangements reached. There have been no debt service payments made to private creditors in the last few years, resulting in the cessation of trade credit facilities being extended to Tanzania (apart from the Bankers Trust coffee-oil facility which sets off coffee export earnings aganist oil-import expenditures within the same financial structure). Because of generous levels of grant financing provided by donors, Tanzania has managed to finance a gap of $1 billion annually betwen exports and imports for the 1987-90 period. Taking into account net flows of principal on the short-term account (which in 1989 resulted in a large outflow of $250 million) total debt service in Tanzania has fluctuated considerably. On the long-term account, debt service has averaged about $125 million between 1984-90 with relatively small fluctuations around that mean. Over that time the share of multilateral creditors in long-term debt service has risen from about 68% to nearly 88%.

Total service on <u>bilateral</u> debt fell to average of $3 million between 1985-88 (when payment obligations averaged about $318 annually) but increased to the $15-18 million level in 1989-90 (when obligations averaged about $155 million annually) with payments of about $8 million on average to OECD creditors (France, Italy, Spain and the UK) and the balance entirely to the USSR/CIS with no payments to OPEC creditors or to other developing country creditors having been made since 1984. Even with an average concessional rate of about 3.5% applicable to its outstanding bilateral debt stock Tanzania's contractual interest burden on bilateral debt amounts to over $100 million annually while its stretched out amortization schedule after rescheduling requires amortization payments of $50-60 million. Debt service performance on bilateral debt has been so poor as to warrant reconsideration of whether continuing reschedulings even begin to address the reality which Tanzania confronts i.e. its absolute inability to devote resources to bilateral debt service, even on these extraordinarily concessional rescheduling terms, when it confronts a current account imbalance of $1 billion annually and receives grant aid averaging $520 million annually which, together with multilateral concessional loan inflows, help to cover that gap. As a result of this reality Tanzania had built up interest arrears of over $300 million at the end of 1990, mostly on the bilateral account.

Multilateral debt service has been met almost fully since 1987 (though Tanzania was in arrears on the multilateral account between 1984-86) reflecting the priority accorded to preferred creditors after the government decided to pursue a route of strong adjustment under the auspices of the Bank and Fund. Contractual obligations to long-term private creditors (on suppliers and export credit account) have not been met at all since 1986 although the outstanding stock of debt on this account is shown by WDT to have diminished from $330 million in 1985 to $173 million in 1990. That reduction has certainly not been attributable to amortization payments and little information is available on whether debt swaps or cancellations account for the reductions.[10] Some of these obligations have, of course, moved from the private to the bilateral debt accounts when indemnities on the 80-90% portions insured by export credit and guarantee agencies have been paid out to suppliers and exporters from

OECD creditor countries. Nevertheless those outstanding obligations at the end of 1990 would, in the absence of a restructuring agreement, still result in contractual obligations on around$15 million in interest charges and $20-30 million in amortization payments causing a substantial build-up of arrears on these accounts which do not appear to have been fully accrued in the debt data base.

Since the onset of the debt crisis Tanzania has received a considerable amount of debt relief in the form of Paris Club reschedulings, a rescheduling agreement with China (in 1986), interest rate relief on charges accruing from its outstanding IBRD obligations through IDA's interest subsidy facility, and full or partial debt cancellations by several large creditors including Sweden and Norway, the UK, the US, Canada, France and Germany. Yet the outcome has been a considerable increase in its bilateral debt burdens since 1985 because the impact of cancellations has been more than offset by interest and arrears capitalization on the residual balances.

Since the start of the 1986 recovery programme Tanzania has been back to the Paris Club every two years. In 1988 and 1990 Toronto Terms were applied to Tanzania. In January 1992 when ETT were applied and will result in much less favourable treatment than had been anticipated by the Tanzanian authorities. In 1986 Tanzania also negotiated the rescheduling of $43 million in payments due to China but not with any of its other bilateral creditors, many of whom it had an active trading relationship with, but which have since been disrupted. The World Bank is presently helping Tanzania formulate a strategy for dealing with non-OECD bilateral debt selectively by creditor, offering different options such as case-by-case reschedulings, long-term commodity bonds, conversions for equity investments, and in kind payments through commodity swaps.

Tanzania has not received any negotiated relief on its private commercial debt obligations largely because it has no London Club type of debt and its supplier creditors are too numerous to negotiate with collectively. It has approached the World Bank to use the IDA financed Debt Buyback Facility to extinguish these residual obligations through some type of buyback arrangement; this facet is also being considered in the terms of reference of the World Bank's advisory assistance.

With a very large outstanding stock of bilateral debt which it is finding impossible to service Tanzania's first option is to seek as much by way of cancellations from bilateral creditors as possible. With a cut-off date of June 30, 1986 the amount of eligible debt rescheduled by the Paris Club was less than $700 million from a bilateral debt stock of nearly $3.7 billion at the end of 1991 (including capitalization of interest in arrears) leaving a balance of $3 billion to be dealt with. Even if Tanzania's already low average rate of moratorium interest were to decline further (from 3.5% to 2.5%) the resulting interest service schedule -- of about $75 million annually -- would still be far higher than Tanzania can realistically afford. This would be true even if the more generous version of Trinidad Terms proposed at first by the UK Prime Minister were to be applied resulting in a cancellation of about $1.8 billion still leaving a residual $1.9 billion to be dealt with. Hence other means of reducing the debt stock, through debt conversions, need to be actively explored quite irrespective of how much is cancelled within the existing parameters.

Tanzania already has a commercial debt conversion scheme though no details were made available on the amount of debt that has been converted through it. On the face of it, the scheme appears to be a relatively costly way of retiring commercial debt (mostly of overdue short-term trade obligations) with the Bank of Tanzania paying full face value in T-shillings less a transaction fee of 15%. At a secondary market price of 10-15 ¢ when the scheme was launched, the net result was that traders in such debt (mainly the local Indian trading community) were able to acquire local currency legitimately at 25-33% of the dollar cost of T-shillings prevailing in the parallel market or one-sixth the cost at the official exchange rate, thus encouraging round-tripping. The competitiveness of the market has resulted in a rise in the secondary market price of Tanzanian private paper which was reported to have reasched 39-40c at the close of 1991, still permitting traders to acquire T-shillings at a better rate than through the parallel market. Moreover, as the debt is exchanged for cash payments of the full amount of T-shillings, rather than for an instrument that is encashable only over a period of time, such transactions would, if they were sizeable, have a distinctly inflationary impact. Nor is there any evidence that the Tanzanian authorities are following up on whether the T-shilling proceeds of these debt exchanges are being used for the purposes intended (investment).

As in the case of Jamaica and Zambia, the opportunities for official debt conversions are considerable because of the sheer size of the stock of public assets available for privatization in Tanzania as well as the large number of social purposes for which local currency proceeds from official debt conversions could be used. The authorities, however, are moving much more slowly and cautiously on the privatization frontier than Jamaica or Zambia thus making it difficult to define with any precision how quickly such a programme could be developed and made operative. Though the government has approached private investors to take over some government-owned parastatals on a selective basis there is considerable political resistance to going ahead with privatization on any large scale because of concerns that it would again result in the dominance of non-indigenous private businesses in the Tanzanian economy. Until such resistance is overcome privatization will remain a sensitive issue on the economic agenda. An official DECP may, for that reason, be premature to float at this time. There is as yet no detailed privatization programme being prepared with a listing of public assets which can be sold over a period of time, what their approximate valuation might be and what the implications are for the public budget of appropriately sequenced asset sales. It is clear, however, that the parastatals targetted for privatization will probably need to go through a prolonged period of financial and operational restructuring, (involving painful dislocations such as large-scale retrenchment) with significant budgetary implications, before they can be brought to market.

Nonetheless the reactions of the authorities spoken to in the BoT and the Ministry of Finance to the idea of a privatization fund of the type proposed in Jamaica and Zambia was unequivocally positive. Officials in BoT believed that such a fund would help to address many of the concerns that had been expressed in Tanzania about how to get the incipient privatization and debt reduction programmes which the government was inclined to promote to gain impetus without stoking up inflationary flames.

There is, in Tanzania, considerable potential for official debt-environment swaps for the preservation of wildlife herds and for the maintenance of its large natural reserves which are being degraded through deforestation and soil erosion, though it was not possible to look into this aspect in great depth during Phase I. These types of swaps, along with swaps for social expenditures (whether for health, children, or education) however raise the usual concerns about potential inflationary consequences resulting from the need to issue currency to meet the counterpart obligation without the assurances that such a increase in monetization will be offset by a reduction in pressure to create money from the budget deficit. In other words, such swaps can only be justified as long as it can be demonstrated that expenditures financed by such swaps are substituting for expenditures that would otherwise need to be made through the public expenditure programme.

As Tanzania's large bilateral debt stock is barely being serviced the actual cash-flow impact of an official debt conversion programme is likely to be quite small. Allowing for cancellation along the lines that the Paris Club has agreed under ETT the actual cash saving effect would be less than $1 million annually in debt service. It is difficult, at this time, to envisage the conversion of much more than 10% of the debt stock being readily absorbed until Tanzania's plans for privatization are much further advanced when conversions of larger amounts into equity ($100-200 million) could be quite easily absorbed through privatization. But, as has happened in the case of other countries where conversions have occurred on any significant scale (Chile and Mexico), it is likely that the economic and second-order financial impact of an official DECP will be far larger than the immediate cash flow savings realized in debt service. If an official DECP could unblock the resistance which is presently being experienced in moving ahead with privatization, it could attract new private capital flows for investment in both privatized and new industries for a multiple (two to three times) of the amounts being converted. It could also unleash a burst of output and export growth through the more productive utilization of assets which are presently being deployed with almost extreme inefficiency.

These considerations suggest that a strong case exists for encouraging the Tanzanian authorities to develop further the idea of an official DECP associated with its evolving blueprints for privatization with UNCTAD/UNDP support under Phase II of the UNCTAD Project which would provide an opportunity for the impact of an official DECP to be evaluated in greater detail.

<u>The Case of Ecuador</u>: As discussed in some detail in the case study, there is quite considerable scope for commercial debt conversions of bilateral official debt in Ecuador, particularly but not only if the new government elected in 1992 launches a programme of privatisation and of further encouraging foreign direct investment flows. The outgoing government is less likely to take major actions in these fields, partly because of limited time available (its terms finishes in August 1992). Furthermore, the use of debt conversions for privatisation in Ecuador may be somewhat restricted because the relative size of state enterprises (to the total of the economy) that are likely to be privatised is more limited, than in the case of other Latin American or African countries; however, as discussed in the case study, enterprises have been identified in Ecuador, which are likely to be privatised by the new government.

Should the new government seem interested in launching such a programme, (which seems likely due to recent communications with one of the consultants), detailed work would be required to develop an appropriate conversion system, simulate, evaluate and monitor monetary and budgetary impact of such conversions, etc. The possibility of establishing a Privatisation Fund, partly financed by bilateral creditors and external providers of new money, but also partly funded by local entrepreneurs (along lines possibly similar to those discussed above for Jamaica) should be discussed with the new Ecuadorean authorities; emphasis would also need to be placed on using ODC, for helping attract foreign flows for new investment, as is occurring in several neighbouring countries. Such work could be carried out in Phase II, starting with an initial workshop, (amply requested by Ecuadorean Government and private sector representatives and backed by local UN officials as well as local academics), and by follow-up work carried out by the Central Bank of Ecuador, Ministry of Finance and - if requested by the authorities - in collaboration with expert consultants provided by UNCTAD/UNDP; such a debt conversion facility in Ecuador should cover <u>both</u> commercial and non-commercial uses (in the latter, conversions for social and environmental spending).

<u>Scope for Non-Commercial Conversions</u>

On the basis of the case studies carried out by the consultants, a review of the literature, and discussions with debtor and creditor governments as well as international organisations, it is clear that there is a great potential scope for debt-for-development swaps. This is based firstly on a clear need for enhancing in a non-inflationary way spending in the social sectors; as can be seen in Table 1 spending on the social sectors has suffered heavily from budgetary cutbacks and adjustment programmes in the countries visited, as well as in most heavily indebted countries, and therefore have a valid claim on additional resources that may become available as a result of debt reduction.

Indeed, as can be seen in Table 1, during the eighties, the share of spending in education, as a proportion of central government spending, fell rather significantly in both Ecuador, Zambia and especially Tanzania (in the latter, the decline was around 40%); there were also declines in health spending (especially in Zambia), though these were slightly less dramatic. It should be stressed that per capita spending in education and health is likely to have declined even more, as government spending fell as a share of GNP, and as the population grew quickly.

TABLE 1:

FUNCTIONAL ALLOCATION OF CENTRAL GOVERNMENT EXPENDITURE IN 3 COUNTRY STUDIES, AND REGIONAL AVERAGES (%)

	Education		Health	
	80-82	85-87	80-82	85-87
Country				
Ecuador	29.7	24.8	7.7	7.3
Latin America Av.	14.9	13.7	8.5	6.8
Tanzania	13.0	8.3	5.8	5.7
Zambia	12.8	10.3	6.8	5.2
African Av.	15.0	13.3	5.1	4.9

Source: B. Ebel "Patterns of Government Expenditure in Developing Countries during the 1980s; the Impact on Social Services". Innocenti Occasional Paper 18, Florence, Italy, 1991; based on IMF and UNDP data.

Table 2 provides some indicators on the limited extent to which basic needs are being met in the countries studied. In Zambia, Tanzania and Ecuador less than 60% of people had access to safe water; in Ecuador and Zambia less than 75% of people had access to health services; mean years of schooling (in 1980) were extremely low in Zambia and Tanzania (at less than 3); they were also surprisingly low (at less than 6) in Jamaica and Ecuador.

Increased spending in social sectors has also been shown to have very high rates of economic return. More broadly, there is increasing evidence that variations in social spending affect the overall rate of return of all investment. The World Bank[11] reports that in the severely indebted middle-income countries, the sharp decline of growth in the 1980s, was only partly due to an important decline in the net investment ratios of these countries; the rest of the decline has to be explained by declining productivity of the capital stock; clearly an important element in explaining lower productivity of physical capital is decreasing quality of human capital, linked to the severe cuts in government spending in health and education in the eighties. Both to increase the productivity of investment, <u>and</u> to encourage an increase in private investment (domestic and foreign) it is essential to increase spending on the social sectors in heavily indebted countries.

This <u>need</u> for increased social spending is complemented by increased international <u>awareness</u>, that human development and poverty alleviation are key development issues in the 1990s, which is now widely shared within governments and international institutions. A major pillar of development strategy that gives importance to human capital development and poverty alleviation is increased provision of basic social services to the poor, within which primary health care, family planning, nutrition and primary education are especially important.

Official debt conversion would be particularly suitable for expanding provision of basic social services. As discussed above, in Chapter II, debt conversions for development have been successfully done with commercial debt; however, the scale of operation tends to be rather small and therefore the amount of administrative and other costs relatively high per unit of debt swapped. Official debt conversions would offer the advantage that they should be relatively simpler to arrange, and that the minimum <u>scale</u> on which they would operate would be larger (a minimum of $10 million per creditor government), thus increasing impact and reducing relative cost of administrative burden.

TABLE 2:

HUMAN DEVELOPMENT INDICATORS, 4 COUNTRY STUDIES

	HDI[1]	Adult literacy (1985)	Mean years of schooling (1980)	% With access to health services (1985-88)	% With access to safe water (1985-87)	Children dying before age of 5 (1990)
Jamaica	59	98.0	5.1	90	72	n.a.
Ecuador	77	83.0	5.4	64	58	300.000
Zambia	118	67.4	2.6	75	59	500.000
Tanzania	127	54.0	2.0	81	56	240.000

[1] Ranks countries according to human development indicators; best is 1, worst is 160.

Source: UNDP Human Development Report 1991.

In all the countries visited for the case studies, as well as in most other heavily indebted countries, governments have a high absorptive capacity for additional resources in the social and environmental sectors; additional local currency resources could be accommodated relatively easily within existing programmes or through expansion of existing programmes. A choice could be made between targeting relatively specific essential high profile programmes, such as to help contain the spread of AIDS (in countries like Zambia) or help contain specific environmental degradation harmful to poor people in a particular region (e.g. clean water of industrial pollutants for drinking) and broader programmes, like those improving primary education. Especially the former types of programmes existed in the countries visited and could be implemented, if funding became available. As regards primary education for example, a recent in-depth study[12] shows that in 1990, approximately 130 million primary school age children were out of school (clearly a problem in Zambia and Tanzania, see again Table 2), and estimates the approximate cost, per country and in aggregate, of achieving such a target; for example, for Tanzania to achieve the target of satisfactory primary schooling for all children, additional resources required (for the whole 1990-2005 period) have been estimated by Colclough and Lewin to total around $700 million; for all developing countries with deficiencies in this aspect, the additional cost of achieving primary education for all would be around $33 billion. If defined as appropriate by creditor and debtor governments, official debt conversions for development could be used to achieve such a target. If considered desirable by the creditor and debtor governments, international organisations such as UNICEF, WHO, UNCTAD, World Bank or others could be involved either in implementing or monitoring such programmes. The involvement of such international organisations as well as the launching of high priority programmes, may in some cases help provide for additionality of debt reduction, as creditor governments may perceive this as giving greater guarantee that the resources will be well spent. This would be particularly the case if the additional local spending thus generated would at least partly be on international public social goods, (such as AIDS control) where the benefits would accrue not just to the debtor country but to the world community at large.

To encourage bilateral debt conversion programmes, it may be necessary and desirable to develop specific proposals to attract and accommodate the additional resources. Such proposals could be based on programmes developed in a general sense, but requiring resources; a possible basis for such plans could be the National Programmes of Action derived from the Plan of Action adopted at the 1990 World Summit for Children; in other cases, programmes could be developed specifically for debt conversion, as was the case of the Polish Environmental Fund. In both cases, technical assistance may be required, i) in the preparation and/or improvement of the social and/or environmental programme, ii) in the setting up, improvement or adaptation of an appropriate debt conversion mechanism in the country (that maximises positive effects and minimises problems), and iii) in negotiating debt reduction with creditor government/s bilaterally or multilaterally via Paris Club or special meeting of creditors. This technical assistance would be especially valuable to deal with two types of issues, which could block or delay bilateral debt-for-development conversion implementation. On the side of some creditors, there may be a preference, particularly in Treasuries and export credit agencies, to try and sell the bilateral debt, if possible, to foreign investors or others;[13] this may inhibit some creditor governments' willingness to do straight debt reduction for development swaps, which would be unfortunate. However they may be willing/keen to sell such debt to their own Ministries of Development Cooperation and/or of the Environment, or using these debts as contributions to multilateral facilities, such as the Global Environment Fund. If such contributions are additional to aid flows that would have materialised anyway, then such operations should be welcomed and encouraged by debtor governments; the Swiss Debt Reduction Facility (see Appendix IV.1) seems to provide an example of additional flows. However, if resources for purchasing the debt from the export credit agency came from aid budgets, and there was no additionality, a careful calculation would be required to see if such a deal was convenient to the debtor economy, as decreased aid flows could in some cases have a more negative short-term foreign exchange effect than the net present value of the debt servicing saved by the cancellation. Technical assistance could therefore be desirable to help structure deals, where either the debt reduction was totally or largely additional to programmed aid flows (based on the high priority of the programme presented, the willingness to grant debt reduction) or at least was structured so as to generate net foreign exchange savings to the debtor economy.

On the side of the debtors, technical assistance may be required to help design a programme that avoids undesirable effects. Perhaps the one causing most concern to debtor governments is the avoidance of inflationary effects; other issues involve avoiding "round-tripping", even though experience shows it is far less important for debt-for-development swaps than for debt-equity swaps.[14] As was discussed in Chapter II, the scale considered for most official debt conversion would be too small to have significant effects on the money supply and/or on the fiscal deficit. However, the impact of debt-for-development conversions would need to be monitored, particularly as they increase in size, to ensure that no inflationary effects occur, or that these are duly compensated (we will return to this issue in Chapter VI).

Preliminary discussion in the countries visited have identified some sectors where debt-for-development conversions could be gainfully used (see above for Tanzania, Zambia and Jamaica). In Ecuador, there is large scope for increased social spending; it seems important for the new authorities (possibly with the help of international technical assistance) to prepare a clear set of priorities and define the institutions that would implement such social programmes. In Ecuador, there is also scope for debt-for-nature swaps, in sectors such as eco-tourism, cleaning of water, air and sewage, pollution and forestation. The fact that Ecuador has quite a large experience with debt-for-social-spending and environment swaps, would provide a useful basis for a larger, well prioritised and well structured programme.

We can conclude that the potential scope for official debt-for-development swaps is immense, given the large "social and environmental debt overhang" inherited from the 1980s, as illustrated by the cases studied. Their implementation will depend on creditor government willingness to grant debt reduction for those purposes, as well as debtor government willingness and ability to present high priority social and environment programmes, and well designed debt conversion facilities. Furthermore, an important step to enable official debt conversions to take place more easily and on a more meaningful scale (both for development and equity) would be to transform the "bilateral, voluntary" clause in the Paris Club to a "multilateral" clause, and to evaluate, on a case-by-case basis, the possibility of expanding the 10% limit.

Technical assistance, given by expert consultants provided by UNCTAD/UNDP, possibly with experts from other organisations such as UNICEF or the World

Bank, could work in Phase II of the project in specific programme designs. The four countries visited by the consultants (and especially Jamaica, Zambia, and Ecuador) could provide a valuable starting point; other countries, like Albania, Egypt and Poland could also be chosen, given synergy with other initiatives in these countries and debtor government interest.

[1] Though Jamaica has ended each year between 1983-90 with a small balance of interest arrears averaging $30 million between 1983-88 (due more to technical rather than substantive reasons) the volume of such arrears grew very rapidly in 1989 and 1990. Jamaica ended each of those years with more than $110 million in interest arrears, a substantial amount relative to total interest payment and debt service obligations. This change signals increasingly greater distress in meeting rescheduled debt serice.

[2] It ws estimated in 1987 that based on a BoJ fee of 6% and the purchase of Jamaican debt in secondary markets for 35¢, the investor accrued a saving of 50% on the forex required to make local equity investments even after taking into account the fees to agent banks. With the price of debt having risen to over 70¢ and even with the BoJ requiring no fee the savings have dropped to 15% which is less than the premium available on parallel market exchanges for the Jamaican dollar in 1991.

[3] Please see the Interim Report submitted to UNCTAD by the Consultants dated 16 November 1991 pp 20-23 and Annex 2 p 27.

[4] The Dutch government deployed $2.5 million for funding debt-equity swaps as an experiment in 1987-88 but owing to unsatisfactory experience abandoned the scheme very quickly.

[5] As a result of the rouble devaluations which have occurred, debt to the USSR could be extinguished for a fraction of the current recorded dollar value.

[6] That data suggests that in the first three quarters of 1989, total buybacks amounted to about $11 million whereas knowledgeable financial sources engaged in this activity estimate that buybacks probably totalled $50 million in face value claims during that period. As a result of this opacity in record-keeping it is difficult to trace exactly how much has been written down on suppliers' and export credits and to determine with any precision what the outstanding balances actually are.

[7] The way in which they have been undertaken has muddied the water for organizing large scale buybacks at a price which reflects Zambia's debt situation more accurately.

[8] Zambian commercial debt, compared to that of Bolivia, Peru and other similar countries did not since 1986 justify a price of more than 5-6¢, yet the average price realized upto 1989 was about 25¢ with domestic parties being the main purchasers. Though the price has dropped since to around 12-15¢ it remains artifically high partly because Zambia's debt servicing priorities often favour commercial creditors preferred creditors.

[9] As in the case of Zambia the question arises as to whether arrangements could be made to repay these claims in roubles without maintenance of value obligations which would require less than 5% of the value of the claims currently expressed in US dollars to extinguish the entire amount.

[10] The real reason appears to be that as Tanzanian debt information is reconstructed the outstanding claims of private creditors are being found to be smaller than earlier documentation (and interim estimates) seemed to suggest and also because they have moved from the private to the bilateral

account after indemnities have been paid out by export credit insurers in their home countries.

[11] World Bank World Debt Tables 1990-91 Vol.1 Box 7.

[12] C. Colclough and K. Lewin Educating all the children. December 1991. Mimeo, IDS.

[13] Interview material; views expressed at NMB Conference on Official Debt Conversions, Amsterdam, 28 January 1992.

[14] See Ecuador case study.

CHAPTER V: THE IMPACT OF OFFICIAL DEBT CONVERSIONS ON CREDITORS

Debt Reduction: A Positive Sum Game

In assessing the impact of debt reduction or relief the focus of emphasis is invariably on the gains to the debtor country, whether the relief arises from reschedulings, full or partial cancellations, restructuring or debt conversions into equity or local currency for developmental expenditures that might not otherwise have been made. It is implicitly (and wrongly) assumed that because debtors gain creditors must lose because the very provision of relief to one party must involve a cost to the other party. In other words, providing debt relief is assumed to be a zero sum game. Seen against a starting point in 1982, when creditors felt they had a right to expect full repayment on schedule of loans borrowed voluntarily by debtor governments, any form of relief through stretched out or foregone receivables involves a cost, unless it is compensated for through fees and interest charges. In the early years of the debt crisis, that was indeed the case.

Certainly the debt crisis has resulted in creditors incurring a heavy cost in terms of principal locked up and foregone, large provisioning requirements, lost capital values on share markets for commercial bank creditors, tax and budget revenues foregone on official loans and additional capital payments to multilateral institutions to provide a stronger line of defence for the international financial system. It can, and has, been argued however that the costs imposed on creditors were not inflicted by the debtors per se but were partly the result of their own misjudgements and competitive aggressiveness. The debt crisis was a debacle to which both creditors and lenders had contributed through irresponsible borrowing which could not have occurred without irresponsible lending. It is still being argued whether the costs of that debacle were made unduly high by ill-conceived creditor pressures in the early stages of the crisis and inappropriate debt management policies applied through bilateral and multilateral discipline. It is also a matter of contention, unlikely ever to be satisfactorily resolved, that the costs of an adjustment which the global community as a whole should have shared for a jointly created global debacle were unfairly allocated. The burden of adjustment and of compressed incomes and consumption was passed on almost entirely to debtor societies. The losses to creditor societies were an insignificant fraction of the continuous growth they enjoyed between 1983-90 partly as a result of receiving from debtors real net resource transfers of over $220 billion over that period. Under normal circumstances without the debt crisis, the transfer of real resources might well have been zero or, if history is a reliable guide, more probably in the order of $50-100 billion from creditors to debtors.

These arguments, interesting as they are, do not advance the cause of undertsanding by much. What matters in 1992 is not what happened in 1982. Since realistic conclusions can only be drawn from case-by-case considerations, some abstractions are useful to make a few general but important points. In 1992 creditors confront a situation in which over 53% of their portfolio of $1.35 trillion in loan assets in developing countries is value-impaired because $715 billion of it is concentrated in SIDCs. That much at least is not at issue. What may be open to dispute is by how much the value is actually impaired. Under a situation in which creditors have a problem portfolio some attempt at valuation based on the probability of expected repayments needs to be made. That is difficult to do with any precision especially on an aggregated global scale. Nevertheless, some hypothetical numbers might be illustrative.

Based on past debt servicing patterns and on present secondary market values it would be surprising if the distressed portfolio of over $715 billion at face value in all SIDCs combined had a real NPV of more than $395 million (i.e. 55% of face value) as a weighted average. It is possible that the portfolio of private creditors, on average is worth about the same 55¢ on the dollar in NPV given the countries in which it is concentrated. The loans of multilateral lenders are worth at least 90¢ per dollar given their status as preferred creditors and their ratio of collections relative to other creditors. This figuring would leave a valuation of the bilateral debt portfolio of around 33¢ on the dollar for all SIDCs based on a distribution weighted by proportion of debt held by each of these types of creditor. Such a price would mean that in NPV terms the bilateral creditors portfolio is not worth the $195 billion that the official debt statistics might show but actually worth around $65 billion instead. These proportions would of course be different for SILICs and SIMICs and even more so in each debtor country. The most sensible approach would be to build up an idea of the average from country-by-country analysis rather than the top down approach adopted here for the sake of simple illustrative exposition.

If those numbers are viewed as crudely proximate valuations for the purposes of argument then the issue of costs and benefits of debt reductions or conversions in 1992 assumes a different hue. In rational terms any bilateral creditor would need to consider not the face value of the debt reduction or conversion that the debtor might seek (which unfortunately is what creditor governments invariably focus on) but whether such a reduction would result in the average real NPV of the creditors' claims increasing above the imputed amount of $65 billion. It is entirely possible that a $20 billion face value reduction from the stock of $195 billion could result in an increased residual value of $70 billion if the implicit average value (or price), after the debt reduction, were to move up to 40¢ from 33¢; a not unlikely outcome given what has happened in Mexico, Chile and Poland. Under those conditions both debtors and creditors are better off as a result of debt reduction and conversion. Two critical assumptions must hold for this to happen: (i) debtors must continue to apply the same levels of debt servicing to the residual stock of debt; and (ii) the debt reduction must be sufficiently large to make a difference to improving the sustainable growth prospects of the debtor.

Under the present Paris Club consensus on enhanced Trinidad Terms the most that can be expected by way of cancellation in SILICs is less than $6 billion although bilateral creditors have agreed to write off nearly $30 billion in Poland and Egypt. No cancellations are contemplated in SIMICs although if all the debt conversion clauses that were presently in SILMIC agreements were to be acted upon the resulting conversions would amount to a maximum of $3.5 billion. Clearly bilateral creditors will need to consider offering SILICs and SILMICs terms at least as good as those for Poland and Egypt before debt conversions begin to make a sufficiently large difference for these two groups of indebted countries to gain rather han for both to be disappointed because the initial cut was not large enough to have any impact.

The Impact of Reducing Bilateral Debt through Conversions

Quite apart from the gain in effective portfolio value that creditors might realize, if significant cuts in outstanding debt stocks result in growth, the prospect of converting the residual into claims which are likely to generate future income are an added bonus for creditors. It is impossible of course to speculate on what the likely returns from such investments might be or when they will accrue in the form of usable (i.e. convertible) earnings. A secondary benefit is that the equity portfolio of creditors resulting from the converted debt is also likely to increase in value, adding a capital appreciation feature to the portfolio value of residual debt plus converted equity. Tertiary benefits to creditors are likely to include enhanced trade, export, invetsment and other economic benefits if debtors are able to recover as a result of debt reduction.

This line of argument implies that the reluctance of bilateral creditors to reduce the face value of their debt claims, through cancellation and/or conversion, is self-defeating. It reduces the NPV of their expected future repayment stream below what might be possible if the burden of debtors was alleviated. The possibility that diminishing the debt burden of SIDCs may be a preferable option to giving the kind of "drip feed financing" which bilateral and other creditors have provided which simply postpones debt repayment and makes it less likely as interest and arrears accumulate. Analysis by Krugman and others[1] employing the concept of a debt-relief Laffer curve provides though-provoking insights into why large nominal debt burdens have acted as a drag on debtor recovery and their ultimate ability to repay and why market-based solutions based on voluntary action are a distinct second best to concerted action in order to avoid free-rider problems which could be disputatious if they applied within the official creditor community.

The conceptual ingredient in understanding why debt reduction is beneficial to creditors and debtors lies in the distinction between the average cost of bearing the debt versus the marginal cost and benefit of reducing the burden of debt by an incremental dollar. The marginal benefit of debt reduction to a debtor is different from the average cost of its debt just as the marginal cost which creditors incur from debt reduction is different from the average benefit of holding on to the debt. Marginal costs and benefits are not generally reflected in the secondary market price. They must take into account the effect of debt reductions on the price of residual debt. The total cost to creditors of reducing the marginal dollar of debt is usually less than the market price for three reasons: (i) the value of the remaining portfolio improves as a result of the reduction; (ii) fewer resources need to be devoted by creditors to extracting collections whether by way of adminis-trative costs or the application of punitive measures; (iii) creditors generally benefit from the debtors' economic recovery. The experiences of Chile and Mexico vs Brazil suggest that the effect of the last two factors are sufficiently strong to result in debt reductions actually increasing the creditor portfolio's worth.

The Financial Impact on Export Credit Agencies

Unfortunately, Phase I of the UNCTAD Project, as a preliminary broad brush approach, did not provide either the consulting time or the budget necessary to undertake a detailed analysis of the impact of debt conversions and cancellations on the financial position of individual ECAs or to build up an aggregate picture of the actual budgetary costs to the creditor countries. Information on the financial construction of ECAs, their reserves, balance sheets and income statements is not readily available without a considerable amount of primary research being done. Nor are ECAs prepared to be forthcoming or transparent about their financial positions and their "net worth". Nor is there much literature on the impact of the debt crisis on the financial position of ECAs comparable to the publications available on the financial positions of commercial banks. Not much can therefore be said from the Phase I findings about the financial impact on ECAs of debt conversions. This aspect will need to be understood in greater detail in Phase II with more in-depth analysis of a few large ECAs in OECD creditor countries (possibly those of the G-7 countries) as examples.

ECAs generally fall into two categories. They are either government departments funded through the government's annual budget or they are independent statutory bodies enjoined to account for their financial condition using corporate accounting practices. The former type of ECA is not normally required to engage in provisioning although most now do so as a matter of practice. In many instances ECAs have been able to sustain substantial book value losses because of the operation of contingency reserve accounts with their respective treasuries. Others have had to be recapitalized. Any large scale debt reduction will affect the financial standing of ECAs though, if confined to SILICs and SILMICs (other than Egypt and Poland) the effects are likely to be absorbed without much difficulty.

The financial standing of ECAs will also be influenced by internal arrangements intermediated through their respective treasuries concerning transfers of their claims to the equity investment promoting agencies should the latter be charged with the responsibility of managing the conversion programmes of bilateral creditors. The mechanisms which are involved and the internal transfer pricing heuristics used will be obvious determinants of financial impact. Given the ambitious scale of debt reduction agreed to by bilateral creditors in Poland and Egypt suggest that considerations of financial impact on ECAs or aid agencies are not, in the final analysis, of great importance to bilateral creditor governments in influencing their decisions.

Other Bilateral Creditor Objectives in Pursuing Debt Reduction

Unlike commercial creditors, creditor governments (though not necessarily their ECAs as institutions) have a wider range of bilateral and multilateral considerations which they (ostensibly) take into account in determining their approach to official debt reduction in either the individual or the general case. Their behaviour so far (which has been quite different in relieving the bilateral debt burdens of SILICs, SILMICs and SIMICs) suggests that the impact of debt reduction actions on the NPV of their residual LDC asset (pre-and post-conversion) portfolios is not their primary concern; as indeed their extraordinary actions in the case of Poland and Egypt have underscored. Politics often override economics or commercial considerations in determining creditor government behaviour towards individual debtors which can be quite different to their posture vis-a-vis the debtor community as a whole (the US is a prime example of this divergence). Unlike commercial banks official creditors have not yet established the basic market mechanisms through which they can realise residual portfolio value through claim sales except at the fringes of the market that already exists for trading private LDC debt. So far, at least, their behaviour as creditors suggests that OECD governments have been less concerned about the NPV of their portfolios and more concerned about:

(a) preserving stability and order in global financial markets and in the official international financial system;

(b) preserving the fiction of valuing their claims at full face value to avoid taking the tough budgetary measures necessary to permit a write-down of their values to more realistic levels;

(c) moral hazard and free-rider problems emerging within government-to-government relations and within the official creditor community;

(d) utilizing the "debt weapon" as a means of leverage to impel changes in debtor economies on both ideological as well as economically rational grounds;

(e) reasserting OECD and G-7 predominance over the multilateral financial system and directing it in a much more focussed way to meet their international interests vis-a-vis debtor countries en bloc;

(f) using debt forgiveness as a tool in their range of actions to foster bilateral government-to-government political or commercial objectives vis-a-vis individual debtor countries (i.e. certain creditors will take entirely different postures with certain individual debtors based on historic or cultural ties, the political influence of ethnic minorities from specific debtor countries in their own societies, the actions of the debtor in support of certain creditor interests).

These mainly political uses of the debt weapon by creditor governments (no their individual agnecies) are, of course, moderated by the ambivalence felt by these same governments -- not least because of political and moral pressure exerted on them by NGOs, their publics and other forms of voluntary organizations -- in taking positions on debt issues which appear to be in conflict with what other agencies in the same governments are attempting to achieve on the humanitarian and development assistance fronts. Occasionally these conflicting impulses are resolved through token gestures, usually by way of agreement to episodic cancellations of concessional debt in amounts which are not particularly meaningful. Despite a prolonged record of actions which have achieved precisely the opposite effects, most creditor governments claim intense anxiety and commitment to resolving the debt crisis quickly in order to:

(a) facilitate recovery, adjustment, development and the restoration of creditworthiness in debtor economies -- not least because such recovery would enable creditor countries to: resume exports to debtor economies thus promoting their own societal and economic interests (in terms of improving their own employment and export peformance); expand global trade which is presently constipated; increase the sustainable growth rate of the global economy; encourage the repatriation of flight capital (though this could have severe repercussions on economies such as the US); and encourage expanded global flows of direct and portfolio investment to reverse large net negative transfers from debtor to creditor countries.

(b) promote actions to alleviate the burdens of poverty, of displaced refugees, and of "human development" in general by relieving the burdens of debt service;

(c) reduce the burdens on themselves of providing more net development assistance simply to enable debtors to meet debt service payments to other bilateral, multilateral or private creditors;

(d) alleviate the debt burden to the extent that it might impinge adversely on the actions which developing countries might take to protect the global environment;

(e) reduce the pressure on all debtor countries to expand exports to creditor countries too rapidly (in order to generate sufficient earnings to finance debt service payments) especially in those products, industries and services which would create major adjustment problems for creditor countries and which have already created additional pressures within structures such as GATT; and finally

(f) consolidate and secure the windfall gain of an unanticipatedly rapid collapse of intrinsically hostile communist regimes in Eastern Europe and in other parts of the world.

Given this gamut of conflicting pressures and objectives -- political, economic, security-related and social -- it should not be surprising that in acting on debt reduction creditor governments, individually or collectively, have behaved in ways which have not appeared to be as single-minded as those of commercial creditors and which have often reflected an inherent element of confusion and ambivalence about providing DDSR through cancellation and/or conversion. Creditors have also become concerned about interest capitalization practices which have led to an accumulation of the bilateral debt burden to intractable proportions; a process which is now exerting its own pressures for corrective reductions. Yet, though creditor govrnments often face the difficult task of reconciling conflicting interests in determining a consistent position on providing DDSR on official debt, their ECAs do have narrower, more single-minded interests which resemble those of commercial creditors. These are more focussed on maximizing current debt service receipts, regardless of the impact on debtor countries or on the NPV of their debt stock portfolios. Indeed in defending their actions in the Paris Club, ECAs seem anxious to emphasize that they are not development agencies but non-concessional, commercially-oriented financing agencies intent on full recovery of claims. The next section outlines the views of ECAs on the prospects for official debt reduction based on interviews held.

Export Credit Agency Reactions to Official Debt Conversion Proposals

Though the optional "10% conversion clause"[2] began to be inserted in PCRAs for SILMICs in September 1990 virtually no ECA has prepared itself properly for the prospect of requests from debtors for creditors to exercise the conversion option. Hence the requests by Poland and Egypt to exercise the option so soon after their PCRAs had been agreed came as an unexpected surprise and has not generally been well received by most ECAs.

Few ECAs have focussed on the implications and consequences of official debt conversions for themselves, their treasuries, for debtors and for potential "swappers". While they realize that insertion of the clause provided a door where there was previously a blank wall, they did not expect to be confronted with pressure from any debtor to open it quite so soon. Some of the reactions of ECAs have already been dealt with in Chapter III.

Nonetheless this section revisits these reactions to portray as comprehensive a view of where ECAs stand on the issue of official debt conversion (ODC).

Legal and Financial Constraints on Debt Write-downs by ECAs : Several ECAs and other debt holding official agencies (e.g. CCC in the US and Canada) felt hampered by the legal prohibitions they have on exchanging, writing down or selling their claims at discounts without specific enabling legislation permitting them to do so and providing budgetary authority for the write-down (Italy, Germany, Japan). Others have the legal ability to do so but not necessarily the financial reserves or capacity to take the balance-sheet or budgetary consequences (France, Spain, US, UK). Several ECAs are now actively examining the possibility of undertaking major portfolio adjustments through liquidation, sale and exchange of claims and of engaging directly or indirectly in swap activity (Belgium, the Netherlands, Spain, Sweden, Switzerland and the US). A few of these have undertaken tentative experimental transactions (Belgium, Sweden, Switzerland and the US). Others are examining the policy implications of undertaking such activity (the UK) while some are strongly opposed to undertaking either an examination of such prospects or of attempting a few experimental transactions (Japan).

The "Tail" Problem : The unresolved issues concerning the uncovered "tail" of the original contract guaranteed by ECAs was a universally shared problem which most ECAs felt needed to be tackled head-on. They were anxious to learn from the experience of other ECAs in handling this issue (especially from those which had undertaken experimental transactions such as Belgium, Sweden and Switzerland). The legal aspects of the tail problem, including the rights of "tail-holders" and the options and remedies available to ECAs to buy-out the tails at an appropriate discount, needed to be studied carefully in the case of each ECA. Should the indemnity pay-outs and the purchase of tail obligations be looked upon as an expense for ECAs (as it inevitably would be under a government accounting system) or as the "purchase price" of an asset i.e. should it be looked upon as an investment under corporate accounting conventions ? Those ECAs which have already undertaken purchases of tail-end claims to give themselves more room for manouvre with debt sales and conversions (Belgium, Sweden, Switzerland) had the following observations to offer: (i) the Toronto Terms had created major problems with "tail-holders" which were still in the process of being resolved; (ii) they found that most tail-end claims could be bought at a discount fairly close to the secondary market price which tail-holders invariably use as a guide price to negotiate with the ECA; (iii) but buying out "most" claims is not enough, these ECAs believe that for certain countries, especially SILICs, a once-for-all open offer should be made to all tail-holders on an all-or-nothing basis; i.e. either all tail-holders accept the terms offered for purchase by the ECA or no purchases of any claims are made; (iv) some ECAs are attempting to buy out a portfolio of mixed country claims for certain countries (e.g. SILICs) from tail-holders at a composite fixed price even though arriving at a single price for a variety of country risks proved to be a difficult exercise; (v) all future policies offered by these ECAs to exporters and banks will require policyholdrs to agree automatically to any rescheduling terms negotiated by the ECA.[3]

Internal Accounting and Provisioning : ECAs were anxious to share information on the balance-sheet and income-statement implications of debt reduction under different accounting regimes which governed their operations, i.e. the different implications of corporate, government and hybrid accounting conventions and protocols on asset valuation, recording of value-impaired assets, provisioning requirements, reserve levels, the maintenance of contingency reserve accounts in Treasuries against which ECA losses could be charged (UK and Canada were interesting examples). The impact on each ECA would need to be done an an individual case-by-case basis give the considerable differences employed in the accounting systems used by different ECAs.

Eligibility of Debtor Countries for Conversion/Cancellation : ECAs were generally concerned about the criteria for eligibility of particular debtor countries for conversion/cancellation treatment. Their concerns reflected considrable unease at the degree to which politics were intruding on selection criteria making it difficult for ECAs to explain or justify to different debtors why certain countries were being favoured with advantageous treatment while others were not. The Poland/Egypt arrangements had created particular difficulties in that connection and had made ECAs wary and uneasy about the politicization of processes which needed to be handled on the basis of more objective and consistently applied criteria across all debtors.

Pricing of Official Debt vs Market Traded Commercial Debt : ECAs are mixed in their views about the price (value) of their claims on SIDCs. They believe that secondary market prices do not accurately reflect true values of their official non-concessional claims but are unable to substantiate that belief tangibly. They have not yet developed a satisfactory way of determining whether their claims should be priced above, below or at market value since there are persuasive arguments in support of all three options. The case for pricing official claims at values above market prices rests on the degree of preferred creditor status which governments are supposed to enjoy in their transactions with each other and the leverage that creditor governments can bring to bear on debtor governments to recover their claims if they were so inclined. The case for pricing official claims at below market rests on the record of debt service performance on official claims relative to private claims between 1982-92 which would provide a strong accounting and actuarial justification for the view that the NPV of official claims was considerably lower than their private counterparts. The case for pricing the claim at market value is that all other values are hypothetical while the market value is the only "real" benchmark of value at a particular moment.

The confusion on pricing is heightened in instances where ECAs have guaranteed commercial bank credits and the banks themselves have disposed of their "tail claims" at market values. Those ECAs which have undertaken experimental conversions of their claims have generally attempted to use the prevailing secondary market price as the "floor" price. Some ECAs (Belgium and Switzerland) appear to have succeeded, in their isolated transactions, in obtaining a higher price. Eventually the right "strike price" for ECA claims in SIDCs will depend on a composite evaluation of four factors: (i) the NPV of applicable Paris Club terms to non-concessional claims on the debtor concerned (i.e. ETT for eligible SILICs, Houston terms for SILMICs); (ii) the secondary market price prevailing;

(iii) the past record of debt service on ECA claims and (iv) the expected record of debt service on residual debt claims.

Debtor Inactivity on Pressing for Official Conversions : The relative absence of debtor interest or initiative in pressing for creditors to exercise the conversion clauses contained in their PCRAs, until the proposals put forward by Poland and Egypt, were cited frequently by ECAs as indications of a lack of "real effective demand" from debtor countries for debt reduction through official debt conversions. This, coupled with monetary caps on debt-equity and other kinds of debt swaps in most SIDCs, led ECAs to feel that it was premature to worry about accelerating the pace of, or promoting, ODC. Peculiarly enough, the debtor governments interviewed claimed that they had not pressed for the 10% conversion clause to be exercised because they felt that the creditors had inserted these clauses grudgingly as a token gesture in their PCRAs. Debtor governments were convinced that efforts to persuade creditors to exercise their conversion options would be rebuffed or would become as administratively costly to negotiate as the reschedulings themselves. This gap in perceptions (and indeed in financial engineering knowledge and ability) on the part of debtor and creditor officials involved in repetitive and sterile debt rescheduling negotiations has resulted in official debt conversion possibilities falling between the cracks. The phenomenon is symptomatic of what has happened earlier with private debt. The impulse for innovations in debt transformations has usually come from specialized financial intermediaries rather than from officials in debtor or creditor governments whose limited knowledge and whose bureaucratic dynamics (within creditor and debtor governments themselves as well in negotiations between debtors and creditors) have tended to lock them in more rigid and less imaginative postures.

Use of Aid Funds to Support ECA Debt Conversions : All the ECAs interviewed were in favour of deploying funds from the aid budgets of creditor governments to finance sales, conversions and write-downs of their own claims at discounts significantly lower than those signalled by secondary trading markets. The enthusiasm of ECAs for raiding aid budgets was matched by the equally emphatic resistance of aid agencies in creditor countries. Several creditor countries had established separate "debt relief funds" and special accounts which were not normally treated as part of the aid budget and which could be used only to provide debt relief.

These funds were prevalent in the Nordic countries, the Netherlands and used most extensively by Japan. ECAs were generally supported by their Treasury officials in the view that the "relief component" of debt conversions should be regarded as an aid substitute and should be seen as part of a creditor country's overall aid effort which might, in conditions of budgetary tightness, be offset by equivalent reductions in other programmed aid flows.

Restrictiveness of Consensual Approaches : A few ECAs (e.g. Belgium) felt that the multilateral consensual approach of the Paris Club was artificially restrictive in limiting the ability of the more adventurous and innovative ECAs from expanding their own debt conversion activity by limiting it to 10% of the non-concessional debt stock or $10 million (in some instances $20 million). They believed that such caps should be removed and individual ECAs permitted to engage in ODC to whatever degree they fealt was feasible. Most other ECAs believed strongly in the consensual approach. They felt it was essential to maintain official creditor solidarity and discipline (i.e. the creditors' cartel) and to avoid free rider problems from emerging within the official creditor community (at least within the OECD group of creditors). The absence of such a cartel would provide debtors with the flexibility of doing preferred deals with individual official creditors at the expense of other ECAs. Therefore they felt that the consensual restrictions were necessary and needed to be respected by Paris Club members to avoid "anarchy" in the rescheduling and restructuring process. If such inflexibility meant that the creditor community as a whole could only move as fast as its slowest member that was a price that had to be paid for maintaining order in the financial system and protecting the integrity of the creditor-debtor relationship. It was left unsaid, however, that the real price was paid by the debtors and not by the rest of the creditors themselves; indeed some creditors were quite content to make bold and imaginative debt relief proposals to obtain political popularity comfortable in the knowledge that the prospects of such proposals being implemented by the Paris Club membership as a whole were remote.

Paradox of Including Conversion Clauses for SILICs/SILMICs but not for SIMICs : Some ECAs pointed out the paradox for inserting the optional conversion clause in PCRAs for SILICs and SILMICs where viable conversion opportunities, expecially for DES, were likely to be limited but not including them in agreements for SIMICs (except Poland) where the opportunities for viable conversions was the greatest. Others felt that the clause itself was an implicit acceptance of the reality that the affected debt was unlikely to be recovered (fully or partially) in SILICs and SILMICs. Inserting such clauses in SIMICs would convey the same signal and would therefore weaken the position of the Paris Club creditors in seeking full recovery. The case of Mexico was cited frequently as a SIMIC which was uninterested in anything other than a full repayment relationship with official creditors because it felt that maintaining full credit cover was more important and economically benficial than obtaining marginal advantages through reduction or rescheduling where official debtors were concerned. In that case, official bilateral creditors were indeed treated as "preferred" over private creditors though subordinate to multilaterals.

DES vs DDS Preference : ECAs saw official DDS conversions as being on a par with outright debt cancellations with "directed use conditionality" attached, rather than as being related to DES which enabled some recovery of value in the future. Most ECAs would not be interested in DDS operations believing that they were more suitable for conversion of concessional aid debt. For their own claims ECAs would prefer to focus on DES opportunities. Many ECAs felt that given the limitations on their internal administrative capacities the trade-off between outright cash sales of their claims to third-parties either through the secondary markets or through negotiated private placements would be in favour of the former. Having gone through a decade of uncertainty on recovery most ECAs would prefer cash realizations today rather than be confronted with similar issues of recoverability of uncertain future cash flows from converted equity investments.

Concerns about Round-Tripping through Official Debt Conversions : Several ECAs (e.g.France and Germany) expressed concern, as official creditors, in engaging in conversion operations which might fuel "round-tripping" abuses (often by officials with privileged access to scarce foreign exchange) in SILICs with distorted exchange rate regimes. They would prefer to see these distortions eliminated through the adoption of market clearing exchange rate regimes with full convertibility before being comfortable about engaging in conversion activity. Official conversions might be undertaken more freely by these ECAs if the debtor countries concerned were given a "good housekeeping seal of approval" by the IFIs for efficiency and probity in the management of their debt conversion programmes. Other ECAs (e.g. the UK) felt that it was not their business to be moralistic about round-tripping or other abuses in debtor countries but to be concerned about recovering maximum NPV for their claims in cash equivalent terms or, in the case of conversions, through expected future recovery of income streams from a different asset.

Maturities of Official Debt eligible for Conversion: As discussed more fully in Chapter III, ECAs were preoccupied with the technical difficulties involved in converting pre-cut-off, post-cut-off and rescheduled debt concluding that it would be easiest for them to convert debt which was post-cutoff and as yet unrescheduled. They were uncomfortable about the absence of Paris Club guidelines on the issue of as yet unrescheduled debt. The criteria which might need to be applied in selecting the right kinds of debt for conversion would be based on : (i) current or short maturities chosen so as to represent claims registered immediately after the cut-off date for consolidation; (ii) nature of the insured party (most ECAs felt it would be easiest to deal with bank credits which were covered); and (iii) the ease of aggregating the selected claims into bundles representing large amounts.[4]

New vs Old Export Credit Money : Unlike commercial banks many ECAs (e.g. Spain) felt that they were under continuous pressure to provide "new money" to debtor countries when debt service treatment of their "old money" had been unsatisfactory and they had effectively become subordinate in most SIDCs to virtually all other classes of creditor. There was a clear need to establish clearer thinking about new vs old money when it came to export credits.

Transparency about capturing Discount Benefits in ODCs : In considering the prospect of ODC on any significant scale ECAs were also concerned about full transparency in the swap transaction: i.e. what would happen to the swap proceeds in end-use; what spreads would be involved for intermediary banks; what profits would involved up-front for potential third party investors in terms of the configuration of the "five-prices"; what share of the discount would be captured by the debtor country ? The market-based view (eg. of the UK) was that these issues should not concern ECAs. But other governments and ECAs felt that as agencies responsible to and funded by governments and legislatures they had obligations which were different to those of private creditors in demonstrating that the alternative use of locked-in public funds (which is what ODCs effectively were) had an impact that were consonant with the interests and objectives of creditor governments.

Standardization of ECA claims : Experience with post-Brady bonds and other standardized instruments which were now being traded on secondary markets suggested to most ECAs that an esential prior step before ODC was likely to "take-off" was the novation and standardization of different types of ECA contractual arrangements and claims on SIDCs. Some ECAs (e.g. Sweden) have a clause requiring debtors to provide standard treasury or central bank promissory notes in exchange for the original contract at the option of the ECA; such notes could be traded or reassigned to any party without permission from the debtor. The optimal outcome was the standardization of ECA paper among Paris Club (and other bilateral) creditors to a degree which would permit it to be traded interchangeably with commercial bank paper and Brady bonds on existing secondary markets rather than in a separate market or a specialized market segment. Such an approach would rule out debt which had already been recheduled since the changing of those claims would require debtor agreement and the terms of rescheduling, especially for SILICs under TT and ETT were such as to make transformed claims unsaleable in markets. As one ECA put it the unfortunate reality was that so far the thrust of ECA efforts and those of the Paris Club had been to protect bilateral creditor rights and not to harmonize for multilateral market creation.

Treatment of Past Due Interest : The ballooning of ECA claims as a result of continuous reschduling and capitalization of interest and arrears had led to a situation where in most SILICs and SILMICs the bilateral debt burden had become unpayable. ECAs were concerned about the treatment of past due interest by debtors and by the Paris Club in terms of its eligibility for ODC. Some debtors (e.g. Egypt) did not recognize past due interest as being a valid claim and refused to consider accepting such claims as eligible for conversion purposes. A clearer position on this question was essential for both the creditor and debtor communities to agree upon.

Conversion Deals Done So far by ECAs : In the absence of more time and budgetary resources it was impossible to undertake an exhaustive review of official debt conversion deals which had been done by OECD-ECAs. During the course of our research for Phase I of the UNCTAD Project the following transactions came to attention; unfortunately the specific ECAs involved cannot as yet be identified in order to protect confidentiality:

(i) Official debt sales and conversions were undertaken by one active European ECA with the consent of tail-holders in Egypt, Peru and Zaire and with similar arrangements now being negotiated for Zambia and the Philippines by the same ECA. In Egypt the paper sold was used exclusively for conversion with agreement being obtained from the Egyptian central bank for the end-use of every single maturity being exchanged; although the ECA was concerned that it had no internal monitoring ability to follow-up on end-use and had no recourse in the event of default on end-use agreement. In the case of Peru the debt sale/conversion was for a specific project involving an outright purchase of the ECAs claims by local investors; the price was established not by the quoted market price but by eliciting a range of competitive offers from different commercial banks.

(ii) Other European ECAs were now doing conversion deals in Egypt though with different approaches about prior consultation on end-use of converted proceeds. One North European ECA had already exhausted its $20 million conversion limit in Egypt. Experience with Egypt suggests that it would provide fertile ground for detailed investigation under Phase II of this Project.

(iii) In the Western Hemisphere official debt conversions had been undertaken by an ECA in Mexico with successful results. Such conversions had also been undertaken by governments of major debtor countries with claims on smaller debtor countries in the region.

(iv) Official conversions were being mooted in Morocco, Nigeria and Mozambique involving mainly European ECAs.

These transactions suggest a growing awareness of conversion possibilities on the part of ECAs. Coupled with increased interest on the part of debtors, in the aftermath of the Polish and Egyptians proposals to their creditors, and on that of financial intermediaries anxious to include official debt in secondary trading markets these forces are resulting in greater pressure to accelerate the ODC process. Many ECAs believe that ODCs could blossom and could be more easily "sold" politically in their respective countries if they were pushed more aggressively in the multilateral Paris Club context. Much more groundwork needs to be done on legal, accounting, provisioning and "tail-holder" issues before the official debt conversion "market" develops in the same way that the private debt market has. But the ODC market has a major advantage in being able to learn from developments in established secondary LDC debt markets and to piggy-back on them without ECAs incurring the same costs or time involved in innovation as commercial banks did. The main constraint to faster movement with ODC appears to lie in: the absence of sufficient political will on the part of creditor governments to move more aggressively with official measures aimed at reducing debt especially in the SILICs; the lack of financial sophistication in ECAs; and their reluctance to involve specialist intermediaries in ODC market development.

1 P. Krugman "Financing vs Forgiving a Debt: Some Analytical Notes" in the Journal of Development Economics, November 1988 pp 253-68.

2 The clause agreed to in September 1990 was as follows: "Creditor countries can on a voluntary basis swap part of their claims for debt-equity swaps, debt for nature swaps or other swaps for upto 10% of bilateral or officially guaranteed commercial loans and (where relevant) for upto 100%of official loans and official development aid".. Variants of this clause have now been incorporated in PCRAs for 14 countries (SILMICs and SILICs). The clause is restricted to only 10% of the non-concessional debt and is voluntary (at the option of the creditor) mainly because of the technical problems involved in determining the equivalence, in NPV terms, of swaps undertaken with different prices (cf the five-price concept) and subsidies. The substantial differences in the nature of offical and private claims and in the interests of the different parties involved in the swap raised concerns in the Paris Club about technicalities and methodologies for determining equivalence which could not easily be dealt with. For that reason the clause was intended to be bilateral and voluntary for a temporary period until agreement on ways of determining equivalence could be reached. In the event the clause has become enshrined though the methodology remains somewhat elusive.

3 A similar clause already exists in the policies of many ECAs (e.g. Germany) although when tested in the courts this clause was found to be applicable to postponed maturities but not to reductions of principal or interest.

4 Using these criteria and constructing these synthetic bundles from diferent claims would however prove a nighmare for debtor central banks to cope with in terms of their own intractable recording and information systems. Also choosing maturity dates close to consolidation dates might be alright in theory but not in practice, especially in SILICs where the cut-off dates are quite old.

CHAPTER VI: THE FINANCIAL AND ECONOMIC IMPACT OF OFFICIAL DEBT CONVERSIONS ON DEBTOR ECONOMIES

In analysing the impact of official debt conversions, we have one major advantage and one disadvantage. The advantage is the vast experience of commercial debt swaps (especially debt-equity) and an important literature analysing this.[1] The disadvantage is that the experience with official debt conversions is very limited, and there is as yet no systematic analysis of potential effects, either in general or in specific cases. However, our task will be helped by the fact that in most areas (though not in all) there are important similarities between the effects of commercial debt conversions and those with official debt.

A second general point to make is that debt conversions, with all their benefits and costs, represent only one more tool for an economy with a debt-overhang. As such it is very much a complement, and not a substitute for, other more important macro-economic policies, such as monetary and fiscal ones. Indeed, those countries that have in the late eighties managed their macro-economic policies best, (e.g. Chile) on the whole have also benefited most from debt conversions; on the other hand, in countries characterised by macro-economic instability, the negative inflationary and "round tripping" effects of debt conversions (e.g. Brazil) are seen to have possibly out weighed the benefits of debt conversion.

The effect on the debt overhang

A major difference between commercial and official debt conversions seems to be that debt reduction in the latter seems far more clearly additional to what would have otherwise been obtained, than in the former.

Increasingly in the case of commercial debt, countries have other options (especially via Brady deals, but also via options such as debt-buy backs) than debt conversions to achieve the aim of debt reduction. In the case of bilateral official debt, because of the way in which the "10% clause" has been introduced (as a bilateral, voluntary clause, to be agreed after the multilateral deal is reached), debt conversion seems to imply additional debt reduction than the country would otherwise obtain. This seems clearly illustrated by what is happening in Egypt. Naturally debtor country negotiations must take care that implicitly debt reduction via the "10%" clause[1] is not granted as a substitute for deeper debt reduction deals in the Paris Club.

As regards the Enterprise of the Americas Initiative, debt conversions there would also clearly seem to be additional, as if the debt is not reduced via this mechanism, it would not otherwise be reduced at all.

The effect on debt reduction will be similar if the conversion is for equity or for development; however, in one case, part of the claim will be swapped into a contingent foreign liability (equity), whereas in the other case, part or all of the claim will be swapped into local currency obligations. Thus the net Balance of Payments effect will be different although debt-equity conversions can have powerful secondary effects in attracting foreign capital over the medium- and long-term. On a sustained basis, enhanced foreign capital flows can offset by a considerable margin foreign outflows resulting from capital and dividend repatriation.

The efficiency gains to the economy; increased investment, and return of capital flight, privatisation and increased social and environmental spending

Clearly the effect here will differ for an official debt conversion for equity and for development; however, what is common to both is that effects on increased foreign investment, privatisation, social spending, etc., may imply additional efficiency gains to the debtor, but also to the creditor economy.

As discussed in Chapter II, commercial debt-equity swaps, mostly in middle-income countries, are broadly seen to have attracted additional foreign investment, thought there is debate in the literature about how much additionality there actually was. The more optimistic analysis[2] estimated that for Chile, Argentina, Brazil and Mexico, over 60% of all debt-equity investments were "additional", to investment that would have happened anyway; other estimates are somewhat lower, but yield meaningful levels, especially in countries where the programmes have remained for a number of years, thus showing the need for "an incubation period" before a conversion programme can start attracting significant additional investment. The reasons why debt conversions have attracted additional investment seem twofold: a) they provide an important bonus up-front, thus both reducing risk by lowering the initial total expenditure and increasing reward, by contributing to create a better rate of return (reportedly foreign investors respond more positively to up-front pre-investment advantages than to post investment advantages, such as tax concessions): b) debt equity programmes seem to have a very important positive indirect signalling effect, that the government is keen to promote foreign investment and is carrying out a number of measures for this objective.[3] As a result of both direct and indirect effects, debt-equity conversion programmes are now seen as having contributed to promoting foreign investment flows in middle-income countries, that pursued them.

There must be some doubt whether the same effect will take place to the same extent in lower-middle and low income countries, where there may be additional problems that detract foreign investors. (e.g. lack of physical infrastructure, small educated workforce, etc). However, if a country is keen to attract FDI, and has taken a number of measures already to improve the business climate, it seems that official debt conversion could provide a valuable catalyst (both directly and indirectly in terms of signalling) to attract such foreign investment.

It could also be hoped that the example of foreign investors and the likely effects of debt-conversions on strengthening private sector finance would also help a recovery of domestic private investment.

As regards return of capital flight, commercial debt conversion has provided a powerful incentive for local residents to repatriate capital, in countries like Chile and Philippines where nationals have been allowed to participate in debt-equity swap transactions. Such a benefit may perhaps be easier to attain for low and low-middle income countries than attracting foreign investors, if nationals are allowed to use the official debt conversion mechanism; return of capital flight then can offer a positive signal to foreign investors.

To ensure beneficial effects for the national economy (and the Balance of Payments), it is important that national authorities take appropriate measures to avoid or limit "round tripping". This can be done (as in Chile) by controlling and modifying the volume of allowable debt-equity swaps by nationals and by monitoring the parallel exchange rate, as well as allowing local residents to hold attractive local securities, as an incentive against round-tripping; it can be done using more direct controls (as in the Philippines) to verify the use of swap resources, by examining invoices, receipts, sales agreements and other relevant documents, and by requiring that funds not used for a project were invested in non-transferable, peso Central Bank bills.

It should be emphasised that the fact that a debtor country has appropriate controls and/or mechanisms in place to avoid "round-tripping" will increase creditor government willingness to allow their debt reduction to be used for debt conversion.[4]

As discussed in detail in Chapter IV, and in the case studies, debt conversions can imply significant efficiency gains for the debtor-country by facilitating privatisation and increased social as well as environmental spending. As regards privatisation, care must be taken that the price at which the state company's shares are sold in the context of the debt conversion is not too low and is transparent; for this objective, policies by the debtor government on the sale price of the debt, the conversion rate into local currency and the price of the assets (as well as any other "sweeteners") should be both consistently defined and transparently conducted.

Potential inflationary impact

Clearly the potential inflationary impact is the most serious real and perceived constraint for debtor governments wishing to implement an official debt conversion. Therefore, a careful analysis is required here, in more general terms, and in more specific terms in the individual countries, given the particular institutional features of their monetary and financial systems.

Firstly, it should be stressed that there are two cases where official debt conversions would have marginal or no impact on inflationary pressures. When external debt is used directly to acquire domestic physical assets (either as companies in debt-equity swaps or more rarely as set aside in debt-for nature swaps), there is no current element of the transaction to increase domestic demand or expand money and credit; there is therefore no inflationary consequence. Furthermore, as discussed in Chapter II, if privatisation leads to increases in efficiency in previously loss-making state enterprises, the debtor government would in future gain from not having to subsidise the enterprise.[5]

Also, if some of the official debt being converted was owed (in the debtor economy) by the private sector, and this was converted into private sector equity, there would still be no monetary impact, as the net result would be a transfer of existing liquidity from the private debtor to the new equity holder without the inter mediation of the banking system and without domestic credit creation.[6] The monetary expansion effect mainly occurs if the swaps are made with Central Bank or government paper or if operations involving privately held paper lead to an increase in overall credit to the economy.

There is another clear cut case when debt conversions will not have a significant inflationary impact; this is when their scale is very small, especially in proportion to the total money supply. It would seem that the small scale argument is particularly applicable for debt-for-development conversions; to date their magnitude has been very small (see Table 3, Chapter II) and the potential increase likely for official debt conversions seems likely to be also fairly limited. However, this requires careful monitoring, as should their scale increase, compensating measures need to be taken.

A final caveat is important. Inflationary impact of debt conversions is a far more serious consideration in countries already having high inflation levels, as well as high fiscal (and/or quasi-fiscal) deficits. If the country has very low inflation, a low fiscal deficit, and especially if it has some spare capacity and an elastic supply response, some limited additional expansion of the money supply would not be so problematic. Furthermore, to the extent that debt conversions generate important efficiency gains to the economy in a fairly short period, the improved supply response may reduce future inflationary impact.

More generally, the analysis of the potential inflationary impact of an official debt conversion programme must take place in the context of a consistent macro-economic programme, with growth and inflation targets. The size and modality of a debt conversion programme would be one relatively small element in that programming process; it is important that the debt conversion (especially if it is large) be integrated into a multi-year macro-economic framework, that will examine its effect on the monetary base, the money supply, credit markets and fiscal spending.

To assess the monetary impact, a realistic assumption needs to be made of whether the country would have in the next few years, been servicing that part of its official debt, if the debt conversion did not take place. As we have argued in section 1) of this chapter, it seems unlikely that a debtor country would be granted debt reduction instead of debt conversion. The issue is therefore whether the government could afford (given its other pressing foreign exchange needs) to service that Paris Club debt. Some useful indication can be provided by the country's past record; thus, a country like Ecuador - though in large arrears to commercial banks - has tended to service most Paris Club debt on a regular basis, and is likely to continue doing so; prospects of bilateral debt servicing for some of the low-income severely indebted economies, for example in sub-Saharan Africa, are more doubtful.

If a country would have serviced its debt (had the debt conversion clause not been applied), it is necessary to take a dynamic view of the net impact on monetary expansion over time. As debt is converted, service payments are reduced in that year and in the future, leading to a decline in net monetary expansion . In the first year, there will be (if the debt is swapped for new investment or increased government development spending, and this is not compensated, see below) an expansionary monetary effect; however this will be partly compensated by the lower money expansion required that year as government financed debt servicing is reduced; as the years pass (and the "savings" on money expansion grow, with every year's debt servicing and with the hypothetical need to amortise the debt when it becomes due), there comes a point when a programme of debt conversion can have a net cumulative zero impact on monetary expansion, and later can become negative. Thus if the inflationary potential of the first years can be absorbed, the expansionary impact of the initial period will reverse itself in later years and free monetary expansion capacity for those later years.

Some of the variables discussed above can perhaps more clearly be presented in diagrammatic form (See Figure 1); as illustrated there, debt conversions are most desirable if inflation is initially low and debt is being serviced.

FIGURE 1:

CONDITIONS UNDER WHICH DEBT CONVERSIONS ARE MORE OR LESS DESIRABLE

	INITIAL LOW INFLATION I	INITIAL HIGH INFLATION II
Debt that would be serviced	Very desirable.	Desirable, but monetary impact needs to be regulated, for large operations.
Debt that would not be serviced	III Desirable, only if spending priority changes essential to justify programme for efficiency gains.	IV Only desirable if conditions in both II and III are met.

Finally, there are some contractionary indirect effects on the money supply rarely mentioned in the literature. If part or all of the foreign exchange saved (because of lower debt servicing) is used to finance imports, then the consolidated banking system (Central Bank plus commercial banks) will absorb private sector money, thus further reducing the net monetary expansion effect. Furthermore, the imports financed by these foreign exchange savings are likely to attenuate supply bottlenecks and reduce future inflationary pressures. Increased availability of foreign exchange reduces the need to devalue, and the inflationary impact of devaluation.

If in the initial years of a debt conversion programme, the monetary expansion would be feared to be excessive, the financial authorities can take a number of measures to reduce, neutralize, or sterilize the effect. This is illustrated by the case of Chile, where in spite of a major debt-equity programme in the second half of the eighties, inflation remained modest by the country's own historical as well as by regional standards.

The Central Bank can firstly regulate the redenomination rate, to define how much local currency it spends per unit of debt swapped. To further moderate the effect on inflation, it can issue long-term bonds in exchange for the debt swapped, with the principal being amortized fully upon maturity. This method delays and distributes the monetary consequences of debt conversions by transferring the cost of servicing the debt to the private financial markets in the short run. However, using this mechanism has some costs; by competing in the capital markets with the private sector, the government may push up interest rates; furthermore, interest payments on the bonds created for the debt conversion constitute a drain on fiscal resources. In spite of these long-term costs, such mechanisms do moderate inflationary impact, for it to be feasible however it requires a comparatively well developed domestic capital market that can absorb these long term public bond issues and an overall limited fiscal deficit, so government paper is an attractive option. It is necessary therefore to examine at a country level, whether domestic capital markets are deep enough, and whether government paper can be easily absorbed. This may be more difficult in the low-income economies, than in a country like Chile where the debt-equity swap programme coincided with the development of domestic capital markets, via pension funds and other mechanisms.

Another mechanism to neutralize monetary impact is the monthly quota system of swaps, which limits the amount swapped and thus curbs monetary effects, quotas can be modified, e.g. decreased if there are fears of excessive monetary expansion, due to other reasons.

In the case of debt for development swaps, the inflationary impact would usually manifest itself via increased fiscal spending. Such spending can be compensated (if necessary) by reducing other (less high priority government spending and/or increasing government revenues, e.g. via higher taxes. Additionally, long-term development bonds can be placed on private capital markets, as has been done in countries like Ecuador and Costa Rica.

Particularly if the debt conversion is likely to become large, it is crucial for the debtor government to better budget for them in its overall macro-economic programming, and design the programme to reduce or eliminate excessive monetary affects. If these conditions are met, and the rest of the macro-economic programme is feasible, no excessive inflationary impact should result.

Net Balance of Payments effect

As the countries rescheduling their official bilateral debt and using official debt conversion programmes are severely foreign exchange constrained, a crucial effect of debt conversions to be examined closely is its effect on the foreign exchange cash flow.

An important distinction arises here between debt for equity and debt for development swaps. For the latter, the effect is more positive as there is no outflow of profit remittances and capital amortization to offset reduction of debt service payments as occurs in the former. Therefore particularly if the country was or was planning to service that debt, the net foreign exchange effect is likely to be very favourable.

It is difficult to estimate the net present value of future net foreign exchange flows, resulting from debt conversions as there are so many uncertainties in such projections. In a debt equity swap programme, the net effect will depend on:

a) whether that part of the debt was going to be serviced,

b) whether or in what proportion the direct investment coming in will be <u>additional</u> (and/or will help generate other, future additional investment,

c) providing (a) is affirmative, whether the likely future debt servicing would be smaller (in net present value terms) to the likely future repatriation of profits, dividends, and capital, which the foreign investment will give rise to (this partly depends on government regulations of the debt conversion programme), and

d) whether "round-tripping" is small or can be controlled by government efforts (this partly depends on the magnitude of the bonus received, as a very large bonus may make the temptation of "round-tripping" harder to resist and to control).

Partly the net foreign exchange effect of debt conversion programmes can be improved by debtor government regulations (e.g. size of the bonus, regulations to avoid "round-tripping", timing of repatriation of profits etc.); however, the real, as opposed to the projected, outcome will also depend on the country's future evolution. If, as occurred in Chile, the overall economic situation improves (largely for other reasons) as the debt conversion programme evolves, fears of negative effects on the Balance of Payments, as a result of high profit remittances can prove largely unjustified.[7]

If, however, a Balance of Payments crisis occurs in a country which has had a large debt equity conversion programme, then this may lead to pressure to increase profit remittances, and capital repatriation, both legally and via "round-tripping", this exacerbating the foreign exchange crisis.

This leads us to conclude that the positive effects of debt conversion can be enhanced if they are part of an overall deal that assures sufficient debt reduction and/or rescheduling to free the economy of excessive debt overhang effects <u>and</u> if they are accompanied by a policy package that makes sustainable growth in the debtor economy more feasible.

As regards debt development swaps, the net foreign exchange impact of official debt conversion will depend on:

a) whether that debt was being serviced or not

b) whether the debt reduction is funded by <u>additional</u> special contributions or whether it is funded from existing aid budgets (this, similarly to the case of non-additional foreign investments, reducing <u>new aid flows</u> that would have otherwise taken place) and

c) whether "round-tripping" is small or can be controlled. On the whole because there are no likely significant additional outflows, as occur in the case of debt-equity conversions, the likely Balance of Payments effects of debt for development swaps are positive, assuming that the proceeds of the swap in local currency mainly remain in the country.[8]

Brief Conclusions

It can be concluded that official debt conversion is likely to have beneficial economic effects, such as some reduction of debt encouragement of increased foreign investment and return of capital flight, as well as important efficiency gains. Problematic effects, especially on inflation, are likely to be small (especially if assets are being swapped, as in privatisation) and can usually be regulated by appropriate programme design and compensatory measures. Balance of Payments effects are difficult to predict, and are likely to be most favourable for countries previously servicing their debt and for debt for development swaps.

Much depends on appropriate programme design (where we have explored in-depth only some of the more technical issues) and on the over-all policy framework, as debt conversion is only one, amongst several, policy tools available to the financial authorities of heavily indebted countries.

Before finishing the evaluation of the impact of official debt conversions on debtors (and creditors), it is useful to compare the option of debt conversion to that of either outright debt cancellation or new credit.

Firstly, it should be pointed out that to an important extent, for heavily indebted countries, with large debt overhangs, there is likely to be a preferred sequence which implies: a) first, a reduction of the debt overhang, achieved by a mixture of sufficient debt reduction and debt conversion. In this context, debt conversion can be a very valuable mechanism, especially if: i) large enough and/or, ii) complementing sufficient debt reduction. Drawing on the experience of heavily indebted middle-income countries in the late 1980s and early 1990s the Chilean case illustrates the first option and the Mexican case the second option.

The mixture of debt reduction/debt conversion for the heavily indebted lower-middle income countries (HILMICs) is partly defined by existing institutional realities. For example, the levels of maximum bilateral official debt reduction for HILICs have been, for the time being, agreed in late 1991 in the context of the Paris Club, on what was described in Chapter I, as "enhanced Toronto terms"; similarly, HILMICs are in general not entitled to bilateral official debt reduction in current Paris Club practice, though Poland and Egypt are such important exceptions, that they could become precedents. Furthermore, official debt conversions for both HILICs and HILMICs also have clear maximum limits (see Chapter II). Naturally, these institutional constraints are not "fixed in stone", and can evolve as a result of changes in debtor economies, as a result in economic analysis, etc.

b) Once sufficient debt reduction/conversion has been achieved, the country is servicing regularly the remaining debt, and other pre-conditions are met (e.g. prudent macro-economic policies), the likelihood of new flows (especially non-concessional ones), to the country tends to increase, particularly in the medium-term, particularly as uncertainty over macro-economic instability diminishes as a result of the reduction of the debt overhang. A caveat should be made here. For countries, with a somewhat smaller debt overhang (especially SILMICs), a judgement needs to be made by the debtor and creditor government whether less debt reduction/debt conversion is sufficient and even advisable, because less debt reduction may in that context facilitate (by causing smaller losses to ECAs and others) quicker restoration of new flows.

As regards comparisons between official debt cancellation and official debt conversion, these are summarised in Figure 2. This seems to show that particularly for HILMICs, official debt conversion <u>is a very attractive option for both debtor and creditor governments</u>, provided certain pre-conditions are met, such as inflationary impact is small and/or can be neutralized, and there is agreement on what spending and/or asset transfer the conversion should be used for.

For many HILMICs, debt conversion may be the most likely (as well as the most attractive) way to get a reduction in their stock of debt; it will therefore not only have direct efficiency gains, but also indirect benefits, such as contributing to the restoration of new private financial flows.

In the case of HILICs, both debtors and creditors may prefer debt cancellation, due to greater simplicity. However, if direct efficiency gains and indirect beneficial effects are perceived to be important for debtors, and if creditors see debt conversions as a cost effective way of funding public international goods or purchasing foreign assets, also a very strong case can be made for the advantages of debt conversion for HILICs, especially if it is additional to sufficient debt reduction.

FIGURE 2:

	Debt Cancellation		Debt Conversion
HILICs			
Debtor government I	May be preferred option (as no additional monetary or fiscal impact) unless	II	1) Debt conversion (as is likely) is additional to debt reduction, then desirable for debtor government; 2) Debt conversion implies: a) direct efficiency gains, for debtor economy (privatisation, development spending); b) indirect benefit effects, such as additional future new flows. Also makes it more desirable than debt reduction 3) However, less desirable if potential inflationary impact is problematic and cannot be compensated, or if priority spending from creditor perspective differs from priority for debtor government
Creditor gov't III	May prefer due to greater simplicity, unless	IV	May prefer, as: 1) Efficiency gains, imply better prospects of debtor's economic recovery; better repayment prospects on remaining debt. Politically desirable; 2) May fund, in a cost effective way, public international goods, (e.g. combatting AIDS) with externalities for creditors; 3) May obtain either assets or more cash than with III
HILMICs			
Debtor government I	May be preferred option (as no additional monetary or fiscal impact) However, may be less likely than for HILICs, as HILMICs not got cancellation in Paris Club	II	May prefer, more strongly than HILICs as: 1) More likely to be additional, as would not probably get debt reduction; 2a) Implies direct efficiency gains (e.g. via privatisation, dev. spending); b) Indirect benefit effects, new money; more likely, than for HILICs, to attract new private flows; 3) Less desirable, if same as 3) HILICs applies
Creditor gov't III	Less likely to prefer, unless special (e.g. political) reasons	IV	Is likely to prefer as: 1) Efficiency gains, imply better prospects for debtor's economic recovery; politically desirable. Better repayment; 2) May fund, in cost effective way, public international goods (e.g. education for women, implies less fertility, less need for future aid, less migratory pressure); 3) May obtain either assets or more cash eventually than with III.

1 A useful systematic analysis of effects of a hypothetical commercial debt conversion programme can be found in J. Shilling, A. Toft, W. Sung and W. Edisis, "Debt Equity Conversion Analysis", World Bank, Discussion Papers 76.

2 See J. Bergsman and W. Edisis, "Debt Equity Swaps and Foreign Direct Investment in Latin America", IFC Discussion Paper, No 2, World Bank, 1988.

3 See chapter II; also interview material, especially in Chile.

4 Interview material; views expressed by several creditor government representatives at N H M, 28th January 1992, Conference on Debt Conversions.

5 If the enterprise privatised had very high profits, this operation would, however, have future negative effects.

6 For a detailed discussion, see Blackwell and Nocera, op. cit.

7 Indeed, in Chile reportedly foreign investors have significantly decreased their profit remittances in the early nineties, because the Chilean economy is seen so successful and profitable. Based on interviews in Central Bank of Chile.

8 An exception can be when "round-tripping" occurs on a major scale; also problematic, from a Balance of Payment perspective are operations which involve debt currently not serviced at all or to a large degree and the proceeds of the debt swap being used mainly from spending abroad. An example of the latter, using commercial debt seems to be the Harvard deal for Ecuador, used to fund scholarships etc. for Ecuadoreans studying in the U.S. with the proceeds of a debt swap, based on a debt barely being serviced at present.

CHAPTER VII: PROSPECTS FOR OFFICIAL DEBT CONVERSIONS: CONCLUSIONS & RECOMMENDATIONS

A Reprise on Prospects for ODC

Contrary to some skepticism at the outset of this UNCTAD Project about prospects for ODC the findings of this preliminary Phase I investigation, and associated events that have transpired since mid-1991, suggest strongly that the first tentative steps have already been taken in what is likely to become a stronger trend on the part of official bilateral creditors to engage in debt reduction and debt conversion operations on a larger scale than they had earlier envisaged. Bilateral creditors had not expected, when the debt conversion clauses were incorporated into PCRAs with SILMICs signed after September 1990, that debtors would seek, or that creditors would be seriously prepared to consider, exercising their conversion options this early in the process.

That prospect became a reality when Poland and Egypt requested their bilateral creditors to exercise these options very quickly after their rescheduling agreements were reached in April and July 1991. The US has already agreed to the Polish request. Others have indicated an "in principle" willingness to act (Austria, Finland and France) but some large creditors remain opposed to commiting themselves. A few of the smaller export credit agencies have already or are about to undertake conversion operations (Belgium, Sweden and Switzerland) while others are actively considering it (France and Spain).

The considerable interest shown by the creditor community and ECAs in the UNCTAD Project and its findings reflects a process of internal policy analysis and review which seems to have begun in most ECAs. Thorny problems clearly remain to be resolved. But the consensus reached at the Paris Club in December 1991 on enhanced Toronto Terms may provide a spur to those creditors who had wanted to move faster with larger bilateral DDSR programmes, especially in the SILICs, to consider official debt conversions as a second-best means to effecting cancellations through DDS. Whatever the course of events, and there is a considerable role to be played here by neutral dispassionate intermediaries who can guide the process in a manner which reconciles the mutual interests of both debtors and creditors, there can be little doubt that the "conversion genie is now out of the bilateral debt bottle". It is not going to be easily pushed back in.

Our preliminary analysis suggests that there is considerable scope for official debt conversions across the full range of SIDCs. But we believe that the most useful steps would be to eschew the temptation for a series of preparatory studies and get to grips with actually designing an ODC programme in one or two target countries and proceed with a "learning by doing approach". Our visits suggested that Jamaica and Zambia would offer ideal, if vastly different, countries to work out such programmes and persuade creditors to support them. They should be targetted as countries of concentration in Phase II for UNCTAD/UNDP consultants to work more extensively with local staff in developing detailed blueprints along the lines suggested in the case studies.

We also believe that the scope for official debt conversions embaces both commercial and non-commercial applications of converted local currency proceeds. Resistance from multilateral agencies is likely to be lower if the DES programmes could be designed at the outset to preempt fears about money supply effects and inflation impact by associating them closely with concomitant programmes for public asset sales. Similarly DDS on a smaller scale could be concentrated in priority areas where development expenditures need to be augmented as a matter of urgency, where there are international public goods involved and where such programmes can be implemeted without adverse inflationary effects.

On the commercial side we believe that a concerted, coherent approach by creditors is likely to be more effective and productive than a fragmented individual approach which could create political difficulties as well as free-rider problems. If efficiency gains are to be captured from ODC programmes it is crucial that bilateral creditors act as part of a community (not a cartel) by providing resources in a manner which attracts new equity flows and addresses the investment shortfalls in debtor economies. Our proposal for a privatization fund in Jamaica and Zambia which is funded by local currency proceeds from converted debt and by new inflows of foreign exchange from multilateral investment institutions is an idea worth developing further (see Chapter IV and case studies) and exploring with the institutions concerned as well as with debtor governments.

Conclusions & Recommendations

The Pressing Need for further DDSR and Debt Conversions: From a review of the present state of play in resolving the problems of chronic and large debt overhangs in SIDCs it is clear that the euphoria inherent in claims that the debt crisis has been, or is well on the way to being, resolved is both premature and misplaced. Considerable progress has been made in arresting the rapid growth of SIDC debt between 1982-92 and indeed even in reducing the burdens of private debt in some SIDCs. Yet, deep rooted debt problems continue to impede progress towards adjustment and recovery in most SIDCs providing little cause for excessive sanguinity. After a slow start between 1989-91, the Brady Initiative is picking up speed. As many Brady deals were signed in the first quarter of 1992 as had been implemented in the previous eight quarters. Paradoxically that has resulted in faster progress being made with debt reduction in the SIMICs than in SILMICs and SILICs, which arguably need DDSR much more. The indispensability and efficacy of DDSR in promoting economic recovery in SIDCs is no longer in dispute as it had been for the first seven years of the debt crisis. As a result inter alia of DDSR, Chile and Mexico have broken through the debt barrier and regained voluntary access to international capital. With luck Argentina and Venezuela will follow them soon. But that still leaves more than forty SIDCs whose debt problems remain to be tackled and for which sizeable DDSR remains necessary. Taking their growing arrears into account, their debt service ratios are still far too high. Resorting to arrears is a less acceptable way of bringing them into line with underlying debt service capacity than pre-arranging contractually agreed DDSR.

Experience suggests that DDSR is a necessary though not sufficient condition for adjustment to be successful in SILICs. It must be accompanied by sound macroeconomic policies and management. It must be of a size which achieves substantial reductions in negative net transfers on the debt account, eliminates the overhang and creates sufficient confidence in the economy to induce an increase in domestic saving, investment and in the inflow of foreign capital and the repatriation of flight capital. Disconcertingly, however, political rather than economic reasoning now appears to govern the granting of DDSR by the creditor community thus introducing an element of irrationality and inequity which makes more wide-ranging solutions to the debt crisis more difficult to achieve. Less deserving debtors often get better treatment than more needy ones.

Though the growth of private debt has been reversed in SIMICs and almost arrested in other SIDCs, this trend has been offset by very rapid increases in stocks of official debt, particularly bilateral debt which has grown because of interest capitalization through repeated reschedulings. Toronto Terms have not proven efficacious in providing needed levels of DDSR for SILICs and the enhanced Toronto Terms (ETT) agreed in December 1991 are a disappointing outcome to earlier hopes that consensus would be reached on Trinidad Terms. ETT again bear the "too little, too late" hallmark of Paris Club initiatives and will not deal with the DDSR needs of SILICs as extensively as warranted. Official debt conversions through the window opened by the insertion of an optional 10% conversion clause in PCRAs after September 1990 will therefore need to be resorted to on a larger scale than envisaged. Though the reduction of rapidly growing multilateral debt stocks and debt service obligations is not yet a negotiable item on the debt reduction agenda, the extent to which multilateral debt accretion has become a problem in several SILICs will require attention to be turned to this question once the creditor community has taken decisive steps to reduce bilateral stocks and service over the next two to three years.

Conclusions based on a Review of Past Debt Conversion Experience : A review of debtor country experience with (commercial) debt conversions so far leads to three broad conclusions: (i) the economic effects of debt conversions are heterogeneous among countries and sometimes, within different periods, in the same country; (ii) debt-equity swaps have yielded valuable positive benefits when the policy framework and programme design are right; they have resulted in major reductions in commercial debt (in Chile, Argentina and Mexico), stimulated investment promotion and repatriation of flight capital, helped to kick-start a sustained recovery in foreign direct and portfolio investment, helped to promote exports and efficient import substitution, bolstered the process of privatization and the strengthening of private sector finance; and (iii) debt conversion programmes have also had some negative side-effects which can be managed through proper programme design and implementation; these include monetary and fiscal effects, future balance-of-payments effects, and inefficient subsidy effects.

By far the greatest amount of debt conversions have been in the form of debt-equity swaps (which have totalled some $38 billion since 1985) while debt-for-development swaps have totalled around $350 million. These embrace debt-for-nature, debt-for-children, debt-for-education, debt-for health and similar kinds of swaps for social or environmental objectives. Though DDS do not result in the same DDSR effects as DES they have helped to highlight areas of priority concern in social and environmental spending and have helped to focus and direct other expenditures in those areas. Other kinds of swaps have occurred, debt-for-bonds being among the largest under Brady deals; they now exceed even DES volumes but they mainly substitute one form of debt for another albeit with some elements of DDSR involved in the transformation. Debt-for-goods swaps have been attempted to a very limited extent.

The greatest scope for an effective debt conversion programme in SIDCs, whether public or private, exists when it can be associated closely with attendant programmes for large-scale privatization and domestic capital market development. These two aspects help to avoid the monetary expansion effects of large-scale swap programmes and can result in increased productive and allocative efficiency in the debtor's economy genertaing both significant efficiency gains and an increased supply response. The scope for DES is therefore larger in SIDCs with large public sectors which they wish to shrink (Argentina, Brazil, Jamaica, Zambia etc.) than in countries where the state sector is small (Ecuador) though in the latter type of SIDCs, DES can still be deployed as a measure to achieve DDSR by attracting foreign investment and redirecting domestic capital into more efficient activities. Debt-development swaps, though having smaller scope, have also an important complementary role to play in official debt conversion (see Chapters IV and II).

Conclusions on Issues concerning ODC : In dealing with the general and technical issues of concern to bilateral creditors in considering official debt conversions (ODCs), our conclusions and recommendations are that:

- In the SILICs official debt conversions should be additional to rather than substitutes for the maxmum possible levels of cancellation of bilateral debt stock under ETT. In the SILMICs and SIMICs debt cancellation is less likely, except in special cases like Poland and Egypt. In these countries debt conversion can therefor play an important role.

- ODCs can, in certain instances, such as those pertaining in Jamaica and Zambia, help engender wider efficiency returns than cancellations and may therefore be preferable.

- Transparency in the pricing of ODC transactions (i.e. in all the five prices) are a sine qua non for their success and credibility. Debt sales through auctions in debtor countries do not necessarily assure transparency or competitiveness. Setting of the five prices needs to be undertaken with special care in SIDCs with seriously distorted exchange rates; failure to do so can result in debt conversions fuelling exchange rate volatility (e.g. in Zambia).

- The problem that ECAs encounter in dealing with the unindemnified "tail" portion of claims which continue to be held by private parties poses a potentially awkward legal and technical complication which could constrain debt reduction and conversion operations unless resolved in ways which a few active ECAs have already attempted. More sharing of information and experience among ECAs would be helpful in addressing this sensitive problem.

- The non-standard features of different bilateral claims may require an exchange of existing claims for more standard and tradeable promissory notes, which are more readily assignable and tradeable, as an essential pre-requisite for official debt conversion activity on a significant scale.

- Inflationary aspects of DES/DDS are now of sufficiently widespread concern that ODC programmes need to design inbuilt features which satisfy creditors, debtors and multilateral interlocutors that such pressures will not arise. There is also sufficient experience with the design and management of such programmes (e.g. Chile) for the concerns of IFIs to be properly accommodated. DES associated with privatizations are least likely to cause concern. It should be noted however that many observers regard the concerns of IFIs as overplayed and their attitudes as too rigid in coping with the inflationary consequences of DES.

- The manner in which local currency is provided in lieu of converted debt and the implications of domestic bond issuance to achieve this objective in a phased manner accommodates the need to stretch out the emission of local currency but it can lead to side-effects and unanticipated budgetary costs (as in Jamaica) which require careful prior analysis.

- Though preferred by ECAs and creditor Treasuries, the use of aid budgets to finance ODC operations is ill-advised and should be avoided. ODC and DDSR objectives should be a complement to and not a substitute for aid flows to SIDCs.

- Rescheduled debt under bilateral agreements may be difficult to convert. Maturities for official debt conversion will need to be selected from post-cutoff debt.

- Creditor government concerns about the ownership of converted equity claims is misplaced in view of the several options available to them; in our view a "privatization fund" approach of the kind outlined in Chapter IV and Annex 1 is offers a practical solution to that problem.

- ODC operations need not conflict or compete with private DES programmes; indeed there are ways in which the two can be made complementary and mutually reinforcing. There are large segments of potential market demand for DES which have not yet been fully tapped by private DES operations. Rather than displace commercial paper, the entry of official debt in secondary trading markets would help to widen and deepen these markets and to stimulate new innovations by market intermediaries.

- Official creditors need to consider much more carefully and rationally their views on the price or value of their portfolios and what objectives they are trying to achieve as creditors. Arguments exist to support any of the three views that official debt claims should be priced above, below or at market prices. But there is an implicit non sequitur in the belief that the right "price" is one which is bureaucratically judged rather than market-determined.

- Low levels of provisioning in ECAs may cause some concern about the extent of ODC operations that can be undertaken but this is not an insuperable problem to resolve.

- For official debt conversions to work the servicing of post-conversion, residual debt stocks and equity would need to be endowed with seniority and preference features in terms of convertibility and repatriation.

- Though looked at sceptically by ECAs, we believe that use must be made of specialized financial intermediaries to help official creditors develop an efficient trading market for their debt and to facilitate the process of conversion.

- Finally, in a situation where bilateral creditors need to confront the reality of maximizing the net worth of a value-impaired portfolio we see ODCs as being beneficial to creditors and debtors alike rather than as a situation in which debtors benefit at the expense of creditors or vice-versa.

Conclusions on the Scope for ODC : As observed above, our conclusions on the scope for ODC based on an in-depth review of four country cases -- Ecuador, Jamaica, Tanzania and Zambia -- suggested that there was a strong case for proceeding immediately with ODC programme design and implementation in Jamaica and Zambia. In Ecuador and Tanzania the case for proceeding quickly was somewhat less clear largely because of: (a) difficulties within the Tanzanian government and polity in reaching a clear consensus on key issues such as privatization and the future role of the private sector in the economy; and (b) a state of suspended animation in Ecuador till the elections took place in August 1992. However, the fact that the current Ecuadorean government has recently (early 1992) reinstated its commercial debt conversion programme, and senior advisers of leading candidates for the Presidency, as well as senior civil servants, have expressed interest and support in ODC imply that after the elections, Ecuador could well join Jamaica and Zambia, as a country where ODC programme design and implementation could start. The reasons for our conclusions are spelt out in detail in Chapter IV and Annex 1. In both Jamaica and Zambia we believe that governments are committed to taking essential steps for policy reform, structural adjustment and economic transformation. Jamaica has adopted rigorous adjustment discipline since 1980, Zambia did not do so until the election of its present government in late 1991. Both countries have suffered severe losses of reputation with private investors, foreign and domestic. Revival of investment in these economies will not occur if left to the play of domestic and international market forces; it will need to be induced by well-conceived interventions especially on the part of official creditors. In both instances we have recommended the establishment of a "privatization fund" which would be financed partly by ODC and partly by new inflows of foreign capital organized through agencies such as the IFC. UNCTAD and UNDP have a useful role to play in both these countries in providing essential technical assistance for programme design and organizing the necessary elements for programme execution. Our recommendation is that further work on these two countries and, if conditions are right, on Ecuador, be incorporated as a key component of Phase II of the UNCTAD Project.

Conclusions on the Impact of ODC on Creditors : Providing DDSR for SIDCs is not a zero sum game. What debtors gain creditors do not necessarily lose. The experience of the "breakthrough" countries suggests strongly that DDSR is a positive sum game in which both debtors and creditors gain; the former by having their prospects for recovery and sustainable growth enhanced, the latter by realizing an increase in the NPVs of their residual debt and converted equity portfolios and by the increase in global trade, output and welfare resulting from SIDCs' economic recovery. The positive sum outcome emerges because marginal costs and benefits to creditors of providing DDSR are different to the average costs of holding on to the debt; the marginal costs and benefits are not readily captured in the secondary market price of SIDC debt. Official creditors have behaved so far as if they are less concerned about the NPV of their debt portfolios and more concerned about maximizing short-term collections and exerting political leverage over debtor countries to achieve other bilateral and multilateral goals (which are elaborated upon in Chapter V). At the same time these "political" goals conflict with other objectives for promoting development which creditor governments also espouse (but with somewhat less enthusiasm and effectiveness). While creditor governments might have multiple and conflicting objectives in considering the implications of DDSR and ODC, their individual ECAs concerned do not. They are more single-minded about the implications for recovery of their claims, for their own financial condition and for their future ability to extend cover. They are also concerned about various technical and legal restrictions which have been discussed at length in Chapter V.

Conclusions on the Impact of ODC on Debtors : From the experience of the breakthrough countries it is clear that ODC is likely to have beneficial economic effects on debtors such as DDSR, stimulation of foreign investment, repatriation of capital flight, and important gains in productive efficiency, allocative efficiency, recovery of output and general welfare. The problematic effects, such as the impact on inflation, are likely to be small and can be contained by appropriate programme design and compensatory measures. Balance-of-payments effects are more difficult to predict; they are likely to be most favourable for countries which are servicing the debt to be converted (e.g. Jamaica). The efficacy of ODC depends heavily on the quality of programme design, the competence of execution and the existence of a sound overall macroeconomic framework with relatively undistorted "big prices". For SIDCs with a large debt overhang the preferred sequence for achieving a turnaround are: <u>first</u>, a reduction of the overhang through cancellation and conversion to the maximum extent that institutional limtations and creditor proclivities allow; and <u>second</u>, once a stable trend in servicing residual debt obligations and macroeconomic performance is established new voluntary capital inflows and flight capital repatriation increase with salutary secondary effects. For SIDCs (especially the SILMICs) with a smaller debt overhang a fine judgement needs to be made on the trade-off between debt reduction and the quicker restoration of new flows (usually achieved if debt reduction costs for creditors have not proven to be intolerably high). A comparison of official debt conversion vs cancellation for SILMICs suggests that conversion is a particularly attractive option for both debtor and creditor governments other things being equal. In the SILICs debtors and creditors may find the cancellation option more amenable because of its greater simplicity and the much greater uncertainty of future flows from converted equity investments. If, however, efficiency gains and other indirect effects are perceived as critical (as they are in the case of Zambia) a strong case can be made for debt conversion in SILICs especially if it is additional to maximum permissible cancellation.

Suggestions for work in Phase II

As outlined above, and largely as suggested in our Interim Report of 28 October, Phase II should focus on four key high priority areas:

(1) Technical assistance in different forms to debtor countries' governments to help set up an official debt conversion programme (ODC) and aid the debtor governments (if necessary) to persuade creditors to support them. We suggest two/three countries to be chosen from the following list: Jamaica, Zambia and Ecuador, as countries where such programmes could initially be worked out, and efforts would build on initial analysis made and contacts established in the context of Phase I; Albania, Egypt and Poland, as countries where such work would be synergic with actions being taken by the Italian government and where such programmes would be feasible. Other debtor countries could naturally be included, in a slightly later Phase. We consider this "learning by doing" follow-up as having the highest priority and potential yield.

(2) Technical work looking specifically into marketisation and related legal issues such as: (i) legal issues involved in the construction and transferability of official claims, (ii) forms of dealing with "tail claims" (that is the unindemnified portion of outstanding claims), problem raised in Chapter III, (iii) impact on export credit agencies (ECAs) of official debt conversions; this could best be examined by studying impact on two or three ECAs in some depth.

(3) Study of the experience of use of official debt conversions by developing countries (e.g. Mexico, Venezuela, Brazil) as creditors to other developing countries (e.g. Costa Rica, Honduras, Dominican Republic). Some information was gathered, and interviews carried out in Phase I, but this was limited due to time constraints. Two issues could be addressed: (i) what lessons can developed (and other developing) country official creditors learn from this interesting experience, (ii) how can existing mechanisms in countries with such programmes operating be further developed and improved. Senior officials in the Mexican and Brazilian governments have offered their support for such a study; collaboration with SELA, which has prepared a preliminary study, would be envisaged.

The work outlined above (and especially in 1), would be complemented by national and regional workshops (a clear need for having one in Ecuador with strong support for such an initiative by senior government officials, private sector representative, local UN officials and academics, was identified by one of the consultants). In these workshops, successful experiences of debt conversions from other countries in the region would be analysed in detail, by specialists/government officials from those countries and/or by international specialists; the experience of debt conversion of the particular country where workshop held would be looked at in some detail, and the need as well as the modalities of such a debt conversion explored in detail.

P A R T B

C O U N T R Y C A S E S T U D I E S

PROSPECTS FOR OFFICIAL DEBT CONVERSIONS:
THE CASE OF ECUADOR

I Macro-economic overview

Ecuador's economic evolution in the last twenty years has been heavily influenced by changes in oil production and prices. The value of oil and natural gas production, which was practically zero in 1971, reached 9.5 per cent and 23 per cent of GDP in 1973 and 1974, respectively, as simultaneously large scale production in that sector was started and as international prices quadrupled.

As can be seen in Table 1, in the seventies GDP grew, in real terms, on average by 9.1 per cent, with the highest growth concentrated in 1972 and 1973. Growth was not only sustained by a very dynamic growth of oil exports (which increased at very high rates, at around 50 per cent per annum) but also by the growth of external debt, which increased eighteen fold during that decade.

Table 1

Growth of GDP, and Inflation, 1971-91 (%)

Year	Growth of GDP	Inflation	Year	Growth of GDP	Inflation
1971	6.3	7.6	1981	3.9	14.4
1972	14.4	1.2	1982	1.2	17.8
1973	25.3	7.1	1983	-2.8	38.7
1974	6.5	40.0	1984	4.2	39.2
1975	5.6	10.0	1985	4.3	30.9
1976	9.2	12.9	1986	3.1	20.9
1977	6.5	17.5	1987	-6.0	38.0
1978	6.6	7.9	1988	10.5	55.5
1979	5.3	16.1	1989	0.6	75.8
1980	4.9	19.5	1990	2.3	48.5
Average	9.1	14.0		2.2	38.0
			1991e	2.9	48.9e

Source: World Bank; National Accounts,
Banco Central del Ecuador

In the early eighties, the sudden interruption of commercial bank credit, the increase in international interest rates and the sharp deterioration of Ecuador's terms of trade (mainly due to the fall in the oil price) altered dramatically economic prospects for that decade. For the 1980s, GDP growth has fallen to around 2 per cent, well below population growth. Growth performance slightly improved in 1991, with GDP estimated to have grown at 2.9 per cent. The slow-down of growth has been accompanied by an acceleration of inflation. Despite several attempts at stabilisation, inflation averaged 38.0 per cent in the 1980s, compared with 19 per cent in the 1970s. Inflation in the last four years has averaged above 50 per cent (see again Table 1).

The Ecuadorean government, somewhat belatedly, has tried since 1982 to tackle the economic disequilibria and distortions inherited from the seventies and from the external shocks of the early 1980s. In 1982, a first plan was adopted, which both included a package of macro-economic measures (with the first devaluation in a decade!), and some structural reform efforts, including some trade liberalisation.

As the situation continued to deteriorate, Ecuador was forced to deepen its stabilisation efforts and to sign a stand-by with the International Monetary Fund. This agreement included a commitment to apply a system of mini-devaluations on a daily basis.

A new government took over in 1984, with a deep commitment to reform and liberalise the economy. Though initial results in the external sector were favourable (for the first time in ten years, in 1985 the current account of the Balance of Payments had a surplus), and GDP grew at a satisfactory rate in 1984 and 1985, the situation deteriorated in 1986, due to the sharp decline in oil prices and the very rapid expansion of public expenditure, leading to a consolidated public sector deficit of over 5 per cent of GDP.

Though following somewhat populist policies on public spending, the government continued to liberalise the economy in certain aspects, such as in the financial sector.

In 1987, the situation deteriorated further. Major earthquakes destroyed the main oil pipeline, leading to an interruption of oil exports for around half a year; the price of oil continued to fall. Domestic and especially electoral considerations implied that public spending continued to increase, albeit at a somewhat slower pace. The consolidated public sector deficit increased significantly, reaching almost 10 per cent of GDP, which led to an increase in inflationary pressures; the current account deficit of the Balance of Payments reached almost 12 per cent of GDP.

Ecuador was forced to suspend servicing its debt to commercial banks as the large deterioration in the current account deficit, lead to a situation, where net international reserves became strongly negative, at -US$1500m. GDP declined by 6 per cent in 1987.

The new government, which took office in August 1988 was thus faced with major Balance of Payments, fiscal and monetary disequilibria; it adopted an energetic stabilisation programme geared at tackling these large macro-economic imbalances.

Initially, the programme was very successful. The consolidated public sector deficit in 1989 fell below 1 per cent of GDP. This was partly due to a recovery of oil prices and partly due to measures adopted, such as a major increase in the domestic price of oil, some increase in taxation, and a small reduction in government spending.

During 1989 and 1990, the economic evolution was somewhat disappointing, particularly as regards inflation, which had peaked at 78 per cent in 1989 and fell, but less than targeted, to 48.5 per cent in 1990, level at which it also remained in 1991. The new stand-by agreement with the IMF (signed in mid-December, 1991) has a target to reduce inflation to 25 per cent for 1992, but there are some doubts whether this will be feasible in an electoral year and given declining oil prices.

However, during 1989 and 1990, important improvements were achieved. The deficit of the consolidated public sector declined further (in 1989) and was even transformed towards the end of that year into a surplus. The net foreign exchange reserve position improved somewhat, as a result of an improving Balance of Payments, linked to a temporary (Gulf War related) increase in the price of oil and some growth in non-oil exports.

Oil is also very significant in public finances; thus, in 1990, almost 50 per cent of fiscal revenues came from the oil sector. The 1991 decline in oil prices, therefore, implied some deterioration in fiscal performance, as the public sector surplus is projected to have deteriorated (by around 2.7

per cent of GDP) to a deficit of 1.7 per cent of GDP. Government and IMF projections expect the fiscal situation to improve again in 1992, as a result of measures such as increased domestic petrol prices, significant improvement and comprehensive coverage of budgetary control, measures to improve the financial results of state enterprises, and control as well as reduction of fiscal spending.

Monetary policy has been tight, with credit to the private sector declining in real terms in 1991, though it is projected to grow (in real terms) in 1992.

One important issue in Ecuador, of relevance to this study, are Central Bank losses, which in some of the literature[1] are called "quasi-fiscal deficit".

These losses are a source of government and IMF concern[2] The losses started, when the Central Bank assumed the foreign exchange risk of the private sector debt, which the Central Bank had previously taken over (effectively granting a major subsidy to the indebted private sector); other factors causing Central Bank losses are anticipated sales of foreign exchange for future exports, past subsidised interest rates charged by the Central Bank and high administrative costs of running the Central Bank, due to the variety of functions it performs. The government is attempting to reduce Central Bank losses from 2.8 per cent of GDP during 1990, to 2.5 per cent of GDP in 1991 and 1.5 per cent of GDP in 1992.

The link with this study is two-fold. Firstly, as the December 1991 IMF stand-by points out, if there are reductions in the Central Bank's debt/debt service abroad, this will reduce Central Bank losses; these smaller Central Bank losses would imply lower inflationary pressures. In Ecuador, there is therefore a particularly direct link between debt/debt service reduction and tackling one of the key economic problems, a persistently high rate of inflation. Secondly, in the context of debt conversions (which imply local spending in sucres), part of the reservations of government officials about the desirability of such conversions is the fear that it could increase Central Bank losses, and contribute to fuel inflation[3] (for analysis of this, see below).

More broadly, as regards the foreign debt, Ecuador urgently requires debt reduction. Even with the stabilisation efforts outlined above, Ecuador faced an external financing gap of 2.4 per cent of GDP for 1991 and 1.9 per cent of GDP for 1992, and approximately of the same magnitude in the medium-term. Were the government to attempt to eliminate this gap purely by adjustment and stabilisation measures, (and without debt relief), there would be very undesirable effects on investment and economic growth. Indeed, as pointed out above, linked to the debt crisis, economic growth slowed down dramatically in the eighties; investment fell even further, with the investment rate declining from around 21 per cent of GDP in 1981-82 to an average of only around 15 per cent in the 1983-90 period. Government social expenditure also slumped during the 1980s, with real per capita social spending falling by 25 per cent in the 1981-1990 decade (see Table 2); real per capita expenditure fell very sharply in education and social services and somewhat less in health and in health and environment; spending in social welfare and drinking water increased somewhat.

Table 2

Ecuador, Per Capita Public Social Expenditure (1975 sucres)

	Total	Education, Social Services	Social Welfare, Labour	Health and Environment	Drinking Water
1980	1.005	804	26	152	23
1981	1.029	744	36	208	41
1982	866	651	27	152	35
1983	797	591	32	145	29
1985	788	587	20	143	38
1989	792	527	58	151	57
1990	754	480	92	118	64

Source: Ecuador: Crisis, Adjustment and Social Policy in the 1980's, Ecuadorian Centre of Social Research, Innocenti Occasional Paper 19, Florence, 1991

Since 1989, and particularly since 1990, the Ecuadorean government has made progress in its structural reform programme. This is particularly important in the area of trade liberalisation, as tariffs have been significantly cut, import quotas practically eliminated, procedures for exports have been facilitated. The progress of trade liberalisation is receiving further impetus from the acceleration of the Andean Pact trade integration into a free market area. Other related structural reforms carried out recently by Ecuador are the liberalisation of its Foreign Investment Code, substantial reform of the Labour Code, (to provide greater flexibility) and liberalisation of the financial sector (as well as the public sector reforms outlined above).

Thus, the case for debt/debt service reduction of Ecuador is not only based on "financing gap" and growth and development needs, but also on support for a structural reform programme, which though somewhat slow in starting is being consistently and fairly vigorously pursued.

II Debt, debt restructuring and refinancing

Clearly one of the main obstacles to Ecuador's development in the 1980s has been a serious debt overhang, which had had very problematic implications both for public and external finance.

Similarly to most Latin American countries, Ecuador has carried out several rescheduling exercises, both of its bilateral official and commercial bank debt. Ecuador has also resorted to unilateral action, especially in limiting its debt servicing to commercial banks.

As can be seen in Table 3, Ecuador's external debt has almost doubled in the 1981-90 period. Its structure has changed, with an increasing share owed to international organisations and governments, and with a declining (though still very high) share owed to private banks.

As regards its bilateral official debt, Ecuador has rescheduled five times, since 1981 (in 1983, 1985, 1988, 1989 and 1992). We will focus here on the last two reschedulings, though details are given also for the 1983, 1985, 1988 and 1989 reschedulings in Table 4.

Table 3

Level and Structure of Ecuador's Debt, by Creditor

Category	1981	1985	1987	1989	1990
International Organisations	9.9	16.0	21.1	20.3	20.6
Governments	6.9	10.7	14.5	16.6	17.2
Banks	73.3	66.4	59.2	59.3	58.8
Suppliers	9.9	6.9	5.2	3.8	3.4
Total	100.0	100.0	100.0	100.0	100.0
Total Value ($ billion)	5.9	8.1	10.3	11.3	11.8

Source: Central Bank of Ecuador

According to the World Bank's World Debt Tables, 1991-1992, the total outstanding debt owed by Ecuador to bilateral creditors reached $1.9 billion in December 1990; of this, $0.4 billion was concessional, and $1.5 billion was non-concessional. This total bilateral debt has significantly increased (practically doubling) in the 1985-90 period, as it reached only $1.0 billion in 1985, of which only $0.2 billion was concessional.

Table 4

Ecuador's Paris Club Reschedulings

Date of Agreement	Cut off date	Consol. Begin	Period Length (Mths)	Ammount Consoli-dated ($million)	Repayment Maturity Yrs	Repayment Maturity Mos	Terms Grace Yrs	Terms Grace Mos
28 July 1982	1.1.83	1.6.83	12	155	7	6	3	0
24 April 1985	1.1.83	1.1.85	36	265	7	6	3	0
20 January 1988	1.1.83	1.1.88	14	397	9	5	4	11
24 October 1989	1.1.83	1.11.89	14	440	9	5	5	11

Source: World Bank, World Debt Tables, 1990-91

In the October 1989 rescheduling, debt service due from November 1989 to December 1990 for $440 million was rescheduled (including 100 per cent of principal and interest due, except for interest arrears) to be serviced in 8 equal semi-annual payments, with a grace period of six years (see Table 4). Some brief postponement of debt service already rescheduled in 1988 was also agreed.

The remaining debt service due to governments was serviced practically in its totality in 1990, but with some arrears building up in 1991.

In the January 1992 Paris Club rescheduling, the amount rescheduled corresponded to around $400 million; the concessional debt will be paid in a period of 20 years, including a grace period of 10 years, and for the commercial debt will be paid in a period of 15 years, with 8 years of grace. The Paris Club agreement also includes the option of converting debt (for equity and/or for development), to be agreed on a voluntary basis, with each creditor, for a sum up to 10 per cent of the total stock of debt or up to $20 million, whichever is higher.

According to the Finance Minister and the Head of the Monetary Board, the latest Paris Club deal is clearly the best one, if compared with the other three, that have taken place in the last eight years.

As regards debt with commercial banks, the Ecuadorean history combines several reschedulings since 1982, with unilateral action since 1987. Ecuador first rescheduled only commercial bank amortisations due in the November 1982 - December 1983 period, for a seven year period, and with only one year of grace; this deal was accompanied by "new money" of $431 million; clearly this deal was too "short-leash" and it was followed by another rescheduling in 1984; in 1985 "new money" for $200 million was obtained from the commercial banks; in 1986, a Consolidation Agreement was signed with the commercial banks to reschedule the debt owned originally by the private sector, and which had been taken over by the Central Bank in 1983. In December 1985, a somewhat more long-term breathing space was obtained, as regards amortisation of principal, when Ecuador signed a MYRA (Multi-Year Restructuring Agreement), which re-structured amortisation payments due between December 1984 and December 1989; according to World Bank data, the period granted was 12 years, with three of grace.

The problem of very high interest payments remained, however, with interest payments just to banks reaching $520 million in 1986, that is around 25 per cent of that year's total exports; total interest payments to foreign creditors, (see Table 4) at $762 million reached 35 per cent of exports that year.

As the international price of oil continued to decline, the Ecuadorean government declared a temporary moratoria in interest payments in January 1987, to both bilateral official and bank creditors. After the March 1987 earthquake, that so greatly impaired the country's export capacity for six months, the moratoria was prolonged. Between March 1987 and early 1989 practically no payments were made on commercial debt service (see Table 5) and some arrears were also incurred in servicing bilateral government debt. In early 1989, the government announced a policy that "it would pay, according to the country's possibilities, within what is feasible in the stabilisation programme;"[4] this was defined at a level of 30 per cent of interest due to commercial banks. However, reportedly,[5] the interest payments on the consolidation agreement were serviced by even less than 30 per cent as a reaction to Citibank's unilateral action of seizing $80 million of Ecuador's foreign exchange resources in mid-1987. This policy has lead to increased interest arrears with commercial banks, reaching $1.6 billion by the end of 1990, and $1.9 billion at the end of 1991 (see again Table 5). According to figures from the Institute of International Finance, at that date, Ecuador was the debtor with the fourth largest accumulated interest arrears with commercial banks (after Argentina, Brazil and Peru) and with Ecuador reportedly having higher interest arrears than Poland.

Negotiations between the commercial banks and the Ecuadorean government for an agreement have been difficult (soured by actions such as that by Citibank in 1989) and, at the time of writing, without result. In August 1989, the Ecuadorean government proposed debt/debt service reduction through three mechanisms: reduction by 70 per cent of principal, reduction of interest payments to 2.5 per cent, or a combination of both. The banks' steering committee rejected that proposal, and presented an alternative one, that would imply a partial agreement for one year, idea that was rejected by the government.

Table 5

<u>Movement of the External Debt (billions of US$)</u>

	Disbursements	Amortisations	Interest Payments	Adjustment	Interest Arrears (accumulated)	Amortisation Arrears	Final balance, inc. interest arrears
1983 Total	2.6	1.8	0.8	0.0	0.0	0.0	7.4
1984 Total	1.9	1.6	0.9	0.1	0.0	0.0	7.6
1985 Total	1.9	1.5	0.8	0.1	0.0	0.0	8.1
1986 Total	3.1	2.3	0.8	0.1	0.0	0.0	9.0
1987 Total	1.8	1.3	0.3	0.3	0.5	0.3	10.3
1987 Banks	0.8	1.0	0.0	0.0	0.4	n.a	6.0
1988 Total	1.9	1.9	0.5	-0.1	0.8	0.2	10.6
1988 Banks	0.8	1.0	0.0	0.0	0.8	0.2	6.0
1989 Total	1.7	1.3	0.5	0.0	1.2	0.3	11.3
1989 Banks	0.7	0.6	0.1	0.0	1.2	0.3	6.6
1990 Total	0.8	0.9	0.6	0.3	1.6	0.6	11.9
1990 Banks	0.1	0.2	0.3	0.0	1.5	0.6	6.8
1991 Total	0.8	0.8	0.5	0.0	1.9	n.a	12.3
1991 Banks	0.1	0.2	0.1	0.0	1.8	n.a	7.1

Sources: Information provided by Central Bank of Ecuador; Memoria 1990; <u>Analisis Semanal</u>; own estimates

In the course of negotiations during 1991, the Ecuadorean government added two options to their suggestion: a) to include a limited debt conversion facility and b) buy back of debt, with the extra ordinary income generated by high oil prices at the end of 1990.

Points of difference have remained between the steering committee of banks and the Ecuadorean government, even though at several moments in time, an agreement seemed likely. One of the points of disagreement has been that banks wanted the government to increase interest payments to above 30 per cent, whereas the government felt unable to do so, given the still precarious Balance of Payments situation. Another point of disagreement between the Ecuadorean government and its creditor banks is the treatment of the very sizeable arrears; whereas Ecuador would wish to have the same treatment (level of debt/debt service reduction) for arrears and for the rest of the debt owed, the commercial bank are demanding full servicing of arrears, (without any reduction element), and would reportedly be willing to provide "new money" to help fund the servicing of the full value of the arrears. Precedents (e.g. from Costa Rica) seem to indicate that full payment of arrears, in the context of a package with significant debt/debt service reduction, would be unwarranted. Agreement on a complete deal with banks seems very unlikely before the new government takes office, in August 1992, but very likely afterwards.

A major difficulty throughout has been that the Ecuadorean government does not wish to reach an agreement, which would imply increasing cash flow debt service, from current levels, whereas the commercial banks may not be willing to set a precedent (for larger debtors), and accept such a large debt reduction. The moratoria is therefore seen as a "second best" situation, for both the creditors and the Ecuadorean government, for both simultaneously better than other options. This is particularly so, because since the Brady Plan started, it is possible for a country like Ecuador, in arrears to the commercial banks, to sign stand-bys with the IMF, and obtain other multilateral financing, e.g. from the IADB. (Indeed, Ecuador has had a stand-by with the IMF in 1989 and in 1991). However, as new private flows (bonds, foreign direct and portfolio investment) have finally started returning to some Latin American countries in a major way, and as a resolution of the "old debt" overhang, via an agreement with bank creditors, seems to be an important factor in stimulating such flows,[6] the incentive for the Ecuadorean government to reach a "deal" with commercial creditors increases, particularly if it values highly the possibility of significant private inflows into the country, and thinks these would materialise, should the commercial debt issue be satisfactorily resolved (which implies not just agreement with bank creditors, but also sufficient levels of debt/debt service reduction).

More generally, the current Ecuadorean government (and any likely future government) is increasingly committed to a stabilisation programme, agreed with the IMF, and to normalising relations with the international financial community and to obtain support for its structural adjustment programme and to help finance necessary investment. In this context, a settlement, albeit a favourable one, with the commercial banks, increasingly seems an important aim.

III Experience with past debt conversions, implications and lessons for future debt conversions

Ecuador has quite a long and varied experience with debt conversions, which has as yet not fully been written up and evaluated, either by government departments or by academics.

The debt used for the different debt conversion mechanisms is that of the consolidation agreement, which refers to the $1.2 billion debt originally owed by the private sector, whose responsibility was taken over by the government in 1983. As a result, there is no trading of paper, but just a change in the Central Bank accounts, where a consolidation agreement debt is being serviced at less than 30 per cent by the Central Bank.[7]

The first debt conversion mechanism implemented, which operated between February 1987 and August 1987, is the one about which least analysis has been published, even though the amounts actually converted were the more significant, with an estimated figure of a maximum of $480 million converted in this period.[8]

The mechanism, regulated by Central Bank rule 408-807, was open to both foreigners and nationals; it could be used either for investment or for repaying debt, including to the Central Bank of Ecuador. The sectors that could receive investment were very broadly defined; in fact, most of the operations were used for the financial sector.

For foreign investors, profit remittances could be started only during the fifth year and capital be repatriated after the tenth year.

The conversion was apparently paid at 100 per cent of face value, so the Central Bank or others did not share in the discount subsidy.

The majority of operations (95 per cent) were geared towards improving the financial situation of banks and financial institutions, with other national companies operating 2.5 per cent of the operations and the remaining 2.5 per cent being purchased by foreign investors. These operations reportedly were used by 22 banks, 10 financial institutions and 23 companies.

The reason officially given by the monetary authorities for suspending the mechanism in late 1987 was that it was "abused by certain financial intermediaries, that even used resources granted by the Central Bank of Ecuador to fund debt conversions."[9] Basically this implies that credit obtained by nationals from the Central Bank, was used to purchase foreign exchange on the parallel market, which there was used for the conversions (thus gaining a large subsidy); this is an extreme version of the "round-tripping" problem.

Because some financial institutions were in serious difficulties, the implicit subsidy granted to them may have been justified; however, such a subsidy could have been granted directly, and without using the debt conversion mechanism. This is particularly true, in "round-tripping" did occur, as in that case the net foreign exchange effect for the country was probably negative. In cases where the financial institutions were not in serious difficulty, the granting of such a large subsidy through debt conversion was clearly unjustified.

Therefore, though a useful function may have been performed by strengthening certain weak financial institutions (and thus supporting financial intermediation, and indirectly domestic investment), the non-discrimination of its implementation, the loose control over use of resources and the magnitude of the implicit subsidy (c. 70 per cent) challenged the value of the whole mechanism. Furthermore, as only 5 per cent of the conversions were carried out by foreign investors, the aim of attracting foreign investment on a significant scale was not met.

As regards the magnitude of debt reduction, it was fairly significant, at about 8 per cent of 1987 debt owed to commercial banks. However, the long-term net foreign exchange savings of these deals for the Central Bank was unclear to the extent that "round-tripping" played a significant role; furthermore, in the short-term, there would have been little foreign exchange savings (or even a negative effect, when "round-tripping" occurred), because the debt being converted was being services in such a small proportion, or not at all.

Between August 1988 and October 1989, there was no official conversion programme. However, according to Central Bank resources,[10] three debt-development swaps were carried out, for a total of $37.5 million; the two largest were for the well-known Fundacion Natura (for nature conservation, reportedly the first swap involving NGOs in Latin America) and for the Catholic Church (for social programmes).

In October 1989, a formal programme of debt-for-development swap was approved by the Central Bank. Initially, a total limit was set at $50 million, which was then broadened to $150 million. The operation of the mechanism was suspended in mid-1991. Proposals made by the private sector to use debt to make exports more profitable were not implemented by the government.

The programme established that the mechanism could be used by non-profit organisations (in the social, cultural, educational, sport and environmental field), which can receive a foreign donation used to purchase debt. The non-profit organisation received 50 per cent of the face value of the debt (at a time when the secondary market price was around 20 per cent of face value), thus implying a large multiplier effect. The application had to be supported by a defined plan of expenditures and other details about the NGO; both the Planning Ministry and the Central Bank had to approve the operation. Fairly careful screening was carried out by both institutions; external auditors were also used, to avoid possibility of mis-use of funds.

The total of operations actually approved and carried out, before the mechanism was suspended reached $65 million.[11] The Catholic Church was again one of the main users of the mechanism; other institutions using the mechanism included Rotary Club, Care, and Capacitar (the latter, to organise a rather peculiar operation, to fund, in foreign exchange, Ecuadoren post-graduate students at Harvard University).

This latter debt-for-development programme (October 1989 - mid-1991) was broadly seen as positive, it helped to finance high priority social and other activities. The effect on debt reduction was valuable, but relatively small, at around 1-2 per cent of total commercial bank debt (the latter figure would include all debt-for-development conversions). However as in the two previous programmes, the short-term net foreign exchange saving was small or negative (with any "round-tripping") as that category of debt was being serviced in a very small proportion.

Problems arose at different levels: 1) some NGOs found it fairly difficult to obtain donations to purchase debt; this problem was less serious for NGOs with international connections, such as Care, UNICEF, Rotary Club. 2) Criteria for selecting projects were not sufficiently clear, though several high priority projects (from a social perspective) were approved. 3) Though reportedly on a far lesser scale than in the 1987-88 programme, apparently there has been some abuse of the mechanism, such as for example, in some cases the "tying" of foreign donations to purchases of equipment from the donating agency, which could lead to over-pricing. The authorities had however managed to detect and prevent several of these problems. The majority of the deals seemed above board, and were fulfilling their objective. 4) The most serious problem, particularly as perceived by the Central Bank and Finance Ministry authorities, was the impact on Central Bank losses (and the quasi-fiscal deficit) and thus on inflation.[12] This latter connection is seen as particularly serious, given that the government has found it so difficult to lower inflation, below a 50 per cent level (see above). This was particularly problematic as the government was trying to improve its stabilisation performance, partly so as to be able to reach a new stand-by agreement with the IMF.

It was apparently the fear that the debt-for-development swaps were leading to excessive inflationary pressures, that was the main reason behind the suspension of the use of the mechanism in mid-1991, fairly shortly before the mechanism would have expired anyway. The decision to suspend the mechanism in a somewhat abrupt way, implied that several debt-for-development swaps, which were in a process of being reviewed by the Ecuadorean authorities, or prepared for submission to them could not be implemented. A good illustration of this was the request by UNICEF to use the mechanism to convert debt for high-priority child-related social programmes, funded by a special donation for this purpose made by the Dutch government and the Dutch Committee for UNICEF.[13]

In broad terms, it is unclear to what extent the debt-for-development swaps carried out (for a total of face value of $65 million, over a 2 year period, which were converted into longer-term bonds at 50 per cent of their face value) actually were that inflationary. Firstly, it is unclear to what extent in Ecuador monetary expansion and the fiscal deficit were in the late eighties and early 90s the main cause of inflation, given that the money supply was overall growing less than inflation;[14] it is however true that in the first half of 1991, the growth of the issue of money and the money supply was accelerating somewhat, which was the source of legitimate concern for the financial authorities. Secondly, it is unclear to what extent the debt-for-development swaps were making a very significant contribution to inflationary pressures, given their scale. Thus, in 1990, (peak year for the mechanism) according to Central Bank data, the issue of long-term bonds, linked to debt-for-development swaps reached around 23,000 million sucres. The main inflationary impact would have been from the Central Bank paying interest on them; as interest rates were on average around 40 per cent in that year, then the maximum impact would have been less than 10,000 million sucres; this would have been a fairly small proportion (less than 10 per cent) of the total primary money issue in 1990. De facto, the impact would have been smaller, as part of the impact would have been compensated by other measures. Even if the potential inflationary impact seemed excessive to the financial authorities, given the difficulty to bring down inflation and the priority rightly given to this objective by the Ecuadorean authorities, there were two options open to them: a) suspend the mechanism; b) modify it so as to reduce the inflationary impact even further. In the latter option, the value of the bonds issued per unit of debt could be modified, the modality of their issue could be changed, so as to reduce the effect on the money supply, the timing of the interest payments and amortisation could be modified for the same purpose; furthermore, compensatory measures could be taken to absorb any excessive liquidity, either through monetary or fiscal measures.

Finally, should circumstances change and that category of debt be fully serviced, or debt (e.g. official bilateral) used that the government was committing to serving, and therefore if the debt-for-development swap provided a net foreign exchange saving, then the additional foreign exchange remaining in the country, would have a potential contractionary effect on the money supply, as it could be used to fund high imports by the private sector, thus absorbing sucres, and increasing the supply of goods.

This analysis leads us to the following general conclusions on future debt conversions for Ecuador, both for debt-for-equity and for debt-for-development.

1) It would be more desirable to start such a programme, when inflation was declining and at lower levels than its current 50 per cent per annum;

2) Such a mechanism could include both debt-equity swaps (and especially be used for some privatisations, where the monetary impact would either be nil or even contractionary) and for debt-for-development swaps;

3) It would be particularly desirable to use debt, for conversion, which otherwise would have to be fully served; therefore, there would be a clear net foreign exchange saving for the country (very important for itself), and provided this increased foreign exchange was use to finance higher imports, a smaller or no inflationary impact. In that sense, the consolidation agreement debt (to the extent that it continues not to be serviced or is serviced in a very small proportion) is the least convenient debt to use for such purposes; at the time of writing, the Paris Club debt becomes the most convenient to use for this purpose, as any conversion - if approved by the creditor - would imply additional debt reduction and debt service reduction than would otherwise be obtained;

4) The programme has to be carefully designed to: a) ensure proceeds are used in activities, to which the government gives high priority, e.g. some social spending, attracting foreign direct investment, possibly privatisations; b) the mechanism is designed to minimise round-tripping and other abuses. This could be done by tighter controls, preferential use of well-known institutions and possibly by reducing the implicit "subsidy", which may encourage round-tripping, by providing such a "high" profit margin. Useful lessons from other countries' experience can be used here; c) the mechanism is designed

to minimise, regulate in time, and/or compensate inflationary impact. Here again the experience of other countries, e.g. Chile, Costa Rica and recently Mexico, is very valuable, as it shows that both large and successful conversion programmes can be compatible with low and/or declining inflation. As discussed above, this implies choosing appropriate forms of debt to convert, use appropriate instruments and use desirable redenomination rate, (to reduce effect on money issue) and regulate spending in time; above all, the programme must be placed in the context of a **coherent monetary and fiscal programme.**

As several Ecuadorean government officials, private sector and NGO representatives suggested or supported, an international technical workshop on debt conversion could be very valuable; such a workshop could bring in some experts from "successful debt converting" countries, as well as national and international specialists. This could, if the authorities requested it, be followed by some technical assistance in this field.

IV Brief assessment of the case for further debt conversion

Current IMF and Ecuadorean government Balance of Payments projections for 1992 show how foreign exchange constrained the country's growth prospects still are, even if Ecuador continues to pay only 30 per cent of its commercial debt service.

Though some further increase is projected for the trade surplus (with an increase of both oil and non-oil exports projected, to reach $2.97 billion in 1992, and a somewhat smaller increase in imports to $2.14 billion in 1992), there is a remaining overall financing gap projected of around $200 million, even in the case of an option that includes both a Brady type deal for commercial banks and Paris Club rescheduling. Indeed, according to IMF projections, a Brady type deal with the commercial banks would not in the short-term (1992) lead to a net foreign exchange saving; on the contrary the net foreign exchange reserve situation would deteriorate in the short-term, from a fairly low level.

As a result, investment and growth prospects are likely to continue to be foreign exchange constrained. Uncertainty about the future price of oil further complicate these prospects (the 1992 forecast are based on a $16.5 price of oil, whereas at the time of writing Ecuadorean oil is selling at only $14),[15] even though Ecuador's successful efforts to increase non-oil exports, especially of bananas and shrimps, in the late 80s and early 1990s have implied that these exports increased by over 30 per cent between 1987 and 1991, and made the economy somewhat less vulnerable to variations in oil prices. However, Ecuador's broad efforts at structural adjustment and the efforts required for its speedy integration into the Andean Pact free trade area require urgently an increase in investment levels, from the very low levels characterising the 1980s, so the country can be competitive in the new context (see above).

Furthermore, Ecuador urgently needs to increase investment in non-oil export and import substitution activities, given probable diminishing oil production in future years.

As discussed above, debt servicing also implies a heavy burden on fiscal expenditure, with debt servicing just on external debt representing about 25 per cent of fiscal spending in 1990-91.[16] This both increase inflationary pressure and reduces the margin for manoeuvre for increasing vital social expenditure.

For these reasons it is very desirable that Ecuador uses effectively the opportunities open to it: a) to maximise debt/debt service reduction in its negotiations with the commercial banks; and b) uses effectively opportunities of debt conversion (of official and possibly commercial debt) to increase further debt reduction and to obtain the efficiency gains that such debt conversions can offer.

V Assessment of prospects for official debt conversion

Ecuador has just obtained, on 20 January, 1992, the possibility of converting Paris Club debt into equity, and/or development, for amounts up to 10 per cent of each creditor's debt or $20 million, whichever is higher. The limit of $20 million has been particularly welcomed by the Ecuadorean authorities, as it is the first country with a relatively small Paris Club debt, to have obtained the higher ($20 million) limit. This opens up meaningful possibilities for debt conversions, particularly as several creditor governments expressed an interest in participating in such deals.

Central Bank sources noted that the consultant's visit just before the Paris Club meeting, as well as her subsequent communications (see, for example, Annex 1) played an important role in Ecuador requesting and obtaining the debt conversion clause, as previous to that visit the authorities did not know about this option and were not planning to request it.

The willingness of creditor governments to facilitate debt conversions for Ecuador with Paris Club debt seems to be enhanced by two facts: a) Ecuador has not obtained any debt reduction in the Paris Club context, even though there is a lot of evidence to show that the country needs to reduce its debt overhang;[17] therefore, there is a lot of good-will amongst creditors to move on the debt conversion front. If good programmes are designed, and begin to be successfully implemented creditors may even be sympathetic to going beyond the $20 million or 10 per cent limit. b) This is enhanced by the fact that Ecuador is making (and is likely to continue making) large efforts at stabilisation, export diversification and structural reforms; the likelihood of such reforms succeeding is far greater if enough debt reduction is granted, and if this is complemented by debt conversions, which both imply some further debt reduction and support the structural reform process, by helping reduce its social costs, by supporting privatisation and by helping attract foreign direct investment.

Provided that the above discussed problems can be overcome, the authorities in the Central Bank and Finance Ministry are clearly well disposed to implementing this mechanism. The fact that there is a previous experience with debt conversion in the country implies that there is an awareness of such programmes, its benefits and problematic effects.

There are three areas where there is potential for debt conversion of Paris Club debt, in Ecuador with a mixed package likely to be desirable. This would include:

a) **debt-for-equity swaps**; with some priority given perhaps to attract foreign investors to purchase shares in companies being privatised. The magnitude of privatisation potential is restricted by the fact that Ecuador's state enterprises (except for oil) do not cover such an important part of the economy as they did in other Latin American countries. However, in discussion with both public and private sector representatives, a range of state enterprises were identified, whose privatisation was deemed wither desirable or likely. These included: air travel companies (e.g. Ecuatoriana de Aviacion), naval transport (e.g. Transnaviera), sugar, cement, fertilisers and possibly telecommunications. Nevertheless, the exact profile of privatisation will be defined by the new government, which at the time of writing seems likely to be one that will be quite active in the field of privatisation. Concern was expressed that if a debt conversion programme is used for privatisation, excessive implicit subsidies are not involved, especially for companies that are or can easily become very profitable. The debt-equity swap programme should also be used to help attract foreign investment flows into creating new productive capacity, and possibly to attract return of domestic capital previously fled.

b) **debt-for-development swaps**; there is a great deal of concern in different Ecuadorean circles about the dramatic decline in social spending that occurred in the eighties, and therefore a willingness to use properly targeted and focussed debt conversions to fund increased social spending and fight extreme poverty. It seems important however to prepare a clear set of priorities for such a purpose, and define the type of institutions (government agencies, NGOs and others) that would implement such conversion programmes. International technical assistance, as well as local UN backing, e.g. from UNICEF, UNDP offices, could support such a process, if the Ecuadorean authorities found it valuable.

c) **environment**; there is also a potential here, especially as there is quite a significant activity in this field, linked to Fundacion Natura and other NGOs. It is however important that debt-for-nature swaps further Ecuadorean growth and development objectives, and not mainly developed country priorities, e.g. bio-diversity and others. Attractive areas would seem to be, for example: a) eco-tourism, b) cleaning of water, air, sewage pollution, c) reforestation.

As discussed above, it is important that to achieve a significant debt reduction via debt conversion, without undesirable side-effects:

1) Ecuador's previous experience is assessed and compared with that of other countries in the region. Lessons are extracted. An international workshop could play a valuable role here.

2) An appropriate and transparent mechanism is designed and activated that would be agile, and would avoid problems, such as excessive monetary and fiscal impact, and abuses such as round-tripping, as well as maximise debt reduction and foreign exchange savings, as well as efficiency gains for the country.

3) A plan of action is prepared, e.g. for social spending, privatisation, etc. and is presented to bilateral creditors, possibly at a meeting with a group of sympathetic creditors. If deemed desirable, institutions like UNCTAD, UNICEF and the World Bank could play a supportive role.

The political calendar of Ecuador is important to consider, as there are two likely rounds of Presidential election in 1992. Though preparatory work can be carried out by the current government, and possibly some fairly limited action taken, (e.g. restore existing, currently suspended, debt-for-development swap programme) it is more likely that a new government could define a broad new policy in this case. The extent to which this should just include official debt conversion, or would be broadened to include commercial debt would depend on the timing of an agreement with commercial banks, and whether debt conversion would be part of such a deal. The advantages of using official Paris Club debt for conversion, whatever happens with commercial debt, are evident.

1 See for example, CEPAL "Determinants del deficit y politica fiscal en el Ecuador", Serie Pol. Fiscal II, Santiago, June 1991.

2 Interview material; IMF stand-by.

3 Interview material.

4 Declaration by the them President of the Junta Monetaria, Mr Abelardo Pachano, Hoy, March 18, 1989.

5 Interview, Central Bank.

6 See S. Griffith-Jones and R. Gottschalk, "Is there still a Latin American debt crisis?" in G. Bird, Development Issues for the 1990s, Macmillan, 1992, forthcoming.

7 Interview, Central Bank.

8 See, several Memorias, Banco Central del Ecuador and M. Salvador, "Reduction y conversion de deuda externa", in Mecanismas de conversion de deuda ed (M. Salvador et al.), CEPLAES, Euitor 1990, other estimates as somewhat lower.

9 Resolution of Junta Monetaria 298, quoted in Analysis Semanal, November 5, 1990.

10 Interview with Senior Central Bank official.

11 Information prόvided by Central Bank.

12 Based on general interviews in Central Bank and Ministry of Finance.

13 Interviews with UNICEF representatives in Quito.

14 See, overview in Memorias Anuales, several issues, Central Bank of Ecuador.

15 Communication from Central Bank; mid January 1992.

16 Source: Central Bank of Ecuador.

17 Interview material.

APPENDIX 1 - Ecuador Case Study

UNITED NATIONS ECONOMIC COMMISSION FOR LATIN AMERICA AND THE CARIBBEAN

Form for transmission via Facsimile

Room: Z-401
Ext: 2268
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Page 1 of 4
Ref: RLA/90/001
ECO/221/2(6)
Date:12.12.91

TO: Sr. Eduardo Samaniego
Gerente General
Banco Central del Ecuador

FAX No. 570-703

FROM: Günther Held
Proyecto PNUD/CEPAL RLA/90/001
"Políticas financieras para el desarrollo"

De nuestra consideración:

Adjunto sírvase encontrar cartas que se explican por si mismos.

Atentamente.

cc: CONFCOPY (Z-401) REGISTRY

UNITED NATIONS ECONOMIC COMMISSION FOR LATIN AMERICA AND THE CARIBBEAN

Santiago, 12 de diciembre de 1991

Estimado Sr. Samaniego,

Sírvase encontrar adjunta una carta de la Sra. Griffith-Jones, relacionada con una cláusula a la cual Ecuador puede optar en su negociación con el Club de París. Entiendo que si Ecuador solicita dicha cláusula, ella será incluida en forma automática, ya que se relaciona con un acuerdo adoptado por los países industriales en septiembre de 1990.

Me parece que la cláusula indicada es de claro interés para países como Ecuador, ya que significa una reducción adicional de la deuda bilateral, más allá de cualquier otra concesión que el país logre. Por ello, me parece buena la sugerencia de la Sra. Griffith-Jones que el Ecuador incluya esa cláusula en su presentación al Club de París, y que una vez aprobada ésta, tome pasos concretos para implementarla.

Espero esta comunicación le sea de utilidad.

Lo saluda cordialmente,

Günther Held
Asesor Técnico Principal
Proyecto Regional Conjunto CEPAL/PNUD
Políticas Financieras para el Desarrollo

Señor
Eduardo Samaniego
Gerente General
Banco Central del Ecuador
Quito, Ecuador

Santiago, 12 de diciembre de 1991

Estimado Sr. Samaniego,

Me refiero a mi visita a Quito la semana pasada, en la cual conversé en bastante detalle con varios funcionarios del Banco Central, como el Sr. Franklin Proaño y el Sr. Mauricio Valencia, en relación al tema de posible conversión de parte de la deuda del Ecuador con acreedores del Club de París. Como no tuve la oportunidad de conversar con Ud., deseo enviarle esta breve nota, dada la urgencia del tema para Ecuador por sus próximas negociaciones con el Club de París. Agradezco la gentileza de mi colega Sr. Günther Held, quien dada la importancia y urgencia del tema, está enviando esta nota.

A partir de septiembre de 1990, los países de ingresos medios bajos (categoría a la cual pertenece Ecuador) pueden solicitar (y recibirán en tal caso automáticamente) que la siguiente cláusula sea incluida en su acuerdo con el Club de París: "Los gobiernos de los países acreedores pueden, en forma voluntaria, convertir parte de la deuda total para conversión de deuda, y/o swaps de deuda por desarrollo y/o swaps de deuda por naturaleza, en un monto que llegue hasta 10% de la deuda comercial bilateral oficial u oficialmente garantizada, y (donde sea relevante) hasta 100% de la deuda oficial concesional." Esta cláusula ha sido solicitado por prácticamente todos los países de ingresos medios bajos que han renegociado su deuda con el Club de París, a partir de septiembre de 1990; ellos incluyen a Egipto, Polonia, El Salvador, Honduras, Jamaica, Marruecos, Nigeria, Perú, Filipinas, Congo y Senegal.

Es nuestra clara impresión que dicha cláusula es, y debe ser negociada, como una reducción <u>adicional</u>, a las mejores condiciones que pueda obtener el país. En ese sentido, el caso de Polonia es interesante, ya que dicho país obtuvo una reducción equivalente al 50% de su deuda con el Club de París, y además ha incluido esta cláusula del 10%. También, es interesante que Polonia ya ha planteado, en forma conjunta a todos sus acreedores, un plan ecológico, para beneficiarse de dicho 10%, y ha obtenido ya contribuciones de varios acreedores.

Sr.
Eduardo Samaniego
Gerente General
Banco Central del Ecuador
Quito, Ecuador

El punto clave que quería enfatizar en este momento es la conveniencia de que dicha cláusula sea incluida por el Gobierno del Ecuador en su solicitud al Club de París, para aprovechar esta interesante oportunidad para su país.

Si Ud., requiere información adicional en esta etapa o en etapas posteriores, estoy a su disposición para proporcionarsela. La UNCTAD, para la cual estoy trabajando en este proyecto, ofrece a países que lo soliciten asesoría o asistencia técnica en el aspecto de implantación de esta cláusula.

Lo saluda atentamente,

Dra. Stephany Griffith-Jones
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Appendix IX Features of Selected Debt Conversion Schemes

	Argentina	Brazil[1]	Chile	Costa Rica	Ecuador[2]	Honduras	Jamaica	Mexico	Nigeria	Philippines	Uruguay	Venezuela
Eligible investors												
Nonresidents												
Any creditor	x	x	x	x	x	x	x	x	x	x	x	x
Original creditor only												
Residents	x		x	x	x	x		x		x	x	x
Eligible external debt												
Public sector	x	x	x	x	x	x	x[3]	x	x[4]	x	x	
Private sector	x	x	x							x		x
Exchange rate for conversion												
Official exchange rate		x	x	x	x	x	x	x	x	x	x	
Parallel exchange rates	x[5]											x[5]
Valuation of debt for conversion												
Face value		x[6]			x	x[7]	x		x[8]			
Below face value	x	x	x[9]	x		x[7]		x[10]	x[11]	x	x	x
Eligible domestic investments												
Equity												
Parastatal enterprises		x	x			x	x	x		x		x
Private companies	x	x	x	x	x	x	x	x	x	x	x	x
Original obligor only	x[12]											
Debt												
Public sector		x[13]	x	x					x			
Private sector			x									
Repayment of domestic obligations		x	x		x						x	
Restrictions on eligible investments												
Restrictions on capital repatriations	x	x	x	x	x	x	x		x	x	x	x
Restrictions on profit remittances												
Same as for all foreign investment		x									x	
More restrictive than the above	x		x	x	x	x	x			x		x
Other features												
Limit on value of conversions	x	x	x	x		x	x	x	x	x	x[14]	x
Auction system	x	x	x[15]			x	x	x	x	x		x
Conversion fees							x[16]		x			
Additional foreign exchange required			x				x[17]					

Source: IMF, International Capital Markets, May 1991. Washington, D.C., based on ~~Sources~~: Argentina, 1987 Refinancing Plan; Brazil, Foreign Investment Law (Law No. 4.131 and Decree No. 55.762) Central Bank of Brazil, Resolution 1460, February 1, 1988; Central Bank of Chile, *Compendium of Rules on International Exchange*, Chapters XVIII and XIX, and Decree Law 600; Central Bank of Costa Rica, *A Guide for Converting Foreign Debt Securities Issued by the Central Bank of Costa Rica into Colones*; Central Bank of Ecuador, Monetary Board Circular Nos. 395-86 and 408-87; Mexico, National Commission on Foreign Investment, *Manual Operativo para la Capitalizacion de Pasivos y Sustitucion de Deuda Publica por Inversion*; Central Bank of Philippines, Revised Circular No. 1111; Venezuela, Office of the President of the Republic, Decrees Nos. 1259 (Nov. 15, 1990) and 1418 (Dec. 27, 1990), and Central Bank Resolution 89-8-04 of August 31, 1989, and Ministry of Finance Resolution 2401 of September 4, 1989; Central Bank of Honduras Circular D-036/89, July 6, 1989; Central Bank of Uruguay, Disposicion del 8 Diciembre 1987; Bank of Jamaica, *Programme for the Conversion of Jamaican External Debt into Equity Investments*, July 1987; Nigeria *Guidelines on Debt Conversion Program for Nigeria*, July 5, 1988 and 1988 Rescheduling Proposal. IMF

[1] In November 1987, the authorities announced a new debt-equity swap scheme. The description in this table corresponds to this scheme.

[2] Introduced in February 1987 and temporarily suspended in August 1987.

[3] Debt rescheduled under the A tranche of the June 1990 rescheduling agreement with commercial banks.

[4] Rescheduled debt only.

[5] Free market exchange rate.

[6] The June 1988 rescheduling agreement allows for conversion of exit bonds and new money at face value.

[7] Depends on type of investment and on discount in secondary market.

[8] Applies to debt-bond conversions.

[9] Conversions of public sector debt are subject to a small discount; conversion terms of private sector debt are negotiable.

[10] A minimum discount of 35 percent applies.

[11] Applies to debt-equity conversions.

[12] Private sector debt only.

[13] Exit bonds can be exchanged for Treasury securities.

[14] Conversion rights will be administratively allocated if the offers tendered for debt conversion exceed the established annual limit.

[15] Chapter XVIII investments only.

[16] A fee not exceeding 10 percent of the face value depending on priority of investment.

[17] Fees depend on the share of investment funded with foreign exchange.

APPENDIX 2

COMPLETED DEBT-FOR-DEVELOPMENT TRANSACTIONS

As of April 8, 1991

COUNTRY	ORGANIZATION	SECTOR	DATE	COST	FACE VALUE	LOCAL BONDS	PRICE	RATE OF REDEMPTION
BOLIVIA								
	Conservation Int'l	Environment	Aug-87	100,000	650,000	250,000	0.1538	38%
COSTA RICA								
	Nat'l Parks Foundation of CR	Environment	Feb-88	918,000	5,400,000	4,050,000	0.17	75%
	Holland	Environment	Jul-88	5,000,000	33,000,000	9,000,000	0.1515	30%
	The Nature Conservancy	Environment	Jan-89	784,000	5,600,000	1,680,000	0.14	30%
	Sweden	Environment	Apr-89	3,500,000	24,500,000	17,100,000	0.1429	70%
	TNC/WWF/Sweden	Environment	Mar-90	1,953,474	10,753,631	9,602,904	0.1817	89%
	CABEI							
	TNC/Rainforest Alliance	Environment	Jan-91	360,000	600,000	540,000	0.6	90%
DOMINICAN REPUBLIC								
	Nature Conservancy	Environment	Mar-90	116,400	582,000	582,000	0.2	100%
	MUCIA	Education	Jul-90	500,000	2,000,000	2,000,000	0.25	100%
ECUADOR								
	World Wildlife Fund	Environment	Dec-87	354,000	1,000,000	1,000,000	0.354	100%
	RNC/WWF/Missouri Bot Gardens	Environment	Apr-89	1,068,000	9,000,000	9,000,000	0.1188	100%
	CARE (AID)	Ag/Tech Asst/ Environment	Apr-89	500,000	2,000,000	3,500,000	0.1429	57%
	World Mercy Fund	Health	Apr-90	700,000	5,000,000	2,500,000	0.14	50%
	Harvard	Education	Jul-90	750,000	5,000,000	2,500,000	0.15	50%

COUNTRY	ORGANIZATION	SECTOR	DATE	COST	FACE VALUE	LOCAL BONDS	PRICE	RATE OF REDEMPTION
GUINEA								
	IFESH (AID)	Self Help	Mar-90	500,000	1,000,000	1,000,000	0.5	
MADAGASCAR								
	World Wildlife Fund (AID)	Environment	Jul-89	950,000	2,111,112	2,111,112	0.45	100%
	World Wildlife Fund	Environment	Aug-90	445,891	919,363	919,363	0.485	100%
MEXICO								
	Conservation International	Environment	Feb-91		4,000,000	2,600,000		65%
	Rockefeller/Min. of Health	Health	Feb-91	350,000	1,000,000	1,000,000	0.35	100%
	Harvard/Fundacion Mexico	Education	Apr-91	2,000,000	2,900,000	2,900,000	0.69	100%
NIGER								
	IFESH (AID)	Self Help	Mar-90	500,000	1,000,000	1,000,000 (cash)	0.475	
NIGERIA								
	IFESH (AID)	Self Help	Mar-90	1,000,000	3,500,000	3,050,000 (cash)	0.35	
PHILIPPINES								
	World Wildlife Fund (AID)	Environment	Jan-89	200,000	390,000	390,000	0.5128	100%
	World Wildlife Fund (AID)	Environment	Aug-90	438,750	900,000	900,000	0.4875	100%

APPENDIX 3

Established debt-for-nature agreements and debt for development agreements

Date agreem. estab-lished	Date debt exchange executed	Debtor country	Debt stock ceiling, face value US$ million	Secondary market price (cents)	Cost US$ million	Face value of debt acquired US$ million	Redempt. price % face value	Conserv. funds generated US$ million	Conservation investor	Local fund adm.	Participating banks and credit institutions	Donors	Terms and aims
07.87	07.87	Bolivia	0.65	15.3	0.10	0.65	39	0.25	CI	Bolivian Academy of Sciences, Ministry of Agriculture and Peasant Affairs	Citicorp Investment Bank	Frank Weeden Foundation	The US $650,000 debt was cancelled in exchange for full legal protection of the Beni Biosphere Reserve and a $250 000 management fund in local currency. The Bolivian government also agreed to establish four buffer zones in connection with the Beni Biosphere Reserve (ref. Conservation International 1987, Conservation International 1989).
08.87	12.87 02.89	Costa Rica	5.40	17.0	0.92	5.40	75	4.05	NPF	NPF in consultation with the donors	Costa Rican Cooperative Bank (financial intermediary), City Bank, Swiss Bank	TNC, WWF-US, Pew charitable Trust, Jessie Smith Noyes Foundation, Asociacion Ecologica La Pacifica, John D. and Catherine T. MacArthur Foundation, Swedish Society for the Conservation of Nature, W. Alton Jones Foundation, Organization for Tropical Studies	The programme was proposed by the Costa Rican Ministry of Natural Resources, Energy and Mines, and was approved by the Central Bank in August 1987. Donations from various donors were given directly to the National Park Foundation which purchased the debt and exchanged it for monetary stabilization bonds, with maturation periods of up to six years paying an average interest rate of 25%. The goal of the programme is to fund conservation, environmental education, ecological tourism, sustainable forestry and land purchases (ref: Umaña Quesada 1989)
10.87	12/87 (part I)	Ecuador	10.00	35.4	0.35	1.00	100	1.00	FN/WWF-US	Fundación Natura	Bankers Trust, Citicorp	n a	Fundación Natura signed the agreement with the Ecuador government under which Fundación Natura was authorized to exchange $10 million in debt for monetary stabilization bonds denominated in sucres. In December 1987, WWF-US reached an agreement with the foundation to provide financial support and to arrange for purchase of the debt. WWF-US bought the first million of debt in March 1988. The interest payable on the bonds is used by Fundación Natura in connection with the maintenance and conservation of Ecudaor's national parks. The interest rate was 31% the first year and is thereafter tied to the interest paid by Ecuador's five largest banks. The bonds mature in nine years. The principal will become an endowment for Fundación Natura.
	04.89 (part II)	Ecuador		11.9	1.07	9.00	100	9.00	FN/WWF US, TNC/MBG	Fundación Natura	Morgan Guaranty Trust, Bankers Trust, American Express Bank	n a	The second part of the programme was executed in early 1989 by WWF-US and the Nature Conservancy. The bonds received in exchange for US $9 million of debt pay interest every six months (the rate is set as on the first bonds) and the principal is amortized in seven years, starting in 1990. Income from the bonds will be invested by Fundacion Natura in management and conservation programmes in protected areas (ref. World Wildlife Fund 1987, World Wildlife Fund 1989a, Nature Conservancy 1989)
06.88	07.88	Costa Rica	33.00	15.1	5.00	33.00	33	9.90	Gov of the Netherlands	Costa Rican Ministries of Natural Resources and Planning	n a	Government of the Netherlands	The primary objective of was reforestation operations and sustainable development activities in co-operation with various local interest groups like peasant organizations and co-operatives. The allocation of the interest payments (4 year maturation and 15% interest rate) is determined by the Costa Rican Ministries of Natura, Resources and Planning in consultation with the Dutch Government (ref. Umaña Quesada, 1989).
06.88	01.89 (part I)	Philippines	2.00	51.3	0.20	0.33	100	0.39	WWF US	Haribon Foundation	Bankers Trust	n a	The US $2 million swap package was developed by the Philippine government, WWF US and the Haribon Foundation. The first exchange following the agreement was made by WWF-US exchanging US $390,000 in debt for funds contributing to implementation of a conservation strategy, protected area management, strengthening of conservation groups, and training (ref. World Wildlife Fund 1988)

Source: Dogse 1990

Date agreem. established	Date debt exchange executed	Debtor country	Debt exch. ceiling, face value US$ million	Secondary market price cents	Cost US$ million	Face value of debt acquired US$ million	Redempt. price % face value	Conservat. funds generated US$ million	Conservation investor	Local fund adm.	Participating banks and credit institutions	Donors	Terms and aims
07/88	01.89	Costa Rica	5.60	14.0	0.78	5.60	30	1.68	TNC, NPF	NPF	American Express Company	n.a.	The Nature Conservancy bought the debts from the American Express Company and then sold them to the National Parks Foundation for 11 cents on the dollar. The bonds pay an interest rate of 15% and will mature in four years. The income will help build up the National Biodiversity Institute, support NPF and the Neotropian Foundation, protection of endangered species, and management of national parks (ref. Umaña Quesada 1989).
12/88		Sudan	0.80	Bank donation	-	0.80	-	0.80	UNICEF	UNICEF	Midland Bank	Midland Bank	Debt-for-development swap: Midland Bank donated US $800,000 of Sudanese loans to UNICEF which had a deal with the Sudanese government that local money, in exchange for the loans, would be spent in providing water wells with hand-pumps in ten villages (ref: The Economist 1987).
04/89	04/89	Costa Rica	24.50	14.3	3.50	24.50	70	17.10	Gov. of Sweden	NPF	Salomon Brothers	Swedish government, Swedish students and private conservation groups	The swap proceeds will be used for expansion and protection of Guanacaste National Park. The bonds mature in four years and pay an interest rate near 15% (ref: Umaña Quesada 1989)
06.89	04.90 (part Ia)	Costa Rica	45.00	18.2	0.91	5.00	100	5.00	NPF	NPF	Salomon Brothers, Lafisse	Swedish government, WWF-International, TNC (loan)	This three year programme (which could be classified as a debt-for-development programme) adopted in 1989 allows that US $15 million face value of debt is exchanged per year for conservation, education and micro-enterprises projects. Costa Rica's National Parks Foundation exchanged in April 1989 US $ 10.75 million face value debts for conservation bonds. US $5 million were swapped for 20 years local currency bonds with 8% annual interest rate at 100% face value. These incomes will be used mainly for land compensations in La Amistad Biosphere Reserve. The WWF-International donation (US$ 100,000), administered by WWF-US, will be used as a management endowment for La Amistad.
05.89	04.90 (part Ib)	Costa Rica		18.2	1.04	5.75	80	4.60	NPF	INBIO	Salomon Brothers, Lafisse	Swedish Government, Pew Charitable Trust, W. Alton Jones Foundation, US-AID	The second part of the deal, US $5.75 million, were exchanged for dollar denominated 20-year bonds with 3% interest and 80% face value, the income from which will support the National Biodiversity Institute of Costa Rica (ref: Umaña Quesada 1989, Janzen 1990).
07.89	No transactions ?	Peru	10-20.00	Bank donation	-	(5.00)	100	(5.00)	IFESH	IFESH	American Express	American Express	Peru adopted a debt-for-development law in July 1989. The law provides a framework for debt-exchanges for various activities: micro enterprises, nutrition, health, family planning, conservation, education, agricultural development, and historic preservation. American Express donated US $5 million in Peruvian debt paper for the first projects approved (but so far not executed) under the programme, which includes training activities and teaching for the very poor (Lagniappe Letter 1989).
06.89	06.89 (part I)	Madagascar	3.00	45.2	0.95	2.10	100	2.10	WWF-US	WWF-US in co-operation with the Government of Madagascar	Bankers Trust Company, National Westminster Bank PLC, Dresdner Bank, Amro Bank, Banque de l'Union Européenne, Crédit Commercial de France, Société Général	US-AID	Using the official exchange rate, the debt will be exchanged for local cash. US-AID will cover up to US $1 million of the costs and provide US $300,000 for hard currency expenditures in relation to the swap agreement. This agreement aims at supporting conservation work built on education, sustainable development methods, and conservation, in priority protected areas. WWF-US plans to exchange the remaining US $900,000 under the agreement before 1992 (ref: World Wildlife Fund 1989b).

Date agreem. estab- lished	Date debt exchange executed	Debtor country	Debt exch. ceiling, face value US$ million	Secondary market price conv$	Cost US$ million	Face value of debt acquired US$ million	Redempt. price % face value	Conservat. funds generated US$ million	Conservation investor	Local fund adm.	Participating banks and credit institutions	Donors	Terms and aims
06.89	08.89	Zambia	2.27	20.7	0.47	2.27	100	2.27	WWF-Netherlands-	Government of Zambia in consultation with WWF.	NMB Bank	Anonymous Swiss donor	The debts were exchanged for local currency which will be used for conservation and management of wetlands, education programmes, support to local conservation institutions, alleviation of soil erosion, and protection of rhino and elephant populations (ref: World Wide Fund For Nature 1989).
10.89	No transactions	Ecuador	50.00	.	.	.	50	.		n.a	n.a	n.a	The government of Ecuador approved in October 1989 a US $50 million debt exchange programme. The Central Bank will allow that commercial Ecuadorian debt be exchanged (50% of face value) for monetary stabilization bonds paying interest in local currency, to support social, cultural, environmental, and education programmes. The Ecuadorian swap programme has, therefore, expanded beyond debt-for-nature into debt-for-development. The Government agreed in February 1990 that the Rotary Club may buy and exchange debt (US $5 million, which is the maximum amount allowed per investor) for financing of a malaria eradication programme (ref: Junta Monetaria del Ecuador 1989).
11/89	01/90	Poland	0.05	23.0	0.01	0.05	100	0.05	WWF-Internat., WWF-Sweden	n.a	NMB Bank	n.a	The exchange was set up as a first experimental exercise in what is hoped to be a large scale Swedish-Polish project aiming at cleaning up the River Vistula. The revenue from the exchange will support the development of Biebrza National Park.
12.89	No transactions	Argentina	60.00	.	.	.	.	.	.	Neuquén Foundation, Lorenzo Parodi Foundation	n.a	n.a	Argentina's National Development Bank (BANADE) approved that up to US $60 million in debt is exchanged for special BANADE conservation bonds, paying interest either in US dollars or local currency (depending on project needs). The bonds will benefit two national ecological groups: the Lorenzo Parodi Foundation (US $30 million and the Neuquén Foundation (US $30 million). Programmes envisaged include watershed protection and management of national parks and reserved areas (ref: Orme 1990).
03.90	03.90 (part I)	Dominican Republic	80.00	20.0	0.12	0.58	100	0.58	PRCT, TNC	PRONATURA Fund	MG-First Boston	PRCT	The PRONATURA Fund, which consists of 11 of the Dominican Republic's conservation and development groups, reached an agreement with the Central Bank under which within four years up to US $80 million of the country's external debt may be exchanged, at 100% face value, for conservation projects. The US $80 million represents 10% of the Dominican Republic's commercial debt. The first exchange under the programme of US $582,000 (funded by the Conservation Trust of Puerto Rico) will support four conservation projects developed by the Nature Conservancy and PRONATURA, which also administrates the proceeds (ref: Orme 1990, Nature Conservancy 1990a).
05/90	No transactions	Madagascar	5.00	.	.	.	100	.	CI	n.a	n.a	n.a	The Government of Madagascar has agreed that Conservation International exchanges US $5 million of the nations commercial bank debt and trade credits, at 100% face value, over the next five years. The swap proceeds may be deposited in private Malagasy banks as an endowment fund paying interest in local currency. The fund is intended to support conservation activities, including inventories of endangered species, environmental, and education programmes (ref. New York Times 1990).
TOTAL			337-347.3	.	15.42	96.01	.	58.16					
AVERAGE				16.1			61						

Appendix 4

**Environment Fund:
A new source of project finance**

**Poznan Environment Fair
November 20 1991**

**John E Harrow
Coopers & Lybrand Deloitte**

This paper summarises the proposed activities of the Environment Fund - what it will do and how it will do it.

The purpose of the Fund is to implement a cost-effective programme that addresses international environmental problems. Four key areas of concern have been identified:

(a) transboundary SO_2 and NO_x pollution;
(b) pollution of the baltic;
(c) greenhouse gas emissions; and
(d) biodiversity and nature conservation.

Allocation of finances among these four areas will reflect creditor preferences.

The Fund's programme will be one that Poland alone cannot finance. Projects will be additional in the sense that, without the assistance of the Fund, they would have either not proceeded at all or only proceeded at a substantially later date despite their international importance.

Secondary objectives of the Fund will be to stimulate efficiency and professionalism in environmental agencies and to encourage the private sector's contribution to environmental objectives. The latter concerns not just financial assistance with pollution abatement but also financial assistance for private sector companies meeting environmental needs.

The Fund will be created as a new organisation sufficiently distinct from existing environmental agencies to facilitate accountability and demonstrate additionality. Nonetheless, the Fund will work closely with existing agencies to ensure clear coordination with domestic programmes.

Disbursements from the Fund will take the form of grants. Projects offering no financial return will be eligible to receive support up to 100 per cent of the project cost. On the other hand, projects offering some financial return, albeit insufficient for the project to be viable, will be eligible to receive support for a limited proportion of the project cost or an interest rate subsidy. In all cases the guiding principle will be to provide a level of financial support sufficient to render the project viable taking account of other sources of external aid.

The programme will support various types of project including those that:

- clean up existing sources of pollution;
- introduce new clean plant;
- stimulate a domestic environmental protection industry; and
- educate and train.

However, the bulk of the Fund's expenditure will be on projects that provide direct environmental benefits.

Examples of likely priority projects include:

- flue-gas desulphurisation and low-NO_x burners at existing power plant;
- gas supply to all sectors;
- energy efficiency in all sectors;
- forestry;
- methane recovery from coal mines and landfill sites;
- municipal water treatment plant;
- sewerage systems; and
- industrial waste minimisation.

Operations of the Fund will concern all phases of the project cycle: identification; preparation; appraisal; approval and monitoring, together with disbursement administration and general administration to support all of the foregoing.

The Fund will develop strategies in each of its areas of activity and will identify projects to implement those strategies. Thus, project proposals might arise from an initiative of the Fund to invite bids for a specific project - solicited proposals. Alternatively proposals might be put forward on the initiative of a project sponsor - unsolicited proposals. The Fund's policy will be to welcome unsolicited proposals. If a project sponsor is interested in making an unsolicited proposal, it will be encouraged to discuss its proposal at an early stage with the Fund. The potential proposer is warned that the Fund might decide to invite competitive proposals for the project.

Formal responsibility for project preparation will rest with the proposer. Nonetheless the Fund will have an active role in, for example, making sure that proposers with the capability and resources to prepare projects themselves understand the Fund's requirements and standards; and helping other proposers to find the financing or technical assistance necessary for preparatory work. In certain cases the Fund may provide financing through a Project Preparation Facility.

For those projects meeting some simple screening criteria, a formal appraisal report will be produced, which will match the normal expectations of banks and aid agencies for project investment. The report will address the following:

- assessment of benefits;
- assessment of costs;
- environmental impact assessment;
- technical method;
- financing plan;
- project management; and
- monitoring and reporting.

A successful project will demonstrate both cost-effectiveness in meeting its environmental objectives and value for money in respect of the Fund's expenditure. The latter will be influenced by the availability of leverage through cofinance. The terms of the Fund's participation in the project will be confirmed at this stage.

Possible sources of cofinance include:

- corporate funds;
- bank borrowing;
- domestic environmental agencies; and
- international agencies.

The amounts that may be raised by way of leveraged funds will clearly depend on a number of factors including the willingness of agencies to cofinance and the ability of the Polish private sector to become financially involved. The expectation is that cofinancing from overseas agencies and the international private sector will be equivalent to the foreign currency component of project costs.

The approval process for project finance will include acceptance by the Supervisory Board of both the appraisal report and the terms of the Fund's participation. Further requirements will apply where cofinaciers are involved. A formal agreement will then be signed by the project sponsor and the chief executive of the Fund.

The Fund will monitor project implementation, procurement and disbursement against agreed schedules, will identify and facilitate correction of any problems arising, and will ensure timely availability of funds for ongoing projects.

Finally, the timetable for establishing the Fund is short. The Fund will commence operation early in 1992.

The Polish government has a responsibility to ensure that the arrangements for the swap programme will not impose an impossible strain on its budgetary position and jeopardise its ability to meet the conditions of its IMF facility. To the extent that expenditure within the swap framework is matched by reduced debt service there will be no incremental budgetary demand imposed by the programme.

The proposed arrangements would allow Poland to reduce its payments into the Bank for International settlements to the extent that documented eligible expenditure, in either local or foreign currency, has taken place. Expenditure in Zloty will be converted on the basis of the prevailing official rate of exchange. The arrangements will require a relatively simple agreement overlaying the arrangements already in place under the Paris Club agreement.

The mechanism for matching expenditure with debt forgiveness would work on the basis of a cumulative rolling total so that eligible expenditures would match the profile of the debt forgiveness, as would be the case for example during the start up of the administering Fund's operations before the first projects were at the point of implementation, then the unused entitlement would be paid into an escrow account bearing the appropriate market rate but would be available to be drawn upon subsequently by the Polish side, against eligible expenditures. In this way the escrow account will ensure that Poland's debt-for-environment swap is not just an excuse for a "free lunch" as far as Poland is concerned.

With a debt-for-environment programme, creditors' contributions to the programme (made by the Polish Government in consideration of debt canellation) would be leveraged in two direct ways: First, cofinance of specific projects by multilateral agencies (EBRD, World Bank, IFC, NEFCO etc) and bilateral agencies; and second, private sector finance complementing partial project financing from the Fund administering the swap programme.

Appendix 4

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November 1991

THE PARIS CLUB DECISION ON DEBT-FOR-ENVIRONMENT OPTION FOR POLAND

As already mentioned, in April 1991, Paris Club members agreed in principle to provide for exceptional debt relief for the Government of Poland. The agreement, which was in recognition of the unique challenges facing Poland as it moves toward a market economy, provides for a reduction of 50% in net present value of debt service to be implemented in two tranches; in addition the agreement includes a provision for participating creditor governments to cancel a further 10% through debt swaps on a voluntary basis.

The Polish Government wishes to take up the 10% provision to institute a debt-for-environment swap programme funding investments specifically aimed at alleviating Poland's contribution to regional and global environmental problems and achieving the most cost-effective environmental improvements.

If all the Paris Club members accede to the proposed debt-for-environment swap programme, the value of the resources available to fund the programme would amount to about $3.1 billion in net present value terms. The swap would provide a facility which has a value each year of equal to 20% of the debt service stream following the Paris Club Agreement (equivalent to a 10% reduction, in net present value terms, of the level of debt prior to the Agreement). This will make possible an initial annual expenditure of approximately $120 million which will increase in time in line with the annual debt service profile agreed with the Paris Club.

While the funds provided for in the framework of a debt-for-environment programme may be relatively small in relation to Poland's overall environmental needs, they would nevertheless constitute a significant injection of additional resources which would otherwise be not available at this time due to the period of austerity accompanying Poland's structural adjustment programme. This in turn will enable Poland to contribute to environmental solutions in ways which would not be possible if Poland had to rely on its own unaided efforts. Furthermore, a debt-for-environment programme will likely trigger supplementary co-financing by other agencies, in particular the official multilateral financial institutions.

The Polish Government's debt-for-environment initiative has aroused considerable interest amongst the Paris Club creditor countries. Several governments have signalled that they are seriously conditering participating in such a programme, and the United States has already availed itself of the possibility of the further 10% debt swap provided for in the Agreed Paris Club minutes.

The Polish Government understands that there are difficulties for some member countries to participate in the initiative at this time. To accommodate these difficulties the debt-for-environment swap programme is so designed as to leave the door open for countries to join when they are ready to do so. The Government is also anxious not to unilaterally impose its own vision of how the debt-for-environment programme should operate. Accordingly, the specific details as to the form and mechanics of the swap programme are being worked out in close consultation with creditor countries. These consultations are ongoing. As a result, some of the institutional, financial and technical arrangements of the programme have yet to be finalized.

Having said that, there are some basic principles which are at the heart of the Polish debt-for-environment swap proposal.

BASIC PRINCIPLES OF THE SWAP PROGRAMME

The first is the principle of ADDITIONALITY: A primary objective of the programme will be to channel additional resources to projects which adress regional, international and global enironmental problems. The environmental projects selected will be additional in the sense that, without the assistance of the swap programme, they would have either not proceeded at all or only proceeded at a substantially later date despite their international importance.

Thus not only will the funds be used to increase the expenditure on projects of international and global significance, but the expenditure will represent an increase in the total environmental spend so that resources are not diverted away from projects which adress environmental priorities in Poland.

In practice it is very difficult to asses additionality on a project basis since this presumes the existence of a clearly identified baseline programme with a specific timetable for each individual project over what will be a twenty year time horizon. For this reason under these circumstances the more relevant concept of additionality is defined in terms of total expenditure on environmental projects.

In short, the essence of the principle of additionality is that Poland is not seeking a soft option. Debt swap funds will not be used as an easy means of covering the financial burden of the domestic agenda for environmental expenditures. Nor will debt-for-environment be an easy way out of debt repayments. The fundamental objective is to achieve real and measurable additional environmental improvements, and to be able to demonstrate thereby to the international community that their trust and confidence is not misplaced.

A second principle at the heart of the Polish debt-for-enviroment proposal is the issue of COST-EFFECTIVENESS of fund expenditure in relation to achievement of the programme's objectives of adressing international environmental problems. The cost-effectiveness approach is the the most efficient way of spending the fund's resources and the most acceptable to potential co-finacing multilateral institutions.

The cost-effectiveness principle also underpins our view on how the allocation of available money be best achieved. The Polish government believes that it is important for this to be done on a "club" basis. By this we mean that each participating country would be able to indicate their preferences between the different (four) areas of environmental activity and that the individual preferences would then be added together to create an overall allocation of fund resources. In other words, if the size of debt forgiveness for a particular participant in present value terms is $X million then they might allocate two thirds of X to, say, SO2 abatement and the other thirds to biodiversity. The total split between the areas would emerge from the sum of these allocations across all participating countries.

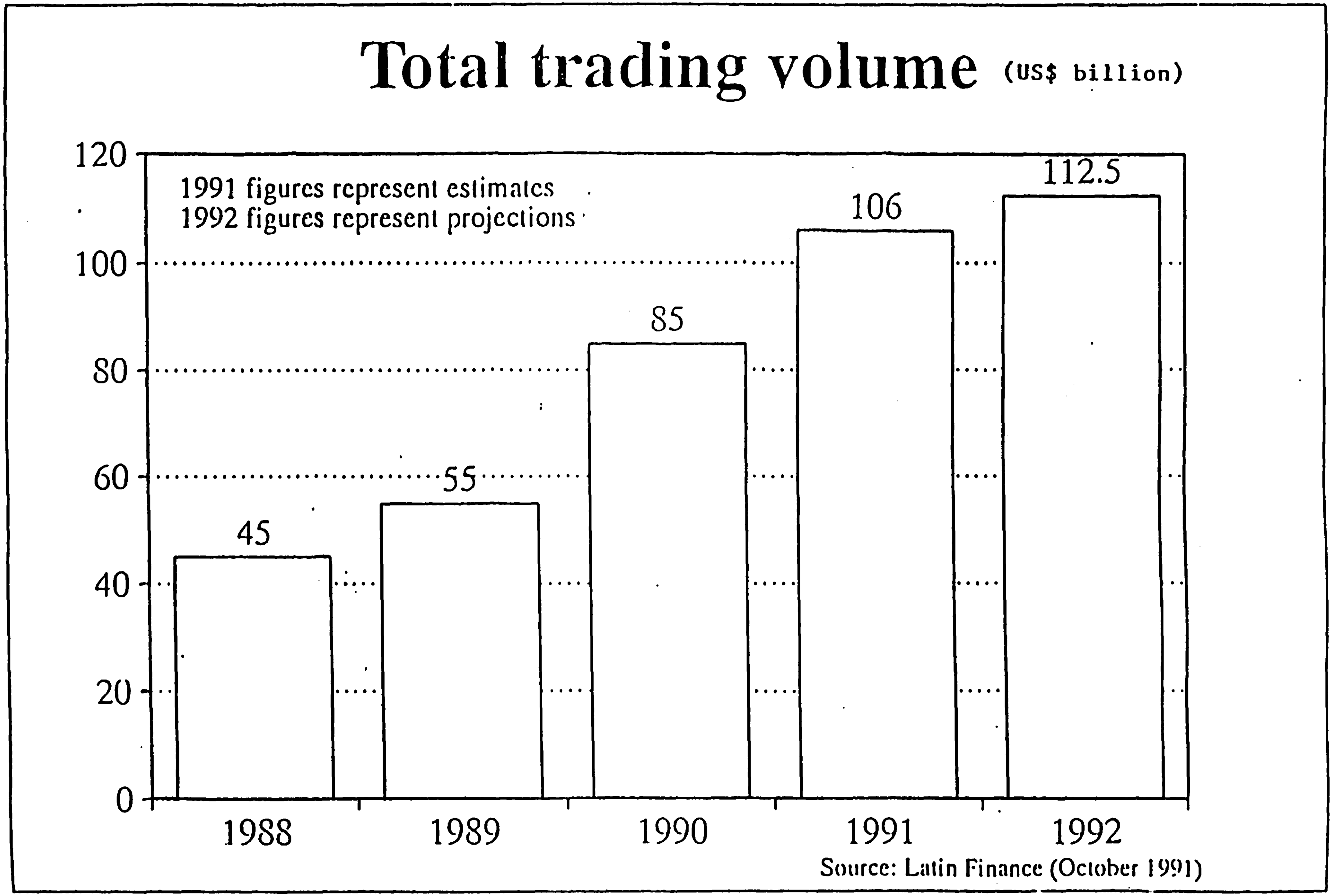
There are several reasons for doing this on a club basis. First, to achieve the maximum result for a given spend requires the potential projects be assessed against each other and then implemented in order of the best projects first. Selecting projects in isolation and allocating funds on an individual basis would be immensly complicated and would diminish the impact of the funds. One debt-for-environment programme would be far more effective and practical than, say, seventeen separate ones. Second, the availability of funds in relation to each individual country will be relativley small to begin with. Hence it would be unwise to start several projects simultaneously, with the larger projects taking years to complete. A collaborative pooling of resources and concentration of projects would produce more effective results for the money available in a shorter period. Thirdly, the size of the individual projects will not neatly match the size and profile of each individual debt forgiveness, hence a whole series of bilateral deals would be impractical to implement.

The issue of the club approach also affects the question of procurement within the framework of the swap programme. The Polish Government's preference is for an open system of procurement rather than a system of tied procurements. First, a system of open tender ensures maximum cost effectiveness of funds spent and thus an optimal allocation of resources. Second, potential co-finaciers may be reluctant to become involved in tied procurement programmes. A number of multilateral organizationshave indicated to us that the degree of their potential involvement in co-financing is dependent on the implementation of an open procurment system. Tied procurements may, therefore, hinder the flow of co-financing resources.

FINANCIAL MECHANISMS

Finally, some words on the financial mechanisms for the swap programme. These are still in the process of development and are the subject of negotitaion between the Polish Government and the creditor countries.

FIGURE 1



Total trading volume (US$ billion)
1991 figures represent estimates
1992 figures represent projections
120
100
80
60
40
20
0
45
55
85
106
112.5
1988
1989
1990
1991
1992
Source: Latin Finance (October 1991)

PROSPECTS FOR OFFICIAL DEBT CONVERSIONS: THE CASE OF ZAMBIA

i. As with the other case studies, this analysis of Zambia is in five sections: (i) an overview of developments in the Zambian economy; (ii) a portrayal of its debt situation; (iii) the attempts that have been made to provide debt relief; (iv) the prospects for official debt conversions; and, lastly, (v) an evaluation of the impact that official debt conversions might have on the Zambian economy.

I Overview of Developments in the Zambian Economy

1.01 With recorded 1990 GNP of just over $3 billion the Zambian economy has been on a path of relentless decline since 1975. Its nominal per capita income has been reduced from a level of over $750 at the end of the 1960s to around $500 at the end of the 1970s and barely $350 in 1990 suggesting a real decline of much greater proportions; real per capita income is now about a third of what it used to be two decades ago. That outcome reflects a combination of egregious economic mismanagement throughout the 1970s and 80s with the basic long term structural problem remaining unaddressed i.e. Zambia's inability to diversify away from its extreme dependence on a single commodity -- copper which accounts for 27% of national output and over 90% of the country's forex earnings. Agriculture accounts for only 14% of GDP while manufacturing (highly inefficient and import-substituting) accounts for a further 25% and services for the remaining 34%. The sharp drop in real income per head also reflects Zambia's inability to curb its extremely high rates of population growth and urbanization. Eight unsuccessful attempts at economic reform under as many structural adjustment programmes monitored by the World Bank and IMF since the mid-1970s have left the country impoverished and incapacitated.

1.02 The windfall revenues triggerred by the early commodities boom following in the wake of the first oil shock were frittered on nationalizing the economy with government control and intervention over almost every aspect of economic life but without a public administrative infrastructure capable of assuming that onerous burden. That orientation on the part of a government which ruled for an uninterrupted 28 years, till November 1991, resulted in an extreme degree of capital and import dependence in agriculture and industry, encouraging highly import-intensive consumption at the expense of domestic saving and investment and systematically discriminating against the development of an indigenous resource base. Zambian government policies led to a land with Africa's richest potential and vast uncultivated tracts being unable to feed itself and reliant on subsidized food imports. Following the collapse of copper prices in 1975 and their prolonged depressed condition till 1987, the government intensified its policy regime of controls and resorted to depletion of international reserves coupled with substantial external borrowing from commercial, multilateral and bilateral sources. In retrospect it appears incredible that lenders could have been quite so imprudent in the anticipation of a rise in copper prices which did not materialize until much too late. Zambia thus built up a very large stock of external debt (over $7 billion) which it has since been unable to service and running up arrears, after successive reschedulings, which now amount to over $3 billion.

1.03 Economic deterioration became a crisis when trade credits to Zambia were suspended in December 1982. Several subsequent attempts at economic restrucuring and comprehensive policy reform, aimed at removing distorted price signals, adjusting a grossly overvalued exchange rate, reducing the role of the parastatal sector, exerting monetary and fiscal discipline and diversifying exports have yielded little. The programmes were unrealistically designed, inadequately financed and failed to account sufficiently for weak implementation capacity or the political will to persist with the reform effort. In the last two bouts of backing-and-forthing over reform the government committed itself an ambitious but ill-conceived adjustment effort in 1985-86 focussed on achieving a market determined exchange rate through the auctioning of foreign exchange. That effort was abandoned in mid-1987 with the kwacha being revalued and fixed under an indigenously designed national recovery programme; it failed dismally and unleashed a bout of inflation which has yet to be brought under control. In mid-1988 the government again began taking serious steps towards partial exchange rate adjustment, price decontrol and removal of maize and petrol subsidies and, on the basis of those efforts, resumed a dialogue with the Bank and Fund in late 1989.

1.04 In March 1990 the government agreed to a tough Fund monitored "shadow programme" under which the Fund provided no new financing but froze its arrears (levying interest on them at current rates) on the assumption that Zambia would earn credits towards clearing these arrears over a three year period by adhering strictly to programme targets (the "rights approach"). New grant money was committed in unusually large amounts by bilateral donors and the multilateral banks to support the programme which involved: reaching a market clearing exchange rate by no later than mid-1992, extensive price liberalization, achieving positive real interest rates by end-1991; limiting money supply growth of no more than 22% in 1990 to bring inflation down to a level of 40% (from around 160% in 1989); reducing the fiscal deficit drastically (by 5% of GDP) through revenue enhancement and restructuring public spending priorities; and undertaking tariff, parastal and civil service reform coupled with the launch of an aggressive privatization programme. In the light of previous experience, overall performance between June 1990-June 1991 was judged to be good though all the fiscal, monetary and inflation targets for 1990 and 1991 had to be revised. But with the pressure to hold democratic elections in October 1991 major programme commitments were abandoned by the Kaunda government which was finally ousted. A new government has just been elected and is finding its feet. It has sent strong signals of intent to pursue the reform efforts and accelerate it, particularly in the area of reducing the size of the government and expanding the role of the private sector in the economy. A new adjustment programme and financing package for 1992-95 is again being designed with hopes on the part of the donor community that implementation and the political commitment will be much stronger than before.

1.05 Conventional wisdom subscribes to the view that time is running out for Zambia and that it has no options left. Its copper ore bodies are dwindling and production is expected to drop below half the current levels by 2000. The cost of producing copper is now 80¢ per lb and transport costs to Dar-es-Salaam are crippling. The collapsing world price of copper is again narrowing margins of profit to near zero. Zambia is hopelessly overborrowed and has to clear a substantial amount of arrears to preferred creditors. Its past performance record has left donors much more cautious about the future though they all believe in supporting the commitment to reform of the new government to the maximum extent. Yet the adjustment programme being designed appears more as if it is intended to extricate the IMF from a financially impossible situation than to put Zambia back on its feet. Though donor financing of over $600 million (or nearly $77 per capita) is again expected to be mobilized through extraordinary efforts, over 60% is expected to be diverted to debt servicing on the multilateral account leaving relatively little left to finance net imports.

1.06 The neglect of Zambian infrastructure over the last two decades has resulted in running down its road and rail arteries and its power and communications facilities. The acute shortage of forex has debilitated its trucking fleet, inhibited agricultural output and brought capacity utilization in manufacturing to an average level of about 25% with a virtual collapse in the delivery of public services. All social indicators have deteriorated rapidly with savage reductions in social sector expenditures, and for urban sanitation and sewerage. The rapidly increasing incidence of malnutrition, HIV infection and AIDS is assuming dimensions of threatening proportions especially in highly congested urban areas which now contain over 50% of Zambia's population. Moreover the massive decline in real income and purchasing power has resulted in an inability on the part of consumers to purchase essential pharmaceuticals, texbooks and food. Under the bleak prospects that Zambia faces, all creditors recognize the need to reduce the external debt and debt service burden. So far they have done by tolerating prolonged arrears even on preferred credits rather than by formal debt reduction agreements which would appear to reward poor performance. Yet Zambia has enormous untapped agricultural potential and manufacturing capability. With the right entrepreneurial inputs the economy's long-term future is by no means hopeless providing that a combination of policy reform, a greater involvement in productive activity by the private sector (foreign and domestic) and substantial debt reduction can be effected and sustained.

II Zambia's Outstanding External Debt

2.01 External claims on the Republic of Zambia at the end of 1990 totalled about $7.2 billion comprising $6.4 billion in disbursed and outstanding debt (DOD) and a further $813 million in accumulated interest arrears (Table 1).

2.02 Dramatic changes have occurred in Zambia's debt position between 1970-90. The overall amount of debt has grown nearly tenfold with particularly large increases in the amounts owed to official creditors (both multilateral and bilateral) and in short-term exposure while private long-term creditors have kept a low and constant profile in dollar terms and a rapidly diminishing one in relative terms. Zambia's debt in 1990 was over 216% of GNP amouting to just under $1,000 per capita with a very large portion (over $3 billion, including $2.3 billion of amortization payments) of the debt portfolio being in arrears. That situation has been caused by GRZ's structural inability to cope with debt service payments of the magnitude required even after reschedulings. It points to the urgency of significant reduction in outstanding debt and arrears coupled with restructuring of residual obligations to bring them more in line with Zambia's realistic debt servicing capacity.

TABLE 1:

ZAMBIA: EXTERNAL DEBT 1970-90

(Amount in millions of US$)

		1970	1980	1985	1990
TOTAL EXTERNAL OBLIGATIONS:		754	3,266	4,637	7,223
of which: Disb. & Outstanding Debt (DOD):		754	3,260	4,467	6,410
Acc. Interest in Arrears (IA):		0 *	6	170	813
DOD owed to:	Multilateral Banks:	61	397	733	1,420
	IMF:	0	447	801	949
	Bilateral Creditors :	59	1,105	1,803	2,824
	Private LTG Creditors:	503	644	624	540
	Private LTU Creditors:	30	0	0	2
	Short-Term Debt Outstanding:	100	586	677	1,488

Source: World Debt Tables 1991-92.

2.03 The specific steps recommended to the government at various stages for achieving this outcome have included the following: (i) restructuring debt and arrears owed to the IMF which constitute the single most serious obstacle to meaningful debt service relief -- the IMF needs to show sufficient flexibility in tailoring its rights approach to meet Zambia's needs for zero net transfers (at worst) from the Fund through the 1990s; (ii) repaying arrears due to the World Bank Group and refinancing residual hard IBRD debt (or obtaining interest subsidies to help servicing it) with sufficient IDA support to ensure positive net transfers being maintained through the 1990s; (iii) approaching official bilateral creditors to cancel all outstanding concessional credit balances and extend the terms offered under the recently announced "enhanced Toronto Terms" (a distant cry from Trinidad Terms) for the non-concessional component to meet Zambia's unique needs; (iv) clearing commercial bank and suppliers' credit obligations through deep-discount buybacks supported by the IDA buy-back facility; and (v) clearing the pipeline of short-term commercial arrears, auction-related LCs, personal remittances and BoZ obligations through initiatives along the lines designed in 1985 but later abandoned due to a shortage of foreign exchange.

2.04 Multilateral Creditors are owed $2.37 billion in principal outstanding of which amortization payments of about $1.4 billion were in arrears as of end-1990 with a further $500 million in overdue interest charges. Zambia owed the IMF $949 million in upper tranche obligations of which 70% are overdue and a further $31 million in Trust Fund obligations. Total IMF arrears of $1.3 billion constitute the single largest debt problem that the government (GRZ) must tackle if it is to unblock movement on other creditor fronts. IMF obligations (including accumulated interest arrears) presently account for 47% of all multilateral obligations and 18% of total outstanding obligations. The World Bank accounts for the next largest component of external obligations. For a country in Zambia's predicament, the mix of World Bank debt is much too hard reflecting earlier high levels of IBRD borrowing in better circumstances. Out of total obligations of $1.15 billion about $539 million was owed to the IBRD; a much larger proportion than is usual for a low-income African country. World Bank obligations now account for 42% of all multilateral obligations and 16% of total external obligations.

2.05 Though much smaller than dues to the Bretton Woods institutions, Zambia's obligations (and arrears) to the African Development Bank (and Fund) are now increasing at a rate which will result in major debt servicing problems with that institution as well. Total obligations have increased sharply since 1989 and an arrears problem has emerged on the hard window account. Despite its desperate need for drawing on forex resources from every available source, Zambia needs to exercise caution in expanding borrowing from AfDB; caution which needs to be mirrored by AfDB management in containing its own hard window exposure to debt-distressed countries. Of similar size to the African Bank, Zambia's obligations to the European

Community institutions have so far been serviced with reasonable regularity. The largest component comprises an EEC (SYSMIN) loan to te copper parastatal (ZCCM) in an outstanding amount of $110 million. The remainder comprises European Investment Bank lending to ZCCM and other parastatals along with European Development Fund credits to GRZ. Though classified as concessional, the EEC claims appear to have distinctly hard features with the "soft" component of EEC lending accounting for only 18% of total EEC exposure. Finally, the multilateral category includes relatively small amounts of (mainly concessional) debt owed to the Arab Bank for Economic Development (BADEA), IFAD, the OPEC Special Fund and the Special Arab Fund for Africa.

2.06 Official Bilateral Debt: Zambia's total outstanding obligations to bilateral creditors exceeded $3 billion at the end of 1990 with nearly $175 million in accumulated interest arrears despite a Paris Club scheduling in mid-1990. OECD creditors accounted for 71% of the bilateral total. CMEA creditors accounted for 13%, OPEC for less than 5% and other developing countries (mainly China) for the remaining 11%. Between 1989-91 significant steps have been taken towards bilateral debt reduction with cancellations of ODA debt by a number of European countries and the US and Canada. Japan has refused to cancel any obligations preferring instead to provide offsetting grants from its special debt relief facility on an annual basis to help Zambia meet its debt service obligations to Japan. There is, however, some confusion as to exactly how much has been cancelled. Cancellations notwithstanding the total amount of bilateral debt outstanding increased in 1990 by $505 million as a result of interest arrears capitalization from the 1990 Paris Club rescheduling. The situation for non-OECD creditors is less clear than for OECD especially with respect to full or partial cancellations which GRZ may have negotiated. The largest windfall for GRZ on bilateral account may result if debt to the USSR denominated in roubles can be repaid in that currency. As a result of the rouble devaluations which have occurred debt to the USSR could be extinguished for a fraction of the current recorded dollar value.

2.07 Of Zambia's OECD creditors, four countries dominate: Germany, Japan, the UK and US. Collectively, they now account for 80% of total OECD bilateral debt. France and Italy are the two next largest creditors, together accounting for another 12% of OECD bilateral debt; almost all on non-concessional terms. Debt reduction efforts need to be focussed on these six donors; both for remaining concessional but, much more importantly, non-concessional bilateral debt. Nearly 85% of all CMEA debt is owed to the USSR on non-concessional terms. China accounts for 72% of the debt due to "other bilaterals"; all its claims are on concessional terms. Also included in this category are Brazil and India. Brazil has joined the Paris Club of creditors in its debt dealings with countries such as Zambia. Along with India it has held its exposure at current levels. A cumulative $2 billion has been rescheduled by the Paris Club in 1983, 1984, 1986 and 1990. A further $390 million in debt owed to East Bloc creditors, India and Iraq was rescheduled in 1989. Total bilateral arrears (after rescheduling in 1990) have already accumulated to nearly $560 million.

2.08 Debt due to Private Commercial Banks: London Club debt (rescheduled once in December 1984) amounts to just under $70 million in outstanding principal. Amortization arrears now exceed $68 million while accumulated interest charges were over $47 million at end-1990. The bank syndicate to which this debt is owed comprises banks from Austria, France, W. Germany, the Netherlands, Sweden, the UK and the US; among these British banks have the largest exposure -- nearly 73% of the total. These figures, however, grossly understates commercial bank exposure, especially to ZCCM and BOZ much of which is classified as short-term. Regardless of tenor, however, the extent of bank exposure leaves banks and GRZ more vulnerable than is justified by the inherent characteristics of Zambia's indebtedness: total bank exposure, including interest in arrears, amounted to over $1.5 billion at the end of 1990. Much of the debt classified as short-term has been in arrears for over 5 years and should be regarded as medium term debt. There is a powerful case for writing it down on the same basis as other bank or commercial arrears.

2.09 Debt Owed to Private Suppliers & Export Creditors: Outstanding obligations to external suppliers and export creditors amounted to nearly $471 million at the end of 1990 though there remains some confusion in GRZ accounts on: (i) former private debts covered by export insurance now being counted under official bilateral accounts; and (ii) sales of suppliers' debts on secondary markets some of which have not been registered in either BOZ or WDT records to the extent that they are reported to have occurred. The largest sources of suppliers and export credits are the OECD countries, which account for nearly 90% of the total. CMEA countries do not feature heavily in this category of debt, but other developing countries do (in particular Brazil, India and Yugoslavia). In the "other" category is also a large credit from Panama which almost certainly represents OECD interests with Panama used as a "booking" centre for the financial facility.

2.10 Most of the debt buybacks which have occurred in Zambia have resulted from sales of this type of debt in the local secondary market. Estimates of buybacks to date range from $80 million to $250 million but these have not been sufficiently well recorded (despite BOZ's claims to the contrary) for a clear assessment to be made of the extent or impact of such activity on debt reduction. The data provided by BOZ for the 257 individual claims which have been bought back between January 1987-September 1989 is unclear. It does not provide any indication of the overall extent of activity (in dollar terms) or the price or terms on which it has been undertaken. That data suggests that in the first three quarters of 1989, total buybacks amounted to about $11 million whereas knowledgeable financial sources engaged in this activity estimate that buybacks probably totalled $50 million in face value claims during the year. As a result of this opacity in record-keeping it is difficult to trace exactly how much has been written down on suppliers' and export credits and to determine with any precision what the outstanding balances actually are.

2.11 The debt service picture is portrayed in Table 2 overleaf.

2.12 The table suggests that the actual debt service picture for Zambia is no longer particularly meaningful as an indicator of its debt burdens. It is instead a derivative of ad hoc day-to-day decisions by the BoZ as to what payments can be afforded in response to extreme exigent pressures from one kind of creditor or another rather than indicative of a clear strategy in meeting Zambia's debt service obligations. In 1990 less than 8% of the interest payments due were actually made and principal repayments were in arrears to the extent of over $2.2 billion. Hypothetically, had Zambia attempted to pay scheduled debt service and extinguish its arrears the amount involved would have exceeded its GNP for 1990 and required 260% of export earnings. After the eigth breakdown of relationships with the Bank and Fund in mid-1991 the debt and arrears picture has almost certainly worsened as of the end of that year as donor grant commitments have not been translated into disbursements and Zambia has again slid back into arrears with the Bank and Fund.

TABLE 2:

ZAMBIA's EXTERNAL DEBT SERVICE PAYMENTS

(Amounts in millions of US Dollars)

			1970	1980	1985	1990
Interest Arrears			0	6	170	813
Total External Debt Service:			96	412	139	281
of which:		Principal	45	270	71	216
		Interest	51	142	68	65
Long-term	Bilateral:	Principal	2	18	12	5
		Interest	2	20	9	9
	BDS		4	38	21	14
	Multilateral:	Principal	4	18	26	5
	Banks	Interest	4	33	30	32
	MBDS:		8	51	56	37
	IMF:	Repurchases	0	57	25	25
		Charges	0	26	25	2
	FDS		0	83	50	27
	Total Multilateral:	Prin	4	75	51	30
		Int	4	59	55	34
	MDS		8	134	106	64
	Private guaranteed:	Prin	29	144	9	45
		Int	23	53	5	16
	PGDS		52	197	14	61
	Pvt. unguaranteed:	Prin	6	31	0	0
		Int	2	10	0	0
	PUDS		8	41	0	0
	Total Private (LT):	Prin	35	175	9	45
		Int	25	63	5	16
	PDS		60	238	14	61
	Short-Term:	Net Prin	13	-65	-119	139
		Interest	11	67	117	3
	SDS		24	2	-2	142

Source: World Debt Tables 1991-92

Between 1985-90 the debt servicing strategy Zambia has pursued has often subordinated the claims of its preferred creditors to those of commercial creditors who have been prepared to lend at large spreads and with substantial collateral to the copper company. Indeed the creditworthiness of the copper parastatal exceeds that of GRZ itself; a uniquely anomalous situation which Zambia's official creditors seem to have been prepared to tolerate for quite a long time. Hence while there has been recognition on the part of creditors that something clearly needs to be done to bring Zambia's debt burdens into line with its debt servicing capacity there has been a reluctance to formalize substantial debt reduction arrangements in the face of repeated failure on adjustment performance.

III Measures Taken to Reduce Zambia's Debt and Debt Service Burdens

3.01 Relief on Official Bilateral Debt: As noted earlier, Zambia has had four Paris Club reschedulings (Table 3 below) and several cancellations of bilateral debt. The terms of the official reschedulings are as follows:

TABLE 3:

ZAMBIA's PARIS CLUB RESCHEDULINGS

Date of Agreement	Cut-Off Date	Consolidation Period Begin	Consolidation Period Length (Mths)	Amount Consolidated	Repayment Terms Maturity Yrs	Repayment Terms Maturity Mth.	Repayment Terms Grace Yrs	Repayment Terms Grace Mth
16.05.83	01.01.83	01.01.83	12	$ 302 m	9	6	5	0
20.07.84	"	01.01.84	12	$ 263 m	9	6	5	0
04.03.86	"	01.01.86	12	$ 468 m	9	6	5	0
12.07.90	"	01.07.90	18	$1,005 m	Menu of Options ABC.			

Source: World Debt Tables 1991-92

3.02 The net effect of the three reschedulings prior to 1990 was that Zambia was unable to meet agreed terms almost as soon as its delegation left Paris on signing the minute with creditors. They did not provide the kind of relief that would have been meaningful in Zambia's circumstances. Recognition of that reality led to a series of bilateral debt cancellations between 1988-90 (first focussing only on concessional debt but later including selective non-commercial debts as well) by all the major European creditors, the US and Canada helping to foster a new, more benign climate for Zambia to benefit further from efforts to reduce debt. Sweden and Norway, of course, cancelled all bilateral debt some time ago. Yet despite these cancellations (the precise amount of which is still unclear) and in the absence of any significant new lending on the bilateral account bilateral debt has <u>increased</u> by $1billion between 1985-90 mainly because of interest and arrears capitalization when write-offs would have been much the more appropriate course of action. In October 1991 the UK announced unilateral application of Trinidad terms to its claims on Zambia but since then seems to have modified its position to conform with the new Paris Club consensus on enhanced Toronto Terms, resulting in a much reduced amount being cancelled. Given Zambia's circumstances it was surprising how many bilateral creditors chose to apply Option B (an inferior option to the other two) rather than opt for debt stock or interest rate reductions. Debt reschedulings have also been agreed with non-OECD governments in parallel with Paris Club exercises resulting in another $420 million being rescheduled.

3.03 The concessional component of the bilateral debt stock amounts to $1.53 billion (or 54% of the total) and, despite cancellations being concentrated in this category it has risen by over $520 million between 1985-90. Zambia's economic circumstances would suggest that the entire concessional stock (80% of which is due to OECD creditors) be cancelled as the prospects of recovery are remote. The non-concessional bilateral debt (NCBD) stock is just under $1.3 billion also having grown by about $500 million between 1985-90 largely through interest capitalization. From a dispassionate perspective the most realistic solution to the NCBD stock would be for creditors to apply, as a first step, the enhanced Toronto Terms to the entire stock (rather than simply to eligible consolidated maturities). A second step would be to exercise the option of debt conversion, which has been extended to lower middle-income debtors, to the remaining NCBD stock linking such conversions to acceleration of the privatization efforts which the new government has committed itself to pursuing.

3.04 In cash, rather than in terms of tenuous political leverage, bilateral creditors are themselves likely to be far better off agreeing to the combination of measures proposed above than insisting, as they previously have (counterproductively) on imposing unrealistic rescheduling terms. Based on past experience even enhanced Toronto terms, whichever choice of options creditors decide to make, are: (a) unlikely to be honoured; (b) likely to constantly threaten the availability of sufficient net external inflows of forex to sustain adjustment if unforessen adversities are encountered; and (c) certain to require donors to supply unrealistic levels of new gross flows to offset unanticipated increases in debt service due to interest or exchange rate movements. Apart from the OECD, the largest NCBD creditors are the USSR, Iraq, Brazil and Yugoslavia with the USSR accounting for by far the largest amount (nearly $300 million at the old fixed rouble exchange rate). As observed earlier, GRZ needs to establish whether that debt can be repaid in roubles without maintenance of value obligations attached.

3.05 Relief on Commercial Obligations : Zambia has had just one London Club rescheduling in 1984 the terms of which are depicted below:

ZAMBIA's LONDON CLUB RESCHEDULING

Date of Agreement	Consolidation Period Begin	Length (Mths)	Amount Restructured	Repayment Terms Maturity Yrs	Mth	Grace Yrs	Mth	Interest Margin
December 84	01.01.85	24	$ 74 m	6	0	3	0	2.250

Source: World Debt Tables 1991-92

3.06 The difficulties involved in reducing outstanding balances (and interest arrears) on Zambia's commercial debt are complicated by: (i) a lack of transparency in establishing the true extent of Zambia's outstanding obligations to commercial creditors; (ii) ad hoc debt buybacks, undertaken in an undisciplined manner without the application of a clear framework or a set of guidelines, have added to the confusion on outstanding commercial debt [1]; (iii) a distorted discount signal: Zambian commercial debt, compared to that of Bolivia, Peru and other similar countries did not since 1986 justify a price of more than 5-6¢, yet the average price realized upto 1989 was about 25¢ with domestic parties being the main purchasers [2]; (iv) the special standing enjoyed by ZCCM whose commercial creditors have invariably been serviced regularly with the unusual situation arising where an instrumentality of government has a higher commercial credit standing than the government itself.

3.07 These factors notwithstanding, the following actions on different categories of commercial debt have been recommended to GRZ: (a) clear all personal remittance accounts relating to expatriate consultants at face value; (b) offer suppliers and export creditors with unguaranteed credits outstanding prior to October 5, 1985 the option of either accepting settlement of claims in local currency promissory notes with a market rate coupon serially encashable over a period of 5 years, OR submitting bids for settlement in foreign exchange at a deep discount with GRZ employing a fund of about $10 million to clear all such arrears -- this option would probably result in clearing commercial claims at an average 5¢ on the dollar; (c) for London Club debt and other commercial bank creditors GRZ's objective should be to clear all outstanding debt at a price of 10¢ on the dollar or less using the resoures of the IDA funded commercial debt buyback facility;

(d) keep ZCCM's private short-term trade lines current and open by regular servicing; but

(e) offer ZCCM's private long-term creditors a choice of: (i) 20-year collateralized bonds denominated in US dollars with a coupon of 3%; (ii) an outright buyback at 15¢; (iii) a local currency option of discountable 10-year Kwacha bonds at full face value with a market coupon -- these bonds being eligible for making preferred investments within Zambia; and (iv) enhanced opening up of debt-equity swaps for the purpose of making new investments or buying stakes in parastatals which GRZ would commit itself to privatizing on an announced schedule.

3.08 Next Steps in Advancing Prospects for further Relief : For any major debt reduction or restructuring exercise to succeed, the immediate steps which GRZ needs to take with respect to debt restructuring are: (i) reconciling the large discrepancies which still appear in BoZ's debt records with audited confirmation of outstanding balances by major creditors; (ii) simulated analysis of the impact of applying enhanced Toronto terms with the assistance of World Bank staff; (iii) approaching Zambia's four largest bilateral OECD creditors to determine the limits of the possible in going beyond enhanced Toronto terms for non-concessional debt restructuring and conversion; (iv) approaching selected commercial banks to explore prospects for discounted buybacks ; and (v) reviving earlier designs for clearing the commercial pipeline.

IV Prospects for Official Debt Conversions

4.01 Unlike the Jamaican case where a sound body of experience has been built up through a structured and well-managed approach to both its privatization programme and the debt-equity conversion programme (DECP) which has been operating for nearly five years, Zambia has resorted to undisciplined ad hocery in both these efforts. Moreover, the debt predicament of Zambia -- despite the low levels of actual debt servicing which it has been permitted by the creditor comunity to get away with for quite a long time (thus causing fundamental damage to the maintenance of proper debt-servicing priorities and of sound debtor-creditor relationships) --justifies an approach which concentrates first on achieving as much bilateral debt reduction through outright cancellation as possible before the conversion option is applied to residual balances. Such an emphasis, of course, diminishes the interest of the creditor community in exposing itself to double jeopardy: if creditors can be persuaded to cancel large amounts they are unlikely to be enthused by the option of converting residual balances. Assumedly the size of the prospective cancellation would be so designed as to to enhance debt-servicing prospects for the residual debt in which case further options would be regarded as superfluous. However, while this type of reasoning may be valid in theory it certainly has not yet been borne out by Paris Club practice.

4.02 Even so, unless official debt conversions were demonstrably necessary in achieving objectives to which creditors and GRZ attached the highest priority it is unlikely that they would be considered seriously. Fortunately, the case can be made that an official DECP may not only be necessary but indispensable to reviving the Zambian economy. A new government has embraced market-oriented reform and the need for rapid privatization with far greater commitment and enthusiasm than its predecessor. It remains short on administrative capacity and the design-cum-implementation skills that it needs to transfer a large part of the productive structure back into private hands on a sound and equitable basis. Zambia also remains vulnerable to: fluctuations in the copper and oil price; global volatility in exchange and interest rates; and most importantly, the largesse of the donor community. For those reasons, there remains considerable scepticism on the part of foreign and domestic investors as to whether the government's sound intentions will or can be translated into concrete reality on the basis of past desultory experience in closing the gap which has always existed in Zambia between public rhetoric and private reality. Until the economy stabilizes and exits from the devaluation-inflation spiral in which it has been trapped since 1985 there is little prospect of sufficiently large foreign capital inflows to support the government's privatization and new investment promotion initiatives. Surviving the medium-term with growth prospects enhanced will therefore require extraordinary efforts on the part of the government and the official donor community to underwrite the front-end risks involved in having the Zambian economy turn a critical corner. The role of a carefully designed official DECP may well prove crucial as an instrument in achieving that difficult objective.

4.03 Past Experience with DECP : In that context key lessons need to be learnt from the past mismanagement of Zambia's "informal" DECP which has, till very recently been characterised by: unclear objectives; poor management; considerable manipulation by politically well-connected insiders who have used it to legitimately acquire local currency at effective exchange rates well above those prevailing in the parallel market; misapplied proceeds which have not gone into genuine equity investments but into financing parallel market trading transactions, building lavish headquarters for the previously dominant political party, or into capital flight through round-tripping. The way in which debt-equity swaps were managed between 1985-89 resulted in a total lack of transparency in: (i) how much foreign debt was actually converted, (with estimates varying between $50-250 million though a recent internal review by BoZ suggests that they were probably less than $100 million); (ii) the secondary market prices at which it was supposedly bought in order to determine a fair sharing of the discount; and (iii) how the purchases were financed by domiciled residents.[3] Since 1990 there has been considerable tightening of procedures and a firm cap placed under the IMF monitored adjustment programme (of $10 million annually) on debt conversions though there is still no proper follow-through on whether local currency proceeds have been applied for the purposes indicated by applicants. The DECP has so far been concentrated on dismantling the "commercial pipeline" of suppliers credit debt. Under the 1990 ceiling of ZK500 million local currency swaps have been implemented with legitimate holders of eligible debt claims which have been approved from 1985 onwards for swaps on a preferential basis. With the substantial devaluation of the kwacha since 1985 the BoZ has levied a fee of 66.67% of the counterpart kwacha amount converted (to ensure that the kwacha proceeds for exchanged debt approximate the parallel market exchange rate taking into account a notional price of purchase of debt at 20¢). The BoZ has attempted to look into the use of converted proceeds though ths aspect requires further strengthening. So far no requirements have been imposed on parties undertaking these swap transactions that new forex be an integral component of every swap deal though that requirement is under active consideration.

4.04 A preliminary proposal (Annex 1) has been made to the Zambian authorities that they consider establishing a Privatization Fund to be financed through both the conversion of official debt and the provision of new forex by agencies such as IFC along the same lines indicated in the Jamaica case study. The preliminary reactions to this proposal on the part of the Minister of Finance and his officials was positive and may need to be followed up. Clearly much more work needs to be done in Zambia (than has already been done in Jamaica) on designing a properly identified and sequenced privatization programme before an official DECP can be credibly launched. Zambia, however, offers an unusual opportunity for technical assistance to be provided which could aim at linking these two initiatives from the outset, so that an official DECP could play an integral and supporting role in both helping to design and accelerate the implementation of a privatization programme.

4.05 The prospects for official debt conversions for non-commercial developmental purposes (including environmental protection) were also explored though there appeared to be less enthusiasm on the part of the Zambian authorities in using official debt conversions for these purposes. The scope for developmental investments through debt conversions is considerable. Two debt-for-nature swaps have already been done in Zambia. Urgent expenditures for improved urban sanitation, controlling the spread of AIDS, reviving educational investment, catering to the health and nutrition needs of children and so on could quite easily be financed through official debt conversions (and a prooportion of converted amounts should be set aside for such uses). The concern in using local currency proceeds for such expenditures, which do not involve an offsetting asset swap in the same way that privatization would, is whether such funding would result in an effective "expenditure swap" in the public budget. To the extent that the money creating effects of the conversions used for social expenditures could be demonstrably offset by public expenditure reductions of one kind or another, thus reducing the fiscal deficit and the calls it makes on central bank credit, such uses could be much more easily justified than they can be under current tightly controlled IMF monitored guidelines and ceilings.

V Impact of an Official DECP on the Zambian Economy

5.01 As in the case of Jamaica it is perhaps premature and extremely difficult (indeed impossible at this juncture) to identify with any precision the potential impact of an official DECP on the Zambian economy until some essential parameters became more transparent. There can be little question but that the sales of public assets alone could, over a five year period, easily absorb much more than the conversion of the full residual stock of NCBD after cancellation. The immediate impact in cash flow savings would, of course, be negligible as Zambia has not been servicing more than 10-15% of its scheduled annual bilateral debt service for several years now but simply accruing arrears and periodically capitalizing them when official reschedulings occur. Conversion of 10% of the extant (pre-cancellation) NCBD would amount to about $130 million available for conversions which would yield debt service savings of less than $2-3 million annually in cash terms though it might reduced scheduled obligations (and arrears) by about $25-30 million in principal and amortization payments. Assuming that 50% of the debt stock were to be cancelled (an unrealistically optimistic assumption given the recent practice of the Paris Club) and the remainder were subject to conversion, a 10% limit would result in $65 million being available for conversion. If expectations on the part of creditors were that post-cancellation debt should be fully serviced that would result in savings of about $5-8 million in savings over the first 10 years (basically the interest payments) followedby savings thereafter of annual savings of $30-40 million assuming amortization payments were equalized over the remaining 25 years.

5.02 The real immediate and indirect economic impact of these conversions could be much larger if they succeeded in transferring public assets to private ownership, and resulted in inducing associated investment and improving the efficiency with which those assets were deployed. In Zambia it would not be difficult to establish that a change in management and asset ownership, which brought with it sufficient new investment for rehabilitation of existing plant, could easily result in substantially improved prospects for output, efficiency, export diversification and profitability if the process of transfer were well regulated and macroeconomic policy-reforms were sustained with donor financing support at current levels. These are, of course, optimistic assumptions. But they would need to apply in the case of any attempt to proceed with inducing a process of durable structural change. In Zambia it is difficult to envisage such a process being launched and sustained in the absence of interventions such as those of the proposed Privatization Fund. The notional 10% limit applied to the extant stock of NCBD would suffice as a first tranche. Leveraging $130 million with a further $30 million, supplied through the equity investment arms of the major multilateral banks and private portfolio funds aimed at emerging markets, could result in facilitating investments totalling $640-700 million providing that the Privatization Fund were limited to investing no more than 20-25% in any privatized entity. Moreover, the establishment of such a fund would lend structure and discipline to the process of privatization and would provide GRZ with a valuable option for downstream development of the domestic capital market when the Fund gradually sold its own holdings to the public at a later date.

5.03 In the Zambian case it would be worthwhile to consider setting aside upto 10% of the converted proceeds of official debt swaps for social expenditures providing the necesary budgetary offsets could be arranged. The impact of such expenditures is difficult to gauge unless detailed studies were done of the types of projects and activities that were to be funded. Targetted use could help to focus on mitigating the high social costs of adjustment which are being incurred, especially by the urban low-income and unemployed groups in Zambia.

1 The way in which they have been undertaken has muddied the water for organizing large scale buybacks at a price which reflects Zambia's debt situation more accurately.

2 Though the price has dropped since to around 12-15¢ it remains artifically high partly because Zambia's debt servicing priorities often favour commercial creditors preferred creditors.

3 The Dutch government deployed $2.5 million for funding debt-equity swaps as an experiment in 1987-88 but owing to unsatisfactory experience abandoned the scheme very quickly.

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MEMORANDUM

December 9th, 1991

TO : THE HON. E KASONDE
MINISTER OF FINANCE, GRZ

FM : PERCY S MISTRY
UNCTAD CONSULTANT

SUB : ZAMBIA - OFFICIAL DEBT CONVERSION FOR PRIVATIZATION

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1 Further to our conversation on the afternoon of December 7th, I have attempted to outline in this brief "aide-memoire" an idea which would facilitate the process of privatization in Zambia while simultaneously contributing to a reduction of its external debt burdens. Basically it involves establishing a special Privatization facility (SPF) financed by new money from agencies of key donor countries (such as Sweden) as well as by conversion of residual bilateral debt after cancellation. The latter component will involve convincing all of Zambia's bilateral creditors to convert, (after cancellation of the maximum amount they are willing to contemplate), a large portion of the residual stock of bilateral debt into local currency to fund the SPF. The SPF would enable Zambia to catalyse and accelerate its intended program of public asset sales.

THE CONVERSION CONCEPT AND ITS BACKGROUND

2 Private debt (both that held by commercial banks and trade suppliers), has, since late 1984, been used in several instances for Debt-Equity Swaps (DES) involving either the creditor himself or a Third-Party to convert debt claims into equity investments in debtor countries. DES programmes have been employed to some extent or other in over 30 indebted countries, the most successful examples being Chile and Mexico. Official debt (ie. bilateral) has, since 1986, been used on an occasional basis to fund "debt-for-development swaps" (DDS) which employ local currency proceeds to be used for financing environmental or social programs. The Craxi Report on Debt suggested more extensive conversion of official debt for both DES and DDS operations as a means to reduce debt and debt service burdens and, at the same time, catalyse a revival of investment in severely in debt-distressed economies. UNCTAD has recently launched a project to investigate : operational problems; technical and legal complexities; as well as the potential benefits, that might be associated with the

launching of significant official debt conversion (ODC) programs for DES and DDS in a selected number of debt distressed countries.

3 Preliminary findings of the UNCTAD Project indicate that a handful of creditor countries have already undertaken official DES operations. These include Brazil (in Bolivia), Mexico (in El Salvador, Costa Rica and Honduras) and Belgium (in a few African countries). In all these instances official debt has been sold or exchanged to/with a third party which has then proceeded to make equity investments. Since mid-1990, the Paris Club of OECD creditors has included in the rescheduling agreements of several lower middle-income countries a specific clause permitting ODC operations on a limited scale. Poland and Egypt have both requested their creditors to exercise this option and a small number of creditors have done so.

4 ODC operations therefore, have already become an explicit option on the debt reduction menu. The challenge now lies in using this option in imaginative ways to tackle the different problems faced by low-income debtor countries in the most constructive and effective manner. In the case of Poland the government has asked creditors to use the proceeds of conversion in funding a large Environmental Facility. Egypt has asked its OECD creditors to use the proceeds for its Social Fund. In both instances some creditors (notably France, Holland and Japan) have expressed an interest in using a proportion of the conversion proceeds to make equity investments. These early examples suggest that Zambia may well benefit from requesting a similar conversion of official debt to finance the proposed SPF. Zambia could, of course, choose to deploy these proceeds for social purposes. But for various reasons, not least among them being prospective inflationary consequences I am inclined to disfavour these other options and to focus on addressing the privatization priority. For its own reasons the present government may share that priority given the urgency of stemming the continuing drain on public resources caused by the operating losses of parastatals, the need to revive investment and efficiency in the productive sectors of the economy, and the urgency of inducing a strong supply-side respon: after years of unsuccessful adjustment which has focussed too heavily on demand compression.

HOW WOULD THE CONVERSION WORK AND WHAT ARE ITS IMPLICATIONS?

5 A request by Zambia to its official creditors to consider conversion of a significant portion of residual bilaterial debt stocks (after maximum cancellation has been availed of) is likely to trigger reactions which will initially be cautious and sceptical. Several concerns and technical difficulties are likely to be raised. In my view virtually all of these problems can be dealt with satisfactorily with Zambia having the weight of argument on its side to make a persuasive case of the SPF. These arguments can developed at length in a later phase should Zambia choose to see UNCTAD's assistance in Phase II of the UNCTAD Project to help it develop a detailed ODC Scheme.

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GRZ

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6 In providing converted debt claims for investment in privatized enterprises bilateral creditors could exercise any of the following options:

(i) They may simply wish to make outright sale of residual claims to an independent third party at the secondary market price (or some other Proxy) as the most convenient and least costly (administratively) option for them. It would then be up to the third party to use these proceeds for investing in Zambian privatization on a case-by-case basis.

(ii) They may wish to transfer the claims (from the export credit agency or the aid agency concerned) to their own bilateral investment arms (eg. CDC in the case of the UK, DEG in the case of Germany and so on) and have these corporations make investments directly in privatised enterprises on the usual basis. Clearly such arrangements would involve appropriate internal compensation offsets to be made. But that is a matter for the creditor government and not Zambia to resolve. (The UNCTAD Project has, of course, explored in a premilinary fashion some of the technical problems that are likely to arise but none of them are insuperable).

(iii) They may wish to contribute their local currency proceeds (generated by conversion of their debt claims) into the SPF, in which they would have and exercise proprtionate owner- shares ship claims as passive portfolio investors. The SPF would be established with the participation of investors such as IFC, Swedfund, IFO, FMO which might provide new money. It would be managed professionally and Agencies providing, new money such as the IFC, Swedfund and others, as well as those contributing converted debt would be represented in the Board of SPF.

7 Of these options, the third is likely to be most advantageous for Zambia and its bilateral creditors. The reasons for this assertion can be expatiated upon at length at a later stage.

8 Looked at from Zambia's view point, what are the advantages of ODC for privatization? They include the following:

(i) At present Zambia's bilateral debt stock exceeds $3 billion inclusive of accumulated arrears. Even with maximum cancellation it is inconceivable, at least in the medium-term, that more than $1.5 billion will be cancelled outright. Upon cancellation of such a large portion, bilateral creditors will expect Zambia to service the remainder much more assiduously than it has serviced outstanding bilateral debt in the past. In my view a balance as large as $1.5 billion cannot be serviced by Zambia, at the same time as it is servicing a heavy burden of multilateral and private debt, with any degree of comfort. GRZ will need to seek to reduce the residual debt stock by at least a further $500 to 700 million. Assuming that creditors can be persuaded to accept a conversion price of about 25 cents on the dollar for residual debt (allowing for the fact that Zambian private debt is presently trading at 15-18¢) that would result in a conversion of $500 million generating about $125 million worth of Kwachas at the going exchange rate: the kwacha equivalent thus being substantial enough to underpin a good start to the intended privatization program. The new money component might provide a further $30-50 *million*. Clearly the providers of new money would need to be given preferential treatment (in terms of representation and voting power in SPF) over the providers of converted debt.

(ii) The disbursement of $125 million worth of kwacha in one shot by BOZ would clearly have undesirable liquidity creating and inflationary effects. These could be countered by the issuance of 5-year Equity Investment Bonds encashable in five tranches (as in Jamaica) but bearing a relatively low rate of interest and being non-negotiable except for investment in privatized entities. Because public-asset sale proceeds will accrue to the Treasury as revenue, there is likely to be an anti-inflationary effect resulting from the reduction of the budget deficit caused by extraordinary revenue inflow. Moreover, the Treasury is likely to benefit in two other ways. First, it will no longer need to make expenditures to cover the operating or capital losses of sold parastatals. Second, it will no longer need to raise, borrow or create kwacha to finance debt service on residual external debt obligations which have been converted. The challenge is to design a programme which, in financial terms, will have either a neutral impact on money supply or even a beneficial one (ie. where the net returns to the Treasury from all three sources exceed the outflows that would otherwise have occurred). That is a task for the next stage of technical assistance.

(iii) An ODC program to help fund the SPF is advantageous for another reason. In its present circumstances Zambia does not present an attractive investment opportunity for foreign portfolio or direct investors. Though it undeniably has considerable future potential it is plagued by many present problems which are unlikely to be resolved quickly. Merely changing the Investment Act and being less hostile to foreign investors is not going to be sufficient to overcome the sustained loss of reputation which Zambia has suffered (since achieving independence with the foreign and domestic investor communities.
To attract the level of investment necessary to enable full-scale privatization will require extraordinary efforts as well as the type of resources which the proposed SPF could provide.

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(iv) Providing that the proposed SPF is structured and financed properly it could also bring to Zambia a package of specialized expertise in various aspects of privatization and provide a vehicle through which investor interests in restructuring public enterprises prior to privatization could be discussed and expressed.

(v) The SPF, which would provide a useful nucleus for financing privatization, is likely to attract interest from a wider range of foreign and domestic investor than would otherwise be attracted to invest in Zambia. These investors might well provide additional foreign exchange funding through investments in cash or kind for the restructuring and expansion of privatized enterprises.

(vii) The proposed SPF also has the advantage of enabling foreign investment in privatized Zambian enterprises through a difficult interregnum on a friendly, non-threatening basis. Assuming that present efforts to stabilize the economy and to revive sustained growth pay off in the medium term the SPF could gradually divest its equity holdings in privatized enterprises in the Zambian and international capital markets on a basis mutually acceptable to equity holders in SPF and to GRZ.

9 The proposal has other advantages as well which need not be elaborated upon at this preliminary stage. Some of the perceived "disadvantages" might include:

(i) Concern on the part of GRZ that foreign creditors becoming foreign share-holders in the Zambian economy on a significant scale could raise some of the same political and nationalist sensitivities that were so sharply felt immediately after independence. This would be particularly problematic if only the large creditors dominated the privatization programme through SPF.

(ii) Concern about the potential inflationary impact of a large-scale official debt-equity swap progam (these concerns are in my view overplayed).

(iii) Concern that requesting bilateral creditors to consider a large conversion program might deflect their attention from cancelling as much of the debt as possible.

(iv) Concern that the SPF will not bring in sufficient "new money" for investment in the Zambian economy.

(v) The prospect that an official DES program might displace emergent private sector interest in privatization through conversion of outstanding private debt (in Theory, once an SPF is set up there is no reason why the private creditors should be excluded).

10 Thinking carefully about these perceived disadvantages will probably reveal them to be insufficiently serious to merit abandoning the idea of an SPF set up as suggested. These concerns clearly need to be addressed in designing a properly structured conversion program which dovetails with a well planned and properly sequenced privatization effort.

NEXT STEPS

11 Based on careful consideration of the points articulated herein at policy-making and technocratic levels within GRZ, the government should, if it decides to proceed with the idea:

(a) Inform UNCTAD, through the local UNDP Resident Representative of its desire to seek assistance in Phase II of the UNCTAD Project for formulating an ODC program for Zambia aimed at setting up the SPF.

(b) Advise its multilateral interlocutors and its major bilateral creditors of its interest in an ODC scheme for privatization and inform them of the steps being taken to develop the blue print for such a scheme.

(c) Advise other key donors (such as Sweden) who are not major bilateral creditors, because they wrote off their claims a long time ago, of GRZ's desire to pursue this opportunity and seek their assistance for augmenting UNCTAD/UNDP efforts and to encourage them to participate in the SPF.

PROSPECTS FOR OFFICIAL DEBT CONVERSIONS: THE CASE OF JAMAICA

i. An integral part of the UNCTAD Project was to consider the applicability of commercial and non-commercial conversions of official debt in a few specific country cases. Time and budget constraints precluded coverage of as wide a sample of middle and low-income indebted countries as would have been desirable. This case study focuses on Jamaica. It provides in its five main sections: a broad contextual overview of economic developments; characteristics of the Jamaican debt problem; a review of actions taken to ameliorate the debt burden so far; the prospects for official debt conversions; and, finally, their likely impact on the future of Jamaica.

I The Development of the Jamaican Economy

1.01 Jamaica is among the larger Caribbean islands with a GNP of about $3.5 billion (1990), a population of just over 2.4 million growing at about 1.4% annually. Over the period 1965-90 the economy has suffered a negative growth rate of -1.3% annually, with per capita GNP having remained unchanged in nominal dollars over the last 15 years. Yet, Jamaica is well endowed with natural agricultural and mineral resources, has a relatively well-educated and skilled labour force (with substantial emigration of high level manpower), enjoys proximity and access to North American markets and has a fairly sophisticated financial system with respectable levels of domestic savings. Its performance on social indicators stands in sharp contrast to its desultory economic record though the relentless decline in its economic fortunes is now having severe perverse effects on the island's internal security and social fabric. The economy, saddled by an onerous debt burden incurred in the 1970s and 1980s (discussed later), is excessively prone to exogenous shocks, not having diversified rapidly enough from primary to manufactured exports. It remains highly sensitive to international price and demand changes for coffee, sugar, bananas and bauxite and, on the import side, vulnerable to movements in the oil price and to volatility in global interest and exchange rates on its debt service account. In terms of output the principal contributing sectors are tourism (25% of GDP), bauxite mining and processing (25%) and manufacturing (20%). Agriculture absorbs the largest amount of employment (35% of the labour force) though it accounts for only 5% of output. Other services (finance, construction, transport, education, health care and government services) provide for the remaining 25% of output.

1.02 From independence in 1962 to the first oil shock in 1973 the economy grew at an average real 5% annually with a per capita income growth rate averaging 3.5%. Private direct foreign investment in mining, tourism, import-substituting manufacturing and plantation agriculture contributed substantially to this performance within a stable domestic financial regime. But, with new foreign investments concentrated largely in capital intensive mining and manufacturing, net employment grew hardly at all. When the first oil shock hit, the economy remained largely foreign-owned and unemployment was rising; coupled with the turbulent undercurrents of politics in the Caribbean these factors resulted in the election of the first Manley government on a platform of socialism and nationalization. The consequence of radically interventionist domestic policies, further oil shocks, a sharp decline in tourism and the deep global recession of 1979-81 resulted in a substantial economic contraction between 1973-82 (when the debt crisis erupted) despite the temporary buoyancy of Jamaica's own commodity export prices (though with much reduced output and demand) during part of that period. Over the decade GDP declined by over 22% in real terms while government consumption rose by 20%; the fiscal deficit rose to 15% of GDP with the bulk (60%) being monetized resulting in much higher inflation and an overvalued exchange rate coming under considerable pressure. Policies intended to tackle unemployment and contain foreign economic dominance through nationalization, expanded social spending, trade and price controls, sharp hikes in marginal tax rates, and a government capital spending programme, thus led to an over-extended public sector unconstrained by financial discipline. The overdose of populism resulted in a disruption of production, a collapse of confidence, sharply reduced inward investment flows and the flight of both capital and skilled professional manpower. Real interest rates were highly negative and incentive structures distorted with an anti-export bias. Import and price controls resulted in further distortions. Jamaica's deteriorating external account balance was financed by drawing down reserves and external borrowing. In 1980 Jamaica faced an acute balance of payments crisis reflecting the unviability of its economic policies and structure.

1.03 The severity of the crisis (and the change in global political wind) led to the 1980 election of the market-oriented Seaga government which introduced a sweeping economic liberalization programme. Import licensing was eliminated with non-tariff barriers being replaced by gradually diminishing tariffs; export of primaries was encouraged by focussing on lowering production costs and recapturing lost market share; tourism and non-traditional manufacturing were promoted vigorously through investments in new facilities, more effective marketing, export processing zones and the expansion of freight and passenger transport facilities; and a programme of large-scale privatization was launched. The exchange rate was made more competitive through foreign exchange auctions coupled with a range of modified fiscal (tax and expenditure control) and monetary policies aimed at controlling domestic inflation and encouraging a higher level of financial savings. But the response of the economy -- in terms of growth and structural change -- to these policy reforms has been disappointing; in large part because of the extraordinarily large proportion of savings and output extracted by creditors by way of debt service. Between 1980-85 the economy did not grow at all, the fiscal deficit remained excessively high (at about 16% of GDP), inflation kept rising and the external current deficit remained at 14% of GDP. Over that period of intense adjustment, external debt grew exceptionally rapidly from under $2 billion to over $4 billion with the debt service ratio rising from 30% to 70% before rescheduling and from 26% to 45% after rescheduling. Between 1986-90 the economy began to turn around registering real growth of over 3% annually over those five years, despite the considerable devastation caused by Hurricane Gilbert in September 1988. By 1990, the public sector deficit had been reduced to 3.5% of GDP and the external deficit to 7% . Increased foreign capital inflows and flight capital repatriation resulted in the external debt stock stabilizing at about $4.6 billion. But the economy suffered a sharp reversal in 1991 as a result of the oil price increase and a precipitate drop in tourism arrivals immediately preceding and following the Gulf War. Though tourist arrivals have recovered since, they have been affected by prolonged recession in Jamaica's main tourism markets of North America and Europe. An acute shortage of foreign exchange in 1990-91 has led to a slide in the Jamaican dollar with an instantaneous impact on inflation -- which has begun rising rapidly again (22% in 1990 and over 50% in 1991) resulting in further pressures on the exchange rate which is now market determined.

1.04 The continuing pain and fatigue of adjustment over a decade resulted in the Seaga government being replaced by a reformed, second Manley government in 1989 which is continuing with the same free-market policy orientation. After one decade of post-independence stability and growth the Jamaican economy has been subject to intense (and opposite) changes in its second and third decades of development oscillating from a sharp left policy orientation in the 1970s to a sharp right posture through the 1980s. Yet it enters the 1990s not substantially changed in structure, in a somewhat precarious condition, and still vulnerable to exogenous influences. Policy reforms have resulted in an economy which is more open than in the 1970s (though not much more so than in the 1960s) with a gradually changing export base including non-traditional agricultural and manufactured items but with traditional exports remaining the mainstay of forex earnings. However, Jamaica's terms of trade, which deteriorated dramatically in 1990 after improving between 1987-89, are not expected to improve substantially over the medium term; powerful, pro-active policies to expand and diversify export earnings will therefore remain necessary. Jamaica will need to attract a larger volume of foreign private capital for new investment and through public asset sales. More importantly, it will need imaginative approaches to debt reduction and relief than provided by normal reschedulings if its debt service and interest payments to GDP ratios are to improve sufficiently for the structure of the economy to change and respond more durably to policy reforms.

II The Jamaican Debt Problem

2.01 Part of the reason for Jamaica's failure to respond adequately to strong adjustment discipline is that too large a proportion of the gains accruing from economic liberalization and reform has been exported to external creditors through debt service. A larger portion of the returns, if retained within the domestic economy (through large debt conversion programmes similar to Chile's), would almost certainly have created a more robust base, less vulnerable to external shocks and created genuine popular (political) sentiment in favour of continued liberalization and reform. Appreciating the basis for this assertion requires deeper understanding of the Jamaican debt problem which is portrayed in Table 1 overleaf.

2.02 As is evident, Jamaica's external debt in dollar terms has nearly quintupled in 20 years but doubled as a proportion of GNP, increasing from less than 65% to over 132%. Changes in the structure of its debt are even more revealing. Debt to bilateral creditors (mainly OECD countries) of over $2.1 billion in 1990 is now 74 times larger than it was in 1970 and 3.5 times larger than in 1980. The main reason is not additional net external borrowing from bilateral sources for investment between 1980-90 but the impact of exchange rate movements between 1985-90 and capitalization through reschedulings. Multilateral debt has ballooned in much the same way with borrowings from the IMF rising to a peak of nearly $700 million by 1985 but diminishing to half that amount by 1990; though this drop was offset by a rise in the outstandings owed to multilateral banks (mainly the World Bank, the Inter-American Development Bank and the Caribbean Development Bank) which largely financed Jamaica's repayments to the Fund.

TABLE 1:

THE STRUCTURE OF JAMAICA's EXTERNAL DEBT

(Amounts in millions of US Dollars)

		1970	1980	1985	1990
Total External Debt: of which:		1,057	1,903	4,068	4,598
Long-term	Bilateral:	29	626	1,732	2,140
	Multilateral Banks:	30	285	750	1,176
	IMF:	0	309	693	357
	Total Multilateral:	30	594	1,443	1,533
	Private guaranteed:	101	510	640	557
	Pvt. unguaranteed:	822	75	66	34
	Total Private (LT):	923	585	706	591
Short-Term:	Private	75	98	187	334
Memo:	Total Pvt LT+ST:	998	683	893	925

Source: World Debt Tables 1991-92[1]

2.03 Long-term debt to private creditors has dropped substantially over the last 20 years, though the total amount of debt owed by Jamaica to the private sector (including short-term debt) has, except for a trough in 1980, remained remarkably stable in dollar terms (at around $900 million). In relative terms it has declined from 95% of the total debt stock in 1970 to just 20% by 1990. Thus the credit risk in financing Jamaica has been shifted in two ways: (i) from private external creditors financing unguaranteed private borrowers in Jamaica to the government, as a result of both large scale nationalizations in the 1970s and the provision of government guarantees for previously unguaranteed debt; and (ii) from private to official creditors over the 1970-90 period.

2.04 It is remarkable that while unguaranteed long-term private creditors took nearly 80% of the total credit risk on Jamaica's external debt in 1970 that proportion had declined to less than 0.75% by 1990. Equally, while official creditors took less than 6% of the total external credit risk in 1970, this proportion had increased to nearly 80% by 1990 with bilateral creditors alone accounting for 47%. That movement reflects the dramatic deterioration in creditworthiness which Jamaica has suffered over the last two decades; but it also reveals that 33% of Jamaica's debt structure is now owed to preferred, multilateral creditors and is, for that reason, much more rigid and inflexible in terms of its reschedulability; although as indicated there has been recourse to tacit refinancing within the multilateral creditor community. In terms of debt stocks, commercial banks were exposed for a mere $300 million in 1990, or for less than 7% of the total debt stock; unusually low for a middle-income country located in the Western hemisphere. The main reason was that the tenure of the Manley government throughout the 1970s created a climate in which even the relatively unconstrained commercial banks were extremely hesitant to lend. The remainder of private debt is owed to suppliers from creditor countries whose claims have either not been guaranteed by export credit agencies (ECAs) in their home countries, or have been serviced by Jamaica with sufficient profiency to avert their movement into the bilateral category as a result of guarantees from ECAs being called.

2.05 So much for the picture on how Jamaica's external debt stocks have materialized. What of its debt service and resulting negative net transfer burdens? That situation is depicted in Table 2 below. Jamaica's total debt service burdens did not increase significantly between 1970-80 even though the debt stock nearly doubled largely because there was a massive substitution and expansion effect. The precipitate reduction in debt owed to private unguaranteed creditors was coupled with a commensurate increase in debt owed to official creditors whose amortization terms were longer and softer. Thus though the interest burden on the increased debt stock increased proportionately (it more than doubled) the debt service effect

TABLE 2:

JAMAICA's EXTERNAL DEBT SERVICE PAYMENTS

(Amounts in millions of US Dollars)

			1970	1980	1985	1990
Total External Debt Service:			257	280	566	750
of which:		Principal	187	120	278	464
		Interest	70	160	288	286
Long-term	Bilateral:	Principal	1	26	71	103
		Interest	1	29	73	88
	BDS		2	55	144	191
	Multilateral: Banks	Principal	1	10	28	102
		Interest	1	16	46	86
	MBDS:		2	26	74	188
	IMF:	Repurchases	0	19	62	111
		Charges	0	23	55	34
	FDS		0	42	117	145
	Total Multilateral:	Prin	1	29	90	213
		Int	1	39	101	120
	MDS		2	68	191	333
	Private guaranteed:	Prin	4	55	48	95
		Int	7	69	89	51
	PGDS		11	124	137	146
	Pvt. unguaranteed:	Prin	164	10	14	8
		Int	54	7	4	3
	PUDS		218	17	18	11
	Total Private (LT):	Prin	168	65	62	103
		Int	61	76	93	54
	PDS		229	141	155	157
	Short-Term:	Net Prin	17	0	55	45
		Interest	5	16	22	24
	SDS		22	16	77	69

Source: World Debt Tables 1991-92

was ameliorated by a $67 million reduction in amortization payments as a result of substitution. The debt service ratio in 1970 (though the data are somewhat unreliable) was nearly 45% (with an interest payments to GDP ratio of 5%). The DSR dropped in 1980 to a healthier 19%, since when it has again risen to 45% in 1990 with the interest payments to GDP ratio rising to over 8%. The latter ratio indicates the extent to which the economy is being sacrificed in terms of current earnings being exported to meet current account payment obligations on debt; the amount exported by way of interest exceeding the 1990 growth in GDP by 5%.

2.06 Moreover, though debt service payments in 1970 were relatively high the negative net transfers on debt account (-$54 million) were more than offset by inflows on the private investment capital account (over $150 million). In 1980, however positive net transfers on the debt account (+$130 million) were offset by private capital outflows by way of repatriation and capital flight although it is unclear precisely to what extent. In 1990 net transfers on the debt account were negative and large (-$272 million or just under 8% of GDP) while private capital flows showed an unprecedented net surplus of about $208 million, still leaving a net 2% of GDP being extracted by creditors. Thus even under highly propitious conditions on the private capital account, the net effect on Jamaica in terms of real per capita income growth in the domestic economy was a standstill.

2.07 The conclusion which emerges from the foregoing analysis of growth in Jamaica's debt stocks and debt service burdens is that there is something seriously wrong with the financial design of structural adjustment programmes (and with the financial programming exercise which dictates the design) if the extent of debt servicing, after rescheduling, and the substantial negative net transfers (after unprecendented private capital inflows) remain as high as they do. Under such circumstances profound questions are raised about whether: Jamaica's vulnerability to external influences can indeed be quickly reduced; its economic structure can be transformed, and it can exit the devaluation-inflation spiral in which it seems to be trapped. Clearly the multilateralization of such a large portion of its debt (33%) and an even larger portion of its debt service obligations (45%) as a direct consequence of its adjustment efforts has deprived it of a considerable amount of flexibility in its ability to manage its debt profile. Until prospects for relief on multilateral obligations become a reality (and such prospects seem remote) the burden of further restructuring and relief must necesarrily, therefore, fall on bilateral obligations and on debt service to private creditors.

2.08 In the case of official bilateral creditors the extent of relief is demonstrated by continuous reschedulings which have enabled annual debt service to bilateral creditors to be maintained at around 25% of total debt service; but at the expense of accretion in the share of bilateral debt stock (from 33% in 1980 to 42% in 1985 to 47% in 1990). The problem is thus being deferred for a later reckoning rather than being resolved. Conventional Paris Club reschedulings which continue in the same vein do not appear to be leading to a sensible conclusion. They are only building up Jamaica's bilateral debt stock to a point where, in the absence of timely well-structured programmes of debt conversion, large-scale cancellation will be the only option left open to creditors and debtor alike.

2.09 Though steps have been taken to reduce private commercial bank debt through a carefully designed and capably managed debt capitalization programme, Jamaica has managed to reduce its London Club type debt stocks to commercial banks by only about $100 million between 1985-90 and by $55 million to suppliers between 1987-90. But it has not managed to reduce its debt service obligations to private creditors between 1980-90 although the interest component of debt service has declined sharply between 1985-90. In 1990 private creditors (long-term, guaranteed) accounted for over 19% of total debt service and 18% of interest service although their stock of debt acounted for only 12% of the total. The scope for further relief (mainly through conversions) on the private debt frontier therefore remains large in theory but in practice it is constrainedby the IMF-imposed cap on debt-equity swaps under tightly controlled targets for money supply expansion.

III Efforts Made to Provide Jamaica with Debt Relief

3.01 As observed earlier, in the absence of reschedulings of its London and Paris Club debt, Jamaica would have been confronted with meeting debt service obligations amounting to over 70% of its export earnings. Since that would have proven impossible, the official and private reschedulings undertaken were perhaps more in the interests of creditors to reach agreement on, than in the interests of Jamaica (as the contrasting way in which Costa Rica managed its debt strategy would seem to suggest). To a large extent these reschedulings, particularly for bilateral debt, have been driven also by the need to create headroom for maintaining debt service obligations to multilateral creditors, particularly the IMF.

3.02 Official (Paris Club) Reschedulings: Since 1984, Jamaica has undergone six Paris Club reschedulings on official bilateral debt owed to OECD members (with a cut-off date of 1, October 1983). These consolidations have included arrears, as well as previously consolidated debt, with 100% of debt falling due being consolidated in each of these exercises. The consolidation period for current maturities in these rescheduings has varied between 12-18 months and, until the last resched-uling in July 1991, repayment terms were generally over maturities of 8-9 years with 4-5 years of grace. The last rescheduling agreement also contained a conversion clause, permitting creditors to exercise the option of converting upto $10 million or 10% of the outstanding debt stock (whichever was the higher) of non-concessional debt and upto 100% of concessional debt outstanding at the beginning of the consolidation period. These reschedulings are tabulated below:

TABLE 3:

JAMAICA's PARIS CLUB RESCHEDULINGS

Date of Agreement	Cut-Off Date	Consolidation Period		Amount Consolidated	Repayment Terms			
		Begin	Length (Mths)		Maturity		Grace	
					Yrs	Mth.	Yrs	Mth
16.07.84	01.10.83	01.01.84	15	$ 132 m	8	5	3	11
19.07.85	"	01.04.85	12	$ 66 m	9	6	4	0
05.03.87	"	01.01.87	15	$ 188 m	9	5	4	11
24.10.88	"	01.06.88	18	$ 147 m	9	3	4	9
26.04.90	"	01.12.89	18	$ 116 m	9	3	4	9
19.07.91	"	01.06.91	13	$ 97 m	19/14	6/6	8/4	9/9

Source: World Debt Tables 1991-92

3.03 In addition to Paris Club reschedulings, Jamaica has restructured its obligations to the Venezuelan Oil Facility seven times between 1983-90. In 1990 the Canadian government forgave $94 million in concessional debt. In 1991, agreements reached under the Enterprise for the Americas Initiative, resulted in Jamaica reducing its PL480 obligations to the US by $216 million with the remainder ($55 million) bearing concessional interest rates payable in local currency to fund environmental projects jointly agreed by the Jamaican and US governments. As observed earlier, the net result of these bilateral reschedulings has been to maintain bilateral debt servicing at around 25% of total debt servicing while ensuring a steady increase in dollar payments to Paris Club creditors. Absent other pressures these relief measures might have been adequate. But, given the imperatives of maintaining full debt service to multilateral and private creditors, the relief provided by the Paris Club has been largely offset and has proven inadequate. As will be discussed in the next section, the type of approach which the Paris Club needs to take in the case of Jamaica should be modelled on the Poland/Egypt model or, at the very least, the application of Toronto Terms to debt stock reduction, below market interest rates and much longer maturity/grace stretch-outs.

3.04 Private Creditor (London Club) Reschedulings : In addition to these official debt reschedulings, Jamaica has restructured long-term debts owed to commercial banks six times between 1981-90. The details of these are shown overleaf.

TABLE 4:

JAMAICA's LONDON CLUB RESCHEDULINGS

Date of Agreement	Consolidation Period		Amount Restructured	Repayment Terms				Interest Margin
	Begin	Length (Mths)		Maturity		Grace		
				Yrs	Mth	Yrs	Mth	
April 81	01.04.79	24	$ 126 m	5	0	2	0	2.000
June 81	01.07.81	21	$ 89 m	5	0	2	0	2.000
June 84	01.07.83	21	$ 164 m	5	0	2	0	2.500
Sept 85	01.04.85	24	$ 359 m	10	0	3	0	1.875
May 87	01.01.87	39	$ 366 m	12	6	9	0	1.250
June 90	01.01.90	48	$ 315 m	14	0	0	6	0.8125

Source: World Debt Tables 1991-92

These reschedulings have resulted in fairly significant reductions in total debt service due to commercial banks between 1980-90. Total debt service to banks increased from $70 million in 1980 to a peak of $122 million in 1983 since when they have declined steadily to a level of only $37 million in 1990, comprising mainly interest payments with only $1 million in amortizations. The 1990 London Club agreement resulted in the deferral of principal payments of $54 million with $18 million in such payments, which were due to be amortized in 1990 being deferred.

3.05 By contrast, debt service on long-term debt held by private suppliers has increased substantially, rising from $14 million in 1983 to $109 million in 1990, thus effectively resulting in no relief at all on the total private creditor account. It is clear that in future private debt rescheduling or reduction efforts, private debt owed to suppliers is going to have to be dealt with in more imaginative ways rather than through large amortization payments (which have increased from $11 million in 1983 to $94 million in 1990) resulting in gradually reducing outstanding obligations to suppliers (reduced by $55 million over the last four years from a peak of $315 million to $260 million in 1990 and to $166 million in 1991, if there has been no further net borrowing from this category of creditor). Jamaica's rapid reduction of suppiers' credit obligations through straightforward amotization raises questions about its debt servicing priorities and about whether reductions in reschedulable London Club debt being matched by commensurate increases in suppliers credit debt may not reflect a phenomenon of debt switching by the same group of private creditors to forms of debt which have a higher likelihood of being serviced.

3.06 In addition to these official and private reschedulings, net new money flows (in terms of net disbursements of principal) through the last decade have contributed in small part to helping Jamaica meet debt service obligations without running up arrears until 1990;[2] but this has happened at the expense of incurring further and increasingly unmanageable debt obligations. Between 1983-90, net disbursements of principal (mainly from multilateral creditors) and reschedulings (which are counted as net flows for these statistics) amounted to about $744 million (or an annual average over the period of $93 million). But when accumulated interest payments of over $2.1 billion made by Jamaica to its creditors are taken into account, net transfers (on the debt account) have been negative, amounting to a cumulative -$1.4 billion betwen 1983-90. That amount is equivalent to roughly 6.5% of Jamaica's cumulative GDP over the same period. Such a large outward transfer of real resources throughout the 1980s, coupled with the effect of capital flight and the net effect of external shocks (and gains) which Jamaica has experienced intermittently during the 1980s, helps to explain why it has been so difficult to stabilize the economy and place it firmly on a durable growth path. It suggests that though creditors may feel that their debt relief efforts have provided Jamaica with sufficient breathing space to meet its obligations on more realistic lines, the overall impact of these relief efforts in restoring the economy to sound health, despite impressive adjustment and reform efforts, has been negligible.

IV The Scope for Official Debt Conversions

4.01 It is in the context of these developments in Jamaica's economy and external debt that the scope for conversions of official bilateral debt needs to be judged. Clearly, putting Jamaica on a sounder economic footing will require bolder efforts at reducing debt stocks and debt service and restoring the flow of sustainably positive net transfers from the creditor community as a whole until such time that Jamaica's income and output levels permit affordably negative net transfers. The two main areas in which attention on debt and debt service reduction must be focussed are in reducing:

(i) stocks of <u>bilateral</u> debt and attendant debt service obligations and (ii) stocks of non-bank private credit obligations through conversion rather than amortization. The estimated bilateral debt stock at the end of 1991 is thirteen times the size of outstanding obligations to private suppliers. Half of it is concessional and can be serviced if amortization ayments are lengthened further. The other half (over $1 billion) is non-concessional and expensive to service. Also the cut-off date for reschedulable official debt goes back ungenerously to 1983 when the bilateral debt stock was 60% of its present level. It is on this large block of accumulated (bilateral non-concessional) debt that attention for conversion ought to be focussed first; although means of reducing the large amounts of annual amortization payments to private suppliers need equally urgent consideration. Prospects for the conversion of official debt stocks need, however, to be assessed against the experience of debt conversions which have taken place so far under Jamaica's debt capitalization programme.

4.02 Jamaican Experience with Debt Conversions:[3] Under terms agreed to in the 1987 London Club rescheduling agreement, the Government of Jamaica (GOJ) instituted a debt-equity conversion programme (DECP) in the middle of that year. It aimed to convert $185 million of commercial bank long-term debt (or upto half the outstanding amount which, in 1987, stood at $378 million[4]). The programme, which was constructed with the assistance of N.M. Rothschild and marketed by both Rothschild and (the now defunct) Libra Bank got off to a fitful start and has been modified along the way. Applications in excess of $185 million were received from commercial banks by June 1988 but the government decided in July to cancel the original programme and redirect $60 million of the available debt to its hotel divestment programme (under which foreign investors could purchase upto 25% of the purchase price of government-owned hotels with existing eligible debt) while remaining open to considering small investment projects on an ad hoc basis. By the end of 1988 only $9.3 million had actually been converted with the amount increasing to $15 million as of May 1989. Commercial banks also found it hard to accept the IMF imposed limits on the conversion programme arguing that the immediate impact of the conversion programme on monetary expansion would be limited[5] because: (i) the local currency payments were made with domestic debt instruments (Equity Investment Bonds - EIBs) having the same amortization schedule as the original debt with the EIBs issued amounting in 1988 to a mere J$49 million; (ii) the only source of monetary expansion from the conversion programme would be generated by the interest rate spread adjusted for variations in the exchange rate between the EIBs (which in 1988 earned 14%) and the original loans at LIBOR + 1.25% -- in 1988 this spread added J$2 million to current government expenditures or 0.10% of total government outlays;[6] and (iii) conversions aimed at privatized assets, such as hotels, involved no government outlays with the net impact of such conversions on government finances being positive.

4.03 It is unclear whether these concerns registered or not. But, the conversion programme was modified after the 1990 London Club rescheduling.[7] Both Tranche A (i.e. those maturities falling due for amortization before the year 2000) and Tranche B (amortizations between 1998-2004) maturities became eligibile for conversion whereas only Tranche A was eligible previously. The eligibility of investors was expanded beyond non-residents to include Jamaican residents as well.[8] And the eligible investments were liberalized considerably to include almost any type of investment in listed or unlisted Jamaican companies although the purchase of Jamaican assets through the debt conversion programme has to be undertaken through a registered Jamaican investment vehicle.[9] Repatriation of capital provided through the DECP is now restricted to a waiting period of three years if the investment is in new facilities in priority sectors or seven years if it is not. Dividends cannot be repatriated for at least three years and must be held in blocked deposit accounts (with any commercial bank but registered with BoJ) bearing market rates of interest or can be re-invested as "related qualified investments" with the approval of BoJ. Assets purchased by investors through the conversion programme can be sold within the restricted period if consideration for the sale transaction does not involve forex acquired through the domestic interbank market. Investors applying to purchase assets through debt-equity conversions are not required to put up fresh new money (forex) in all transactions though such a requirement may be imposed at the discretion of BoJ depending on the type of investment being made. The local assets exchanged for convertible debt include: (i) land or shares in public sector entities or (ii) local currency debt instruments rediscountable by Jamaican financial institutions. In the latter case the Jamaican dollar proceeds are less than the face value of convertible debt with the difference representing a "fee" through which the government can share in the secondary market price discount. The fee is variable subject to a maximum of 10% on Tranche A maturities and 19% on Tranche B.

4.04 These changes have helped. As of mid-1991 about $85 million had been converted for equity investments in some fifty projects, with 73% of the converted amount being concentrated in the tourism (mainly hotels) and mining (alumina) mining sectors and the remainder almost entirely for the manufacturing sector. A further $71 million had been approved for conversion with local currency disbursements of about $10 million having been made for imminent investment. Applications were in process for about $13 million; earlier applications which had now become inactive (for lack of investor interest in pursuing the conversions at this time) amounted to another $70 million. Thus it has taken Jamaica four years to commit 85% of its originally targetted amount of conversions with a further 7% being processed in the pipeline.

4.05 The main restraint on moving ahead faster since 1990 has been the application of fairly tight ceilings (restricted to about $25 million annually) on private debt-equity conversions applied under IMF-monitored adjustment programmes. But three further reasons have contributed to decelerating the pace of debt conversion activity: (i) the rising price of Jamaican debt in the secondary market (which has increased from under 40¢ to over 70¢ between 1987-91) making conversions less attractive as a means of securing local currency vis-a-vis straight forex swaps on the parallel market;[10] (ii) the increasing premium on the parallel market over the "market-determined" exchange rate -- in mid-1991 the premium was over 25%; and (iii) a diminishing amount of Tranche A maturities (now amounting to only $100 million) as a result of the 1990 London Club rescheduling and Jamaica's relatively impressive performance in servicing its commercial obligations, which has perversely reduced the incentive for commercial banks to exercise the conversion option.

4.06 An overall evaluation of the DECP would conclude that the programme stuttered between 1987-89 but picked up steam after the June 1990 rescheduling agreement with the commercial bank creditors. However it has since run out of steam again for the four reasons suggested above. Moreover, and somewhat surprisingly, it has not yet been specifically focussed on large-scale privatizations (except in the case of hotel purchases) such as those involving the full or partial sales of shares in a large public commercial bank, the largest cement company and the sale of Jamaica's telephone company, all of which would have enabled debt conversions on a far larger scale, and with careful design, without the monetary expansion effects so opposed by the IMF. The domestic debt instruments offerred to investors using the DECP have become inordinately expensive for the government to service (and impose much larger budgetary costs than earlier envisaged) because of large, and unforeseen, divergence in the interest rate spread between LIBOR and domestic interest rates caused by rapidly rising, devaluation induced, domestic inflation. Yet, despite these problems, considerable scope remains for carefully designed debt-equity conversions involving the much larger stock of official bilateral debt. Such DECPs could be aimed specifically at accelerating the rate of privatization and of investments now included under the public sector investment programme (PSIP) -- including social sector investments in educational, leisure, retirement and health care facilities -- but which could just as easily be undertaken by the private sector using 'build-own-operate-transfer' (BOOT) financing techniques involving debt swaps. In both instances the DECP could be designed so as to have a neutral or positive budget impact (and therefore monetary impact to the extent that the budget deficit is monetized).

4.07 The Scope for a DECP dsigned for Official Bilateral Debt : Discussions in Jamaica between the author and relevant government officials[11] suggested clearly that there was considerable scope for, and more than 'in principle' interest on the part of the Jamaican authorities, in actively pursuing prospects for an official DECP. No satisfactory reason could be discerned as to why the government had not already pursued with creditors the 10% conversion option included under the June 1991 Paris Club rescheduling agreement which opened the door to a limited amount of such conversions. After all, the official (non-concessional) bilateral debt stock owed to Paris Club creditors amounted to just under $1 billion of which about $700 million was the pre-cutoff date stock providing immediate opportunity for converting between $70-100 million (using the 10% limit) of official bilateral debt into equity or into local currency for designated social and environmental expenditures. The general sentiment on the part of the authorities was that this had not been offered as a 'serious' option by creditors and seemed to be intended more for non-commercial rather than commercially oriented conversions. There was a'wait and see' attitude on the part of the Jamaican authorities in observing how events materialized with the much larger Polish and Egyptian requests for conversion (for their environment and social funds respectively) which they felt had attracted greater political commitment on the part of donors to achieve something than seemed to be the case for Jamaica. It was also pointed out that the cancellation/interest conversion schematic employed under the PL480 cancellation arrangement agreed under EAI would generate sufficient local currency funds for environmental expenditures for the next 2-3 years unless the scope for despoiled mining land rehabilitation schemes was expanded and investment in this area accelerated.

4.08 It was, however, immediately acknowledged by the authorities that an official DECP would have considerable scope and could be quite useful if it was aimed specifically at: (i) facilitating and accelerating remaining privatization initiatives (which require some very large enterprises to be sold in the next 3-4 years); and (ii) substituting private investment for some of the projects presently included in the public sector investment programme. Detailed design work, involving simulations on the budgetary and monetary impact of such conversions, would need to be carried out (in Phase II of the UNCTAD Project) by expert consultants provided by UNCTAD/UNDP in conjunction with staff of the BoJ, the Ministry of Finance (MoF), and the team specifically responsible for the privatization programme in the National Investment Bank of Jamaica (NIBJ).

4.09 The scope for an official DECP can be discerned from Annex 1 which lists the enterprises intended to be privatized by the government in the immediate and medium term. While no valuation has been attached to each of these enteprises (for obvious reasons) it can safely be assumed that even if the entire non-concessional bilateral debt stock were to be converted it would account for no more than 20-25% of the total value of the enterprises to be put on the block, and could, in the right market climate, account for much less than that proportion. Hence the absortive capacity for applying such conversions to public asset sales is not a constraint. In addition the 1990-91 PSIP lists public investments in directly productive enterprises in agriculture, mining, manufacturing and tourism (which could be substituted for to the extent of at least 50% by private investment) amounting to J$2.9 billion for the 1991-95 period; investments in economic infrastructure (transport communications, electric power and water supply and sewerage) of J$6.4 billion; and social investments (such as hospital rehabilitation) for a further J$750 million. These programs also suggest considerable scope for absorbing the local currency proceeds of official debt swaps in a manner which would replace government borrowing and expenditure for the public investment with the involvement of public asset swaps. Clearly, there is also room for other types of recurrent social expenditure; but, unless it can be assured that budget funds thus released are not again redeployed, but used either to close the fiscal gap or to generate a surplus in order to retire existing public debt, (and the attendant future servicing obligations) such substitution could prove problematic.

4.10 In considering the prospects for an official DECP the Jamaican authorities were considered about how the mechanics of conversion would be handled at the creditor end. Obviously, having decided to privatize their own holdings of assets the government would be disinclined to see foreign governments (or even foreign parastatals) become significant holders of equity in Jamaican enterprises. They do acknowledge that many bilateral creditors have specific equity investment promoting arms within their institutional armouries (e.g. CDC, FMO, DEG, OPIC etc) which have already take up equity investments in Jamaica and which for all intents and purposes are, despite their ownership, similar to any other private foreign investor except perhaps with a greater developmental orientation and a slightly longer-term perspective. How the debt is transferred from the present holder (e.g. ECGD) to a more appropriate equity investor (e.g. CDC) is not the concern of the Jamaican government nor is the internal price at which such a transfer takes place (though these may of course involve complex issues for creditor governments and agencies themselves to address). What is important is: the likely behaviour of the investor operating through an official DECP; the price at which the debt is to be converted into local currency; the price at which local assets being privatized are to be valued and exchanged; and what 'sweeteners' if any are necessary to induce acceleration of the privatization programme through an official DECP.

4.11 Official debt equity conversions could be handled either on: (i) a case-by-case basis in the context of each privatization, which might involve laborious, lengthy and repetitive arrangements between the government and each bilateral creditor in each case; OR (ii) through a more flexibly designed general purpose vehicle such as a Privatization Fund managed on a professional portfolio management basis. Such a fund could be financed by local currency proceeds derived through both debt conversions as well as new (forex) money; though the 'rights and advantages' offered in connection with the new money component might need to be tailored to offer some preferences. For example, a privatization fund could be established in which bilateral creditors (or more specifically their designated equity investment agencies) could pool their converted local currency claims within a structure would enable them to have representation in the management and direction (i.e. Board) of the fund. Such a structure could also accommodate providers of new money (such as the IFC, IIF and CDB along with private professional investor funds in emerging markets such as those run by the major global funds or boutique funds run by ex-IFC staff from Washington) who could bring additional technology and management to the venture. The Privatization Fund could then bid for a significant but limited (to say 25-30%) proportion of any privatization issue under the same types of terms, and with same priorities, as the government's present DECP. This broad idea could be developed in much greater (country specific) detail in Phase II of the UNCTAD Project.

V Impact of the Proposed DECP for Official Bilateral Debt

5.01 In the absence of a detailed structure for the proposed official DECP and specific targetted ojectives in its operation it is difficult to evaluate its impact except in sufficienctly generic terms to justify pursuing further development of the concept and its application. To begin with, the financial impact would depend very much on how much official bilateral debt creditors were willing to convert in the next 2-3 years. As indicated earlier, the non-concessional component of official bilateral debt owed to OECD creditors amounts to nearly $1 billion with pre-cutoff date debt amounting to $700 million. Assuming official debt conversions were confined to the current 10% ceilings of the entire debt stock this would result in annual debt service savings of about $15 million annually (on average) between 1992-96. The net financial effect in terms of debt service savings would not, therefore, be significant in its own right. But, if this small amount of converted official debt was seen as the first tranche of a privatization fund of the sort outlined above it would have financial leverage effects several times its own size. For example if $100 million in converted debt were to attract a further $30 million in new money from other funders (e.g. IFC, IIC and CDB) and if the privatization fund thus set up were to take up no more than an average of 25% of the total equity of the enterprises being privatized, the potential leverage effect would result in enabling $520 million worth of privatized assets to be financed; not an inconsiderable sum in the Jamaican context.

5.02 If, however, the creditors (and the Jamaican authorities) were to be more ambitious and aim to convert 50% of the outstanding official bilateral non-concessional debt stock now with the proceeds being invested over the next five years (i.e. $500 million) then the effect in terms of debt service savings would be substantial (an average of $85 million annually between 1992-96) along with the leverage effects. But the impact of such conversion programmes (as the cases of Chile and Mexico clearly suggest) extends well beyond the mere financial savings involved. If organized in a structured and comprehensive rather than piecemeal fashion such programmes can signal a powerful commitment on the part of creditors and debtor to recovery and growth rather than repeating resched-uling exercises aimed at bleeding the economy, through debt service, of the maximum amount of real resources that can be extracted, with no serious concern on the part of creditors (and no counter-vailing political power on the part of the debtor to exert its preferences) for establishing firmer footings for sustainable recovery.

5.03 An official DECP in Jamaica of between $300-500 million could play just such a role in signalling the intent of the creditors to ensure sustainable recovery of the Jamaican economy and to underline that commitment by the preparedness of their agencies to take an equity risk, jointly with other partners willing to provide new money, again on an organized and (in relative terms) impressive scale. It could also signal, on the part of the Jamaican government, its commitment to proceeding with privatization rapidly by overcoming, through such a programme, the natural limits imposed by domestic capital market absorption constraints and the unwillingness on the part of private foreign investors (or holders of flight capital) to put their best foot forward in an environment subject to instant economic destabilization by events such as hurricanes or the Gulf War. Clearly bilateral debt conversion alone would not fully ameliorate concerns on the part of dispassionate observers (and investors) that the Jamaican economy, in terms of its output and export capacity is being squeezed by the international community for much more debt service than it can reasonably afford or sustain and grow at rates of 5-7% at the same time. Conveying that message unambig-uously would require action on the multilateral debt front and in the debt service currently being extracted by private creditors.

5.04 In the final analysis, the objective of the creditor community should be to reduce the annual debt servicing obligations of Jamaica from around $750 million or over 20% of GDP to a level of less than $400 million, which would still represent a very high 11% of GDP but would be more manageable. Such a reduction would need to be achieved in a manner which did not simply defer the ballooning of debt service to five years from now but resulted in a terminal reduction. Achieving that size of reduction, when preferred multilateral obligations alone absorb around $300-350 million a year in debt service, will be extremely difficult unless Jamaica's multilateral obligations can be stretched out and refinanced on intermediate terms at least for the next 5-10 years. But even in the absence of that eventuality materializing an official DECP could play a major role. The availability of a large portfolio of public assets, which could be more productively deployed by the private sector offers a feature which should be seized on swiftly to construct an interwoven debt swap-privatization link which could have profoundly beneficial effects on economic revival and sutained growth.

[1] Data from the World Debt Tables 1991-92 issue have been used throughout this report. They differ (in some instances quite significantly) from data provided by the Bank of Jamaica in its Annual Report of 1990. However the differences could not be readily reconciled and an arbitary decision was made to use the WDT series because of completeness for the 1983-90 period.

[2] Though Jamaica has ended each year between 1983-90 with a small balance of interest arrears averaging $30 million between 1983-88 (due more to technical rather than substantive reasons) the volume of such arrears grew very rapidly in 1989 and 1990. Jamaica ended each of those years with more than $110 million in interest arrears, a substantial amount relative to total interest payment and debt service obligations. This change signals increasingly greater distress in meeting rescheduled debt service.

[3] See also "Debt Equity Conversions: A Guide for Decision Makers", UN - ST/CTC/104-1990.

[4] This figure is sourced from WDT91-92. The 1989 Report of the Institute of International Finance (IIF) (representing the comercial banks) indicated an outstanding amount of $481 million at the end of 1987 while the Bank of Jamaica reported a figure of $380 million.

[5] See IIF Report cited above pg 10.

[6] In an inteview with the author the Governor of BoJ rightly observed that since 1989 with domestic inflation, and interest rates rising rapidly and the exchange rate becoming unstable the issuance of EIBs had become much more expensive with the domestic interest rate rising to over 28% in mid 1991 while LIBOR had fallen substantially.

[7] See "Programme for the Conversion of Jamaican External Debt into Equity Investments: Guidelines for Investors"; BoJ publication, 1990.

[8] Though Jamaican residents (or domiciles) have to staisfy BoJ that they have sufficient assets abroad or can borrow abroad to finance the dollars necessary for secondary market debt purchases on terms acceptable to BoJ.

[9] However, the government did express a preference for conversions to be used for investment in priority areas: (i) construction or expansion of tourist hotels; (ii) manufacturing investments in the "free zones"; (iii) construc-tion of new factory space in Jamaica; (iv) export production with high domestic value-added; (v) employment generating investments in labour intensive enterprises.

[10] It was estimated in 1987 that based on a BoJ fee of 6% and the purchase of Jamaican debt in secondary markets for 35¢, the investor accrued a saving of 50% on the forex required to make local equity investments even after taking into account the fees to agent banks. With the price of debt having risen to over 70¢ and even with the BoJ requiring no fee the savings have dropped to 15% which is less than the premium available on parallel market exchanges for the Jamaican dollar in 1991.

11 Please see the Interim Report submitted to UNCTAD by the Consultants dated 16 November 1991 pp 20-23 and Annex 2 p 27.

APPENDIX 1

ENTERPRISES/ASSETS/ACTIVITIES APPROVED FOR PRIVATIZATION ADVERTISED AND CURRENTLY IN NEGOTIATIONS

ENTERPRISES/ASSETS/ACTIVITIES	INDUSTRY/SECTOR	OWNERSHIP	SUBJECT MINISTRY/AGENCY	COMMENTS Incl. PRELIMINARY PROPOSED MODALITY FOR PRIVATIZATION
1. Air Jamaica Ltd.	Air Transport	100%	Ministry of Public Utilities and Transport	Dilution of interest from injection of new capital. (Special Committee appointed by Govt. to privatize airline. Chairman - Mr. Danny Williams.)
2. National Cassava Products Ltd.	AgriBusiness	100%	JAMPRO/JIDC	Sale/lease of assets
3. National Tool & Die Co. Ltd.	Manufacturing	100%	JAMPRO/JIDC	Sale of shares/ assets.
4. Cornwall Dairy Development Ltd.	AgriBusiness	100%	Ministry of Industry, Production & Commerce JAMPRO/JIDC	Sale of asset and lease of assets.
5. Jamaica Public Service Company Ltd.	Electrical Utility	100%	Ministry of Mining and Energy	Purchase of Private Power, contract of power generation, share sale.
6. West Indies Glass Ltd.	Manufacturing	61.5%	Jamaica Development Bank	The two major users of the product have expressed interest in acquiring GOJ's shares. "A" Ordinary shares listed on the Stock Exchange.
7. Negril Cabins	Hospitaility/ Tourism	100%	Ministry of Mining and Energy	Sale of assets

ENTERPRISES/ASSETS/ACTIVITIES APPROVED FOR PRIVATIZATION
IMPLEMENTATION STAGE

	ENTERPRISES/ASSETS/ACTIVITIES	INDUSTRY/SECTOR	OWNERSHIP	SUBJECT MINISTRY/AGENCY	COMMENTS Incl. PRELIMINARY PROPOSED MODALITY FOR PRIVATIZATION
1.	Jamaica Fisheries Complex Ltd.	AgriBusiness	100%	Ministry of Agriculture	Lease of assets
2.	St. Jago Farms	Agriculture	100%	ADC Group Limited	Sale of Assets and lease of assets.
3.	Kingston Dry Dock Limited	Dry Dock Service	100%	JAMPRO/JIDC	Lease of land and building. Sale of machinery and equipment
4.	Agricultual Mechanical Services (Workshop)	AgriBusiness	100%	Ministry of Agriculture	Sale of assets

ENTERPRISES/ASSETS/ACTIVITIES APPROVED FOR PRIVATIZATION
PRELIMINARY ASSESSMENT

	ENTERPRISES/ASSETS/ACTIVITIES	INDUSTRY/SECTOR	OWNERSHIP	SUBJECT MINISTRY/AGENCY	COMMENTS Incl. PRELIMINARY PROPOSED MODALITY FOR PRIVATIZATION
1.	National Commercial Bank of Jamaica	Banking	39%	NIBJ	Sale of shares by private treaty to exsisting shareholders and other worker groups. Company listed on th Stock Exchange.
2.	Shettlewood Property Montpelier Property	Agriculture	100% 100%	ADC Group Limited	Sale of Assets and lease of assets.
3.	Certain Services in certain Hospitals	Public Service	100%	Ministry of Health	Sale of assets. Contract of services. Opportunity to increase number of players in private sector enterprise.
4.	Government Printing Office	Public Service	100%	Ministry of Public Service	Contract of services Sale/lease of assets
5.	Port Authority of Jamaica Boundbrook Wharf Bowden Wharf	Port Services	100%	Ministry of Public Utilities and Transport	Lease/sale of asset.
6.	Jamaica Soya Products Ltd.	Manufacturing	60%	Ministry of Industry, Production and Commerce	Sale of shares.
7.	Highgate Foods Ltd.	AgriBusiness	38%	Ministry of Industry, Production and Commerce	Sale of shares

ENTERPRISES/ASSETS/ACTIVITIES APPROVED FOR PRIVATIZATION
PRELIMINARY ASSESSMENT

	ENTERPRISES/ASSETS/ACTIVITIES	INDUSTRY/SECTOR	OWNERSHIP	SUBJECT MINISTRY/AGENCY	COMMENTS Incl. PRELIMINARY PROPOSED MODALITY FOR PRIVATIZATION
8.	Trans-Jamaica Airlines Ltd.	Air Transport	100%	Ministry of Public Utilities and Transport	Sale of shares
9.	Milk River Hotel and Spa	Hospitality/ Tourism	100%	Ministry of Tourism	Lease of asset
10.	Bath Fountain Hotel, St. Thomas	Hospitality/ Tourism	100%		
11.	Ariguanabo Co. of Ja. Ltd.	Manufacturing	100%	Ministry of Industry Production and Commerce	Sale of assets
12.	Innswood Vinegar Limited	AgriBusiness	51.21%	Ministry of Agriculture	Sale/Lease of assets
13.	Cocoa Industry Board (properties)	Agriculture	Cocoa farmers	Ministry of Agriculture	Sale of properties on open market by Cocoa Industry Board.
14.	Caribbean Cement Company Limited	Manufacturing	28%	NIBJ	Sale of shares to the public. Company listed on the Stock Exchange.
15.	KIW International Ltd.	Manufacturing	42% Ord. 100%Pref	Ministry of Industry, Production & Commerce	Sale of shares Company listed on the Stock Exchange.
16.	Black River Upper Morass Development Company (BRUMDEC)	Agriculture	100%	NIBJ	Sale/Lease of Assets
17.	Lydford Farms	Agriculture	100%	Ministry of Agriculture	Sale of Assets
18.	CMP (Shares)	Manufacturing	52,221 shares	Jamaica Development Bank	Sale of Shares

ENTERPRISES/ASSETS/ACTIVITIES APPROVED FOR PRIVATIZATION
PRELIMINARY ASSESSMENT

ENTERPRISES/ASSETS/ACTIVITIES	INDUSTRY/SECTOR	OWNERSHIP	SUBJECT MINISTRY/AGENCY	COMMENTS Incl. PRELIMINARY PROPOSED MODALITY FOR PRIVATIZATION
19. Tanners (Shares)	Manufacturing	164,970 shares	Jamaica Development Bank	Sale of Shares
20. Dairy Industries (Shares)	Manufacturing	15,014 shares	Jamaica Development Bank	Sale of Shares
21. Tropiculture Limited (Shares)	Agriculture	45%	Jamaica Development Bank	Sale of Shares
22. Road Maintenance - Repairs of wards, bridges etc.	Public services	100%	Ministry of Construction	Lease of Equipment. Contract of Services.
23. Postal Services and Package delivery	Public services	100%	Ministry of Public Utilities and Transport	Lease of franchise.
24. Minard Estate	Agriculture	100%	ADC Group Limited	
25. National Water Commission List including sewerage processing plants being finalised by NWC.	Water Utility	100%	Ministry of Public Utilities and Transport	Some sewerage processing plants already privatized. Lease of Assets. Contract of Services.
26. Airport Terminal/Donald Sangst International Airport	Air transport Services	100%	Ministry of Public Utilities and Transport	The government has received proposals to privatize the terminal at the Donald Sang Airport. Build-Own-Operate Terminal.
27. Catering for Infirmaries (Island wide)	Public Services	100%	Ministry of Local Government	Sale/Lease of Assets. Contr of Services.
28. Parking Meters/Traffic Flow Monitoring	Public Services	100%	Ministry of Local Government	Contract of Services.
29. Local Government - Motor Vehicle Repairs	Public Services	100%	Ministry of Local Government	Contract of Services

ENTERPRISES/ASSETS/ACTIVITIES APPROVED FOR PRIVATIZATION
PRELIMINARY ASSESSMENT

ENTERPRISES/ASSETS/ACTIVITIES	INDUSTRY/SECTOR	OWNERSHIP	SUBJECT MINISTRY/AGENCY	COMMENTS Incl. PRELIMINARY PROPOSED MODALITY FOR PRIVATIZATION
30. Abbatoirs	Public Services	100%	Ministry of Local Government	Lease of "franchise"
31. Jamaica Pegasus	Hospitality/Tourism	59.8%	National Hotels & Properties	Sale of Shares
32. Forum Hotel Complex	Hospitality/Tourism	100%	Urban Development Corporation (UDC)	Sale of Assets
33. Oceana Hotel	Hospitality/Tourism	100%	Urban Development Corporation (UDC)	Sale of Assets
34. Montego Freeport Limited and its Subsidiares:			Urban Development Corporation (UDC)	
- Seawind Beach Hotel Limited	Hospitality/Tourism			Sale of Assets
- Seawind Limited	Hospitality/Tourism			Sale of Assets
- Montego Shopping Centre Ltd.	Property management			Sale of Shares
- Montego Wharves Limited]	Port services			Sale of Shares
- Montego Shipping Services Lt]				Sale of Shares
- Montego Stevedoring Limited]				Sale of Shares
35. Grains Jamaica Limited	AgriBusiness	51%	NIBJ/JCTC	Sale of Shares
36. Caribbean Steel Company	Manufacturing	51%	NIBJ	Sale of Shares
37. Antillean Food Processors Ltd.	Manufacturing		Ministry of Industry, Production and Commerce	In receivership Sale of Assets
38. Victoria Banana Limited	Agriculture	100%	ADC Group Limited	Sale of Shares
39. Jamaica Bauxite Mining Company	Mining	100%	Ministry of Mining & Energy	Lease of Assets
40. PETCOM	Petroleum related	100%	Ministry of Mining & Energy	Sale of Shares
41. Petrojam (Refinery)	Manufacturing	100%	Ministry of Mining & Energy	Sale of Shares
42. Petrojam (Belize)	Manufacturing	100%	Ministry of Mining & Energy	Lease/Sale of Assets

ENTERPRISES/ASSETS/ACTIVITIES APPROVED FOR PRIVATIZATION
PRELIMINARY ASSESSMENT

ENTERPRISES/ASSETS/ACTIVITIES	INDUSTRY/SECTOR	OWNERSHIP	SUBJECT MINISTRY/AGENCY	COMMENTS Incl. PRELIMINARY PROPOSED MODALITY FOR PRIVATIZATION
43. Ethanol Dehydration Plant	Manufacturing	100%	Ministry of Mining & Energy	Lease/Sale of Assets
44. Font Hill Farms (Luana)	Land/Agriculture	100%	Ministry of Mining & Energy	Sale of Assets
45. Negril Royal Palm Resort	Hospitality/Tourism	100%	Ministry of Mining & Energy	Lease of Assets
46. Police Services - Garage, Canteen.	Public Services	100%	Ministry of National Security	
47. National Rums Limited	AgriBusiness	100%	Ministry of Agriculture	Sale of shares
48. Jamaica Railway Corporation	Transportation	100%	Ministry of Public Utilities and Transport	Lease of Assets Lease of franchise
49. Standard Building Products Ltd.	Manufacturing	100%	Ministry of Industry, Production and Commerce (JAMPRO)	Sale of assets, Incluing land and building.
50. Jamaica Export Trading Co. (JETCO)	Trading	100%	JAMPRO/Bank of Jamaica	Sale of Shares
51. Darliston Community Foods Ltd.	AgriBusiness	100%	Ministry of Industry, Production and Commerce. (JAMPRO)	Sale of assets
52. Eastern Banana Limited	Agriculture		ADC Group Limited	Sale of Shares
53. RJR 'A' & 'C' class shares		29%		

PROSPECTS FOR OFFICIAL DEBT CONVERSIONS: THE CASE OF TANZANIA

i. This case study of Tanzania is organized in five sections which: (i) provide the economic context; (ii) discuss the Tanzanian debt situation; (iii) analyse the debt relief measures applied so far and their effects; (iv) examine the scope for official debt conversions; and (v) attempt to indicate what impact such conversions might have.

I Developments in the Tanzanian Economy

1.01 Tanzania is a large, populous but extremely poor country with considerable but as yet unexploited natural resource endowments. Its economy, like that of most sub-Saharan countries, suffered many reversals through the 1970s which were exacerbated by inteventionist policies and extensive controls over virtually all aspects of economic life. These represented a deliberate attempt at departing from a colonial economic legacy in an effort to develop a self-reliant, diversified modern state built on collectivist principles. Successive droughts, oil shocks, the collapse of the East African Community of which it was an integral part, and the war with Uganda to oust Idi Amin, resulted in GDP growth plummetting from a robust annual average of 5.5% between 1973-78 (buoyed by strong coffee export prices) to less than 1% between 1979-85 with accelerating inflation caused by a burgeoning fiscal deficit (16% of GDP). Import capacity declined sharply with 1982 imports being a third below 1978 levels resulting in further discouraging agricultural and industrial output.

1.02 After experimenting with two home-grown economic revival programmes in 1980-81, Tanzania decided in 1982 to adopt a wider range of neoclassical structural adjustment prescriptions abandoning its commitment to African socialism. Real GDP contracted in 1983 and registered very weak recovery in 1984-85. Since 1986, after it adopted another comprehensive Economic Recovery Programme designed to attack policy and structural shortcomings on virtually every front, Tanzania has registered good growth averaging about 4% in real terms upto 1990 when the oil-price effects of the Gulf War and depressed coffee prices contributed to derailing it temporarily. The changed incentive structure resulting from an improved policy environment has triggered an impresive supply response.

Agricultural production and export volumes increased between 1987-90 as a result of improved producer prices, greater availability of inputs and access to more wage goods in rural areas. A major programme to rehabilitate and expand badly run-down transport infrastructure is underway.

1.03 Strong fiscal measures have steadily reduced the fiscal deficit to around 5.5% of GDP in 1990 though the parastatal sector continues to run large deficits despite price decontrol and efforts at public enterprise reform. Covering these deficits through domestic credit expansion has ignited inflation and the government (GoT) is now preoccupied with bringing it under control. Tanzania's external accounts also show signs of continuing structural distress; export earnings covered less than a third of import expenditures in 1990 with the shortfall being financed largely by donor grants and concessional multilateral loans at levels likely to prove unsustainable in the long-run. In the 1979-83 period GoT financed its net external account deficits by external borrowings which could not be serviced resulting in large arrears being incurred which caused suppliers credits, export credits and trade finance to cease. Despite its poverty Tanzania has built up an external debt stock of nearly $6 billion, with large arrears and is effectively unable to borrow further on commercial terms.

1.04 With greater capacity for economic research and analysis than most African countries, Tanzania has imbibed adjustment prescriptions with a more critical and careful eye (and therefore more slowly but also more durably). The pay-off for that approach may be that the long slow haul to recovery will become more firmly rooted; though much remains to be done by way of continued reform, capacity-building, infrastructural investment on a large scale and greater involvement of the private sector in the economy. Macroeconomic stability remains elusive despite four years of strong growth with reform not having been extended fully to all sectors, the continuing reluctance to privatize larger parastatals, and deterioration in delivery capacity for social services. Exchange rate, tariff, fiscal and monetary reforms have all been impressive but need to be carried further. As increasing output growth and export earnings will depend, in the medium-term, mainly on the agricultural sector GoT has: raised producer prices further linking them more closely to world prices, taken steps to improve agricultural marketing efficiency by opening up the sector to public and private agents, and has begun actively to seek new private foreign investment for domestic and export production.

1.05 Tanzania enters the 1990s with a population of 24 million growing at over 3% annually but with a relatively undeveloped economy and a total GNP of just $ 2.2 billion or under $100 per capita in nominal dollars. Agriculture accounts for over 50% of domestic output with industry accounting for a mere 11% (manufacturing less than 8%) and services for the remainder. Excluding donor support, nationally generated savings (at 5% of GDP) are too low to support investment levels for internally financed, self-sustaining growth. In 1990 gross investment of 19% of GDP was financed largely (15%) by current transfers from abroad leaving little scope for expanding investment to needed levels of 25-27% of GDP without attracting much more foreign private investment. This condition is unlikely to be met till the foreign private sector sees a major reduction in outstanding debt claims which are beyond Tanzania's capacity to service.

II Tanzania's Debt Problem

2.01 In 1990 Tanzania had a debt to GNP ratio of 270%, a per capita debt to income ratio of 245% with an outstanding debt stock of $5.9 billion which, as a proportion of exports, was over 1000%. The structure of Tanzania's debt is depicted in Table 1 below:

Table 1: THE STRUCTURE OF TANZANIA'S EXTERNAL DEBT
(Amounts in millions of US Dollars)

		1970	1980	1985	1990
Total External Debt: of which:		205	2,447	3,577	5,866
Long-term	Bilateral:	136	1,111	1,460	3,363
	Multilateral Banks:	38	518	988	1,742
	IMF:	0	171	58	140
	Total Multilateral:	38	689	1,046	1,882
	Private guaranteed:	6	257	340	190
	Pvt. unguaranteed:	15	84	19	12
	Total Private (LT):	21	341	359	202
Short-Term:	Private	10	306	713	420
Memo:	Total Pvt LT+ST:	31	647	1,072	622

Source: World Debt Tables 1991-92[1]

2.02 Debt Stocks: Total debt has grown nearly 30 times between 1970-90 with particularly large increases in official debt, both multilateral and bilateral, which together now account for over 90% of the debt structure. Fortunately, a large proportion of that debt is concessional -- 85% in the case of multilateral bank debt and 62% in the case of bilateral debt yielding an average concessional element of 70% in the official debt structure and 61% in the total debt structure. Tanzania has 33 bilateral creditors with 11 being owed more than $100 million each with the USSR/CIS being the single largest creditor. OECD countries account for over two-thirds of bilateral debt (the largest creditors being Germany, Italy, Japan, the UK and France). USSR/CIS accounts for a further 17%[2] with the remaining 16% being attributable to OPEC oil exporters (7%) and other bilaterals (9%) among whom China and Brazil are by far the largest. A number of OECD creditors have cancelled all or part of their concessional claims at various times since 1985; but those cancellations have not made a discernible dent in reducing outstanding stocks of bilateral debt which have more than doubled since 1985 largely due to interest capitalization; Tanzania has been unable to meet its annual debt service obligations, except to multilateral creditors, for some time now.

2.03 Among the multilaterals, IDA accounts for the largest share (72% of the total multilateral claim) with the African Development Fund being the next largest creditor. Non-concessional multilateral debt is attributable mainly to the IBRD and, to a much smaller extent, the AfDB. Unlike Zambia, the IMF has never been a large factor in Tanzania's debt structure with GoT making minimal use of IMF resources. Private long-term creditors accounted for only 3% of total outstanding debt with short-term debt amounting to another 7%. In the private creditor category suppliers' and uninsured export credits (totalling $177 million) feature much more prominently than commercial bank loans (which amounted to a mere $16 million).

2.03 Debt Servicing: Following peak payments of $183 million in 1983 the Tanzanian government has followed a course of restricting debt service payments only to multilateral preferred creditors. It has sought continuous reschedulings with its OECD and other bilateral creditors but debt servicing to them has not been in keeping with the terms of these agreements despite the concessionality of the arangements reached. There have been no debt service payments made to private creditors in the last few years, resulting in the cessation of trade credit facilities being extended to Tanzania (apart from the Bankers Trust coffee-oil facility which sets off coffee export earnings aganist oil-import expenditures within the same financial structure). Because of generous levels of grant financing provided by donors, Tanzania has managed to finance a gap of $1 billion annually betwen exports and imports for the 1987-90 period. The debt servicing picture is portrayed in Table 2 below on the next page.

2.04 Taking into account net flows of principal on the short-term account (which in 1989 resulted in a large outflow of $250 million) total debt service in Tanzania has fluctuated considerably. On the long-term account, debt service has averaged about $125 million between 1984-90 with relatively small fluctuations around that mean. Over that time the share of multilateral creditors in long-term debt service has risen from about 68% to nearly 88%. The movements in the short-term account represent mainly the bridging lonas made available for short period under the Bankers Trust Facility referred to earlier when there is a time lag between cash receipts from coffee exports and payments on oil imports.

2.05 Total service on <u>bilateral</u> debt fell to average of $3 million between 1985-88 (when payment obligations averaged about $318 annually) but increased to the $15-18 million level in 1989-90 (when obligations averaged about $155 million annually) with payments of about $8 million on average to OECD creditors (France, Italy, Spain and the UK) and the balance entirely to the USSR/CIS with no payments to OPEC creditors or to other developing country creditors having been made since 1984. Even with an average concessional rate of about 3.5% applicable to its outstanding bilateral debt stock Tanzania's contractual interest burden on bilateral debt amounts to over $100 million annually while its stretched out amortization schedule after rescheduling requires amortization payments of $50-60 million. Debt service performance on bilateral debt has been so poor as to warrant reconsideration of whether continuing reschedulings even begin to address the reality which Tanzania confronts i.e. its absolute inability to devote resources to bilateral debt service, even on these extraordinarily concessional rescheduling terms, when it confronts a current account imbalance of $1 billion annually and receives grant aid averaging $520 million annually which, together with multilateral concessional loan inflows, help to cover that gap. As a result of this reality Tanzania had built up interest arrears of over $300 million at the end of 1990, mostly on the bilateral account.

Table 2: TANZANIA'S EXTERNAL DEBT SERVICE PAYMENTS
(Amounts in millions of US Dollars)

			1970	1980	1985	1990
Total External Debt Service:			NA	151	45	126
of which:		Principal	na	74	-6	62
		Interest	na	77	51	64
Long-term	Bilateral:	Principal	na	11	1	4
		Interest	na	12	1	12
	BDS		na	23	2	16
	Multilateral:	Principal	na	8	28	49
	Banks	Interest	na	18	22	34
	MBDS:		na	26	50	83
	IMF:	Repurchases	na	33	8	28
		Charges	na	7	1	6
	FDS		na	42	9	34
	Total Multilateral:	Prin	na	41	36	77
		Int	na	25	23	40
	MDS		na	66	59	117
	Private guaranteed:	Prin	na	7	1	0
		Int	na	7	0	0
	PGDS		na	14	1	0
	Pvt. unguaranteed:	Prin	na	16	3	0
		Int	na	7	1	0
	PUDS		na	23	4	0
	Total Private (LT):	Prin	na	23	4	0
		Int	na	14	1	0
	PDS		na	37	5	0
	Short-Term:	Net Prin	na	0	-46	-16
		Interest	na	26	25	9
	SDS		na	26	-21	-7

Source: World Debt Tables 1991-92

2.06 Multilateral debt service has been met almost fully since 1987 (though Tanzania was in arrears on the multilateral account between 1984-86) reflecting the priority accorded to preferred creditors after the government decided to pursue a route of strong adjustment under the auspices of the Bank and Fund. Contractual obligations to long-term private creditors (on suppliers and export credit account) have not been met at all since 1986 although the outstanding stock of debt on this account is shown by WDT to have diminished from $330 million in 1985 to $173 million in 1990. That reduction has certainly not been attributable to amortization payments and little information is available on whether debt swaps or cancellations account for the reductions.[3] Some of these obligations have, of course, moved from the private to the bilateral debt accounts when indemnities on the 80-90% portions insured by export credit and guarantee agencies have been paid out to suppliers and exporters from OECD creditor countries. Nevertheless those outstanding obligations at the end of 1990 would, in the absence of a restructuring agreement, still result in contractual obligations on around$15 million in interest charges and $20-30 million in amortization payments causing a substantial build-up of arrears on these accounts which do not appear to have been fully accrued in the debt data base.

III Measures taken to provide Tanzania with Debt Relief

3.01 Since the onset of the debt crisis Tanzania has received a considerable amount of debt relief in the form of Paris Club reschedulings, a rescheduling agreement with China (in 1986), interest rate relief on charges accruing from its outstanding IBRD obligations through IDA's interest subsidy facility, and full or partial debt cancellations by several large creditors including Sweden and Norway, the UK, the US, Canada, France and Germany. Yet the outcome has been a considerable increase in its bilateral debt burdens since 1985 because the impact of cancellations has been more than offset by interest and arrears capitalization on the residual balances. The terms of Tanzania's three Paris Club rescheduling agreements are shown below:

TABLE 3: TANZANIA'S PARIS CLUB RESCHEDULINGS.

Date of Agreement	Cut-Off Date	Consolidation Period		Amount Consolidated	Repayment Terms			
					Maturity		Grace	
		Begin	Length (Mths)		Yrs	Mth.	Yrs	Mth
18.09.86	30.06.86	01.10.86	12	$ 644 m	9	6	5	0
13.12.88	"	01.01.89	6	$ 269 m	Menu of Options ABC			
16.03.90	"	01.01.90	12	$ 200 m	Menu of Options ABC.			

Source: World Debt Tables 1991-92

3.02 Since the start of the 1986 recovery programme Tanzania has been back to the Paris Club every two years and has requested a fourth Paris Club meeting in early 1992 when it hoped that Trinidad Terms would be applied. In 1988 and 1990 Toronto Terms were applied to Tanzania. All of the principal and interest payments due were consolidated with moratorium interest averaging 3.5%. Yet, as observed earlier Tanzania has not been able to meet its rescheduled payment obligations and run up a large balance of arrears (over $400 million by the end of 1991). The repayment burden will be exacerbated when the grace period allowed under the 1986 rescheduling expires requiring the first scheduled repayments of principal in October 1992 which will almost certainly also go into arrears. The "enhanced Toronto Terms" which have been agreed by the Paris Club will result in much less favourable treatment than had been anticipated by the Tanzanian authorities. In 1986 Tanzania also negotiated the rescheduling of $43 million in payments due to China but not with any of its other bilateral creditors, many of whom it had an active trading relationship with, but which have since been disrupted. The World Bank is presently helping Tanzania formulate a strategy for dealing with non-OECD bilateral debt selectively by creditor, offering different options such as case-by-case reschedulings, long-term commodity bonds, conversions for equity investments, and in kind payments through commodity swaps. The results of its study will be conveyed to the Tanzanian authorities later this year.

3.03 Tanzania has not received any negotiated relief on its private commercial debt obligations largely because it has no London Club type of debt and its supplier creditors are too numerous to negotiate with collectively. It has approached the World Bank to use the IDA financed Debt Buyback Facility to extinguish these residual obligations through some type of buyback arrangement; this facet is also being considered in the terms of reference of the World Bank's advisory assistance.

IV Prospects for Official Debt Conversions in Tanzania

4.01 With a very large outstanding stock of bilateral debt which it is finding impossible to service Tanzania's first option is to seek as much by way of cancellations from bilateral creditors as possible. With a cut-off date of June 30, 1986 the amount of eligible debt likely to be cancelled by the Paris Club will be less than $700 million from a bilateral debt stock of nearly $3.7 billion at the end of 1991 (including capitalization of interest in arrears) leaving a balance of $3 billion to be dealt with. Even if Tanzania's already low average rate of moratorium interest were to decline further (from 3.5% to 2.5%) the resulting interest service schedule -- of about $75 million annually -- would still be far higher than Tanzania can realistically afford. This would be true even if the more generous version of Trinidad Terms proposed at first by the UK Prime Minister were to be applied resulting in a cancellation of about $1.8 billion still leaving a residual $1.9 billion to be dealt with. Hence other means of reducing the debt stock, through debt conversions, need to be actively explored quite irrespective of how much can be cancelled within the existing parameters.

4.02 Tanzania already has a commercial debt conversion scheme though no details were made available on the amount of debt that has been converted through it. On the face of it, the scheme appears to be a relatively costly way of retiring commercial debt (mostly of overdue short-term trade obligations) with the Bank of Tanzania paying full face value in T-shillings less a transaction fee of 15%. At a secondary market price of 10-15 ¢ when the scheme was launched, the net result was that traders in such debt (mainly the local Indian trading community) were able to acquire local currency legitimately at 25-33% of the dollar cost of T-shillings prevailing in the parallel market or one-sixth the cost at the official exchange rate, thus encouraging round-tripping. The competitiveness of the market has resulted in a rise in the secondary market price of Tanzanian private paper which was reported to have reasched 39-40c at the close of 1991, still permitting traders to acquire T-shillings at a better rate than through the parallel market. Moreover, as the debt is exchanged for cash payments of the full amount of T-shillings, rather than for an instrument that is encashable only over a period of time, such transactions would, if they were sizeable, have a distinctly inflationary impact. Nor is there any evidence that the Tanzanian authorities are following up on whether the T-shilling proceeds of these debt exchanges are being used for the purposes intended (investment).

4.03 As in the case of Jamaica and Zambia, the opportunities for official debt conversions are considerable because of the sheer size of the stock of public assets available for privatization in Tanzania as well as the large number of social purposes for which local currency proceeds from official debt conversions could be used. The authorities, however, are moving much more slowly and cautiously on the privatization frontier than Jamaica or Zambia thus making it difficult to define with any precision how quickly such a programme could be developed and made operative. Though the government has approached private investors to take over some government-owned parastatals on a selective basis there is considerable political resistance to going ahead with privatization on any large scale because of concerns that it would again result in the dominance of non-indigenous private businesses in the Tanzanian economy. Until such resistance is overcome privatization remains a sensitive issue on the economic agenda and an official DECP may, for that reason, be premature to float at this time. There is as yet no detailed privatization programme being prepared with a listing of those public assets which can be sold over a period of time, what their approximate valuation might be and what the implications are for the public budget of appropriately sequenced asset sales. It is clear, however, that those parastatals targetted for privatization will probably need to go through a prolonged period of financial and operational restructuring, (involving painful dislocations such as large-scale retrenchment) with significant budgetary implications, before they can be brought to market.

4.04 Nonetheless the reactions of the authorities spoken to in the BoT and the Ministry of Finance to the idea of a privatization fund of the type proposed in Jamaica and Zambia was unequivocally positive. Officials in BoT believed that such a fund would help to address many of the concerns that had been expressed in Tanzania about how to get the incipient privatization and debt reduction programmes which the government was inclined to promote to gain impetus without stoking up inflationary flames.

4.05 There is, in Tanzania, considerable potential for official debt-environment swaps for the preservation of wildlife herds and for the maintenance of its large natural reserves which are being degraded through deforestation and soil erosion, though it was not possible to look into this aspect in great depth during Phase I. These types of swaps, along with swaps for social expenditures (whether for health, children, or education) however raise the usual concerns about potential inflationary consequences resulting from the need to issue currency to meet the counterpart obligation without the assurances that such a increase in monetization will be offset by a reduction in pressure to create money from the budget deficit. In other words, such swaps can only be justified as long as it can be demonstrated that expenditures financed by such swaps are substituting for expenditures that would otherwise need to be made through the public expenditure programme.

V The Impact of Official Debt Conversion in Tanzania

5.01 As already indicated, Tanzania's large bilateral debt stock is barely being serviced. Hence the actual cash-flow impact of an official debt conversion programme is likely to be quite small. Allowing for cancellation along the lines that the Paris Club is likely to agree under the enhanced Toronto Terms now being applied for low-income debt distressed countries, Tanzania can expect to see about $700 million of its bilateral debt stock cancelled in the next rescheduling with the prospect of conversion (if the 10% conversion clause is inserted in the next Agreement) of about $80-90 million of its non-concessional bilateral debt held by Paris Club members. This would save about $6-7 million a year in scheduled interests costs between 1992-97 but would have a cash saving effect of less than $1 million annually in debt service. It is difficult, at this time, to envisage the conversion of much more than this amount (i.e. 10% of the outstanding debt stock) being readily absorbed until Tanzania's plans for privatization are much further advanced when conversions of larger amounts into equity ($100-200 million) could be quite easily absorbed through privatization.

5.02 But, as has happened in the case of other countries where conversions have occurred on any significant scale (Chile and Mexico), it is likely that the economic and second-order financial impact of an official DECP will be far larger than the immediate cash flow savings realized in debt service. If an official DECP could unblock the resistance which is presently being experienced in moving ahead with privatization, it could attract new private capital flows for investment in both privatized and new industries for a multiple (two to three times) of the amounts being converted. It could also unleash a burst of output and export growth through the more productive utilization of assets which are presently being deployed with almost extreme inefficiency.

5.03 These considerations suggest that a strong case exists for encouraging the Tanzanian authorities to develop further the idea of an official DECP associated with its evolving blueprints for privatization with UNCTAD/UNDP support under Phase II of the UNCTAD Project which would provide an opportunity for the impact of an official DECP to be evaluated in greater detail.

1 Data from the World Debt Tables 1991-92 issue have been used throughout this report.

2 As in the case of Zambia the question arises as to whether arrangements could be made to repay these claims in roubles without maintenance of value obligations which would require less than 5% of the value of the claims currently expressed in US dollars to extinguish the entire amount.

3 The real reason appears to be that as Tanzanian debt information is reconstructed the outstanding claims of private creditors are being found to be smaller than earlier documentation (and interim estimates) seemed to suggest and also because they have moved from the private to the bilateral account after indemnities have been paid out by export credit insurers in their home countries.

Annex 3
(contd).

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