

NEW DEBT REDUCTION TECHNIQUES<sup>~</sup>

Dr. Stephany Griffith-Jones

Institute of Development Studies  
at the University of Sussex

Brighton

BN1 9RE

UK

<sup>~</sup>This paper draws on a study prepared for UNITAR.

## TABLE OF CONTENTS

### **New Debt Reduction Techniques**

paper by

**Stephany Griffith-Jones**

<u>Section</u>	<u>Page</u>
<b>I OVERVIEW</b>	<b>1</b>
<b>II NEED FOR DEBT REDUCTION</b>	<b>2</b>
<b>III TECHNIQUES OF COMMERCIAL DEBT REDUCTION, WITH SPECIAL REFERENCE TO LATIN AMERICA</b>	<b>7</b>
A. Debt conversion programmes	7
1. Debt-equity swaps	7
2. Debt-for-development swaps	15
B. Debt and debt service reduction techniques in the context of the Brady Plan	16
C. Extra-Brady techniques	24
<b>IV APPLICATION OF DEBT CONVERSION TECHNIQUES TO OFFICIAL BILATERAL DEBT</b>	<b>25</b>
<b>V CONCLUSIONS</b>	<b>28</b>
<b>APPENDIX 1</b>	<b>30</b>
<b>FOOTNOTES</b>	<b>33</b>

## I OVERVIEW

This paper will first of all briefly argue the case for the need for debt reduction, in severely indebted low-income and low-middle-income countries (Section II).

In Section III, we will examine the techniques of commercial debt reduction, with reference to the experience in this field in Latin American countries.

This Section will first examine debt reduction techniques employed before the Brady Plan was introduced in early 1989. This will focus on an analysis of debt-equity swaps, made with commercial debt; though references will be made to several countries, special emphasis will be placed on the Chilean case, where commercial debt-equity swaps are seen to have been most successful.

Then, we will examine debt reduction and other techniques introduced in the context of the Brady Plan. Special reference will be made to the Mexican case, seen as one of the most successful, especially in terms of broad objectives, such as restoration of creditworthiness and potential for economic growth. Fairly brief references to the Venezuelan and Costa Rican cases will also be included.

Afterwards, we will examine extra-Brady debt reduction techniques, such as buy-backs. This will be illustrated with the case of the Bolivian buy-back.

Finally, in Section IV, we will briefly discuss the application of some of these techniques to official bilateral debt reduction and especially conversion. This is particularly relevant to the countries of Sub-Saharan Africa, as such a large proportion of their external debt is owed to official bilateral creditors, and as interesting new initiatives are opening up in this field.

Section V includes brief conclusions.

## II NEED FOR DEBT REDUCTION

As can be seen in Table 1, the total level of external debt stocks for all developing countries has grown very rapidly, between 1982 (when widespread debt crises exploded) and 1991. Growth of debt stocks has been particularly rapid in the severely indebted lower-income countries (SILICs), whose total debt outstanding and disbursed (DOD) has more than doubled from \$79 billion in 1982 to \$175 billion in 1991. Total interest arrears of the severely indebted lower-income countries (SILICs) have also increase significantly during this period, from \$1.3 billion in 1982 to \$12.9 billion in 1991, reflecting the growing incapacity of severely indebted lower-income countries to service their debt. Such large arrears have many undesirable effects for both debtors and creditors.

Two factors make the SILICs debt a greater burden than for other highly indebted regions. One is the far more severe poverty of those countries, which implies that contractions of output and income linked to excessive debt overhang are particularly damaging in terms of human welfare. Another is the greater structural weaknesses of those economies, as well as their greater difficulty to adapt to changes in the international environment. As a result of these structural weaknesses and in some cases of mistaken policies, export performance has been disappointing in the 1980s in the SILICs, with an average decline of exports of 2 per cent per annum, leading to a further deterioration (than would have otherwise occurred) in debt service ratios and debt/export ratios (see Table 2). Thus, in the late 1980s, both debt service and debt/exports ratios were higher in the SILICs than they had been either in 1980 or 1982 (see Table 2). Indeed, SILICs' debt service ratio was in 1989 still double the 1980 one, while debt/exports ratios were almost five times as high. There is therefore urgent need for greater debt reduction for those countries.

This situation is in contrast with that of the severely indebted middle-income countries (SIMICs), and especially the upper middle-income ones. Firstly, their total DOD has started to decline in 1991 (see Table 1), mainly as a result of declines in the private debt owed (which has fallen quite significantly since 1988), reflecting the impact of Brady deals, as well as fairly large amounts of debt conversions, mainly for equity but also for development purposes (for more details see below). Second, as can be seen in Table 2, the export performance of SIMICs during the 1980s has

TABLE 1:

GROWTH IN DEBT STOCKS OF SIDCs(Amounts in billions of US Dollars)

	<u>1982</u>	<u>1985</u>	<u>1988</u>	<u>1991(E)</u>
<b><u>SILICs:</u></b>				
Total DOD:	79.12	116.74	160.91	175.35
Interest Arrears:	1.25	3.09	8.00	12.89
Bilateral DOD:	32.06	49.45	75.10	80.43
Multilateral DOD:	10.61	16.76	26.77	34.73
IMF:	3.23	5.56	5.83	6.30
Private Guaranteed:	18.32	24.11	32.24	29.18
Private Unguaranteed:	2.90	3.33	3.09	2.88
Short-Term Debt:	12.00	17.53	17.88	21.83
<b><u>SIMICs:</u></b>				
Total DOD:	346.15	418.46	485.13	486.54
Interest Arrears:	4.53	4.81	15.59	40.50
Bilateral DOD:	35.23	62.58	90.58	99.59
Multilateral DOD:	15.94	24.35	41.71	53.87
IMF:	6.97	12.99	14.71	17.54
Private Guaranteed:	183.49	223.00	255.34	220.69
Private Unguaranteed:	61.70	50.96	29.17	23.10
Short-Term Debt:	48.82	44.57	53.62	71.76
<b><u>Other SIDCs:</u></b>				
Total DOD:	55.00	50.00	69.00	65.00
<b><u>Memo: All LDCs:</u></b>				
Total DOD:	846.00	1,046.00	1,282.00	1,351.00
Interest Arrears:	6.10	8.67	25.64	55.50

Source: WDT 119-92.\*

\* 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 p.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).

TABLE 2:

EXPORT GROWTH AND DEBT RATIOS FOR SEVERELY INDEBTED DEVELOPING COUNTRIES

Categories of countries	Structural features		Growth of exports 1982-89 (% p. a.)	Debt indicators					
	GNP p/cap	Infant mortality		Debt service ratio			Debt/export ratio		
	(% 1988)	(Deaths per 1000 live births, 1987)		1980	1982	1989	1980	1982	1989
Severely indebted low-income countries (SILICs)	288	102.8	-2.0	10	20	23	96	214	493
Severely indebted middle-income countries (SIMICs)	1632	55.0	3.5	36	49	29	196	297	294

Source: Based on data in World Bank World Debt Tables, 1990-1991.

been far better than that of the SILICs, with an average positive growth rate of 3.5 per cent in the 1982-89 period. As a result, debt service ratios have declined quite substantially during the 1980s, even though they are still at a fairly high level.

For many SIMICs (e.g. Chile, Mexico), debt has stopped being a constraint on growth and development (at the time of writing). Indeed, surprisingly, over-abundance of foreign exchange inflows and reserves has become the new source of concern for these countries' central bankers and finance ministers.<sup>1</sup>

An important element explaining the increase in all developing countries' debt stock since 1982 (and particularly for the SILICs) is the very rapid rise of bilateral DOD. For the SILICs, bilateral debt rose from \$32 billion in 1982 to \$80 billion in 1991, representing in the latter year over 45 per cent of the total stock of debt of these countries. This rapid rise in bilateral debt of all SIDCs has occurred despite the bilateral cancellations of ODA debt amounting to over \$8 billion between 1983-90 for the SILICs, and despite the successive application of Toronto, Venice, Houston terms and now "enhanced Toronto terms" in Paris Club agreements for SILICs and SILMICs. The increase has been due principally to the effect of exchange rate changes since 1985 and due to the interest capitalisation practices of the Paris Club.

A further source of concern is the increase in multilateral debt, especially in the case of the SILICs, whose outstanding debt obligations to multilateral creditors rose from around \$11 billion in 1982 to almost \$35 billion in 1991 (see Table 1). It is not clear what can and should be done to reduce the burden of multilateral debt/debt servicing, given the need to safeguard the creditworthiness of these institutions in international capital markets, that allow them to exert valuable leverage for raising private funds from capital markets, with publicly financed capital funds of a significantly smaller size than the private funds raised. However, the large burden of multilateral debt service (and the difficulty of reducing it) increases further the need for action in reducing and/or converting official, bilateral and commercial debt, of both SILICs and SILMICs.

These trends clearly suggest the need for bilateral debt reduction/debt service reduction beyond that envisaged in the "enhanced Toronto terms" (described below) for SILICs and beyond that already granted to SILMICs.

In this sense, export credit agencies now need to accept the same realities that commercial banks have recognised and engage not just in cancellation but also in conversion options on a scale which would reduce bilateral debt to realistically serviceable levels. Debt conversion options should particularly be used not just in cases where debt reduction has been insufficient, but also where they would imply other gains (including efficiency ones) and where undesirable effects (e.g. on inflation) are marginal or can be easily counteracted by debtor government policy.

As regards official bilateral debt, a number of measures for debt reduction have and are being implemented for the SILICs and SILMICs but there is evidence that for an important number of those countries progress is still insufficient.<sup>2</sup> It is disappointing in this context that neither the British proposal (known as Trinidad Terms) made in September 1990 by John Major nor the Dutch proposal made by Minister Jan Pronk were adopted by the Paris Club. (The Paris Club is the forum where most official bilateral creditors meet to discuss debt restructuring with individual debtor countries). The consensus reached in the Paris Club in December 1991 (and already applied to Benin and Nicaragua) dilutes the Trinidad Terms quite considerably, even though signifying progress over previous Toronto Terms. In these "enhanced Toronto Terms", creditors can opt for: (i) cancellation of 50 per cent of eligible maturities being consolidated; (ii) halving interest rates on non-concessional debt; (iii) stretching export credit and concessional debt repayments further; and (iv) capitalising reduced interest rates in a way which would result in equivalence in net present value (NPV) terms with the other options.

The Trinidad Terms, if they had been implemented, would have implied a much more significant step towards solving the Sub-Saharan African bilateral debt problems than the approach de facto adopted. They had suggested: (a) rescheduling of 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) capitalising all interest payments on the remaining one-third debt stock for a period of five years and requiring phased repayment with steadily increasing payments in line with export and output growth in the debtor economy; and (d) stretching repayments of the remaining one-third stock over a period of 25 years.



Because of insufficient action for SILICs on bilateral debt reduction, on help with servicing multilateral debt and even slower progress on commercial debt reduction,<sup>3</sup> there is great urgency in promoting far greater debt/debt service reduction for those countries, to levels which are sufficient to restore confidence in sustainable recovery in them. It is important that, as in the Latin American cases described below, sufficient debt/debt service reduction is accompanied by macro-economic stabilisation and economic restructuring (where necessary) to maximize the benefits of debt/debt service reduction on future growth.

### III TECHNIQUES OF COMMERCIAL DEBT REDUCTION, WITH SPECIAL REFERENCE TO LATIN AMERICA

#### A. Debt conversion programmes

##### 1. Debt-equity swaps

As part of debt management techniques, debt-equity 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.

A debt-equity swap can be defined as a deal converting a developing country's debt into foreign equity (via foreign direct or portfolio investment) in a domestic firm. In some countries, a debt-equity swap can involve a resident, bringing back foreign exchange, rather than a foreign national.

A foreign company decides it wishes to make an investment in a particular developing country. It presents an investment proposal to the relevant authorities. Once the project is approved, the company purchases the foreign debt of the country on the secondary market, at less than its full face value. The debt is then presented for redemption at the central bank of the host country, which usually provides local currency at an implied exchange rate somewhere between the face value and the secondary market value of the paper. The company can then use this local currency to make the approved investment, via purchase of shares or by an injection of capital.

TABLE 3:

VOLUME OF DEBT CONVERSION BY COUNTRY, 1985- 1990<sup>1/</sup>(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 <sup>2/</sup>	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.

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

<sup>2/</sup> 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.

As can be seen in Table 3, 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 per cent of the total commercial debt of all heavily indebted countries, and of the total commercial debt in 1985 of the countries listed in Table 4. Though debt conversions clearly did not lead to overcoming the debt overhang of most heavily indebted countries (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 per cent of 1985 commercial was converted, see Table 4), they did make a meaningful contribution to such debt reduction in several of the heavily indebted countries. As can be seen in Table 4, in both Argentina and Philippines, debt conversions represented over 30 per cent of those countries' 1985 commercial debt stock; for the other

countries listed in Table 4, 1985-90 debt conversions represented less than 20 per cent of 1985 commercial debt stock.

Reportedly,<sup>4</sup> Brazil was the first country in Latin America to establish a small, semi-formalised debt-equity programme. This was followed by Argentina and by Chile. The Chilean programme was sustained for a very long period without any interruptions, led to major debt reduction and is widely regarded as a clear success.

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).

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 3), 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 described below), contain commitments of debtor countries to engage in 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 Latin Finance, total volume of trading of LDC debt reached in 1990 around \$100 billion in 1990. (NMB, the largest European traders, estimates that 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 4:

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 the 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 (described below) are really perfectly tradeable and assignable documents has played a major role in facilitating - and expanding volume of - transaction. Procedures and documentation have 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 also 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 below.

A review of the different country experience with commercial debt conversion and of the literature<sup>5</sup> 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.

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. Major reductions in commercial debt. 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 other cases however, the reduction of debt has been far less meaningful. However, in the Mexican and Venezuelan cases, the countries have (like Chile) now returned to the international capital markets, which was an important objective of their debt strategy; it could be argued that for Mexico and Venezuela 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 to investors had an important influence on persuading particular investors to come into those countries, who may otherwise not have come. Policy-makers 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. 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-conditions 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 limit the magnitude of operations and the additional FDI generated, even though its development impact may be enhanced. Finally, and most importantly, 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. The Chilean experience is also interesting, as a special window 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 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 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. 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 (as in Chile) 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. 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.

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 inappropriate allocation of resources, unless the operation is considered to imply important net efficiency gains. 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).

## 2. Debt-for-development swaps

The growth 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 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. 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. 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 3), which have accumulated a total of around \$38b by early 1992. The magnitude of commercial debt-for-development swaps only represent around 2 per cent 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.<sup>6</sup>

#### B. Debt and debt service reduction techniques in the context of the Brady Plan

The case for commercial external debt reduction for heavily indebted Latin American countries had been argued in many circles since 1982. Some commercial debt reduction had actually taken place, for example via the debt-equity swaps described above and the Bolivian commercial debt buy-back described below. However, till the Brady Plan was announced in March 1989, creditor banks and many creditor governments (and especially the US)

strongly opposed the principle of debt/debt service reduction. This changed with the launch by US Treasury Secretary Brady, of his debt plan in 1989.

Before analysing the features of the Brady Plan, it seems worthwhile to examine the reasons which made the previously almost taboo subject of debt reduction become almost universally acceptable in 1989, and led to it becoming a key element in the US Treasury's new debt strategy. Firstly, in debtor nations, impatience with adjustment and negative net transfer burdens had clearly spread from relatively limited circles of intellectuals to strongly influence the political process, as parties supporting a more radical stance on debt gained many votes or power. The riots in Venezuela in February 1989, in which so many people were killed due to protests against adjustment measures, illustrated the deep resistance to cuts in living standards among poorer people in Latin America. In political and popular circles in Latin American indebted countries massive net transfers, linked to a large debt overhang, were seen as a major cause for declining or stagnant living standards and investment levels since 1982. Increasingly these concerns were shared by representatives of industrial governments, international organisations, international banks and by public opinion in industrial countries. The need to sustain fragile and young democracies and the need to provide some hope for a better future to people in highly indebted countries were often quoted as reasons for the need for a new debt strategy. A strong intellectual case was made by influential economists in the industrialised world, such as Paul Krugman, John Williamson and Jeffrey Sachs, that debt relief was in the economic interest of both debtors and creditors. They - and others - argued that excessive debt burdens act as a disincentive for debtor countries (and governments) to take painful or politically unpopular adjustment or stabilisation measures, as the potential fruits of those measures (e.g. reflected in higher exports) will go in excessive proportion to creditors. Secondly, they pointed out that attempts to extract full contractual debt service risked provoking the debtors into a confrontation, from which both they and creditors will lose. Furthermore, excessive debt burdens not only have direct negative effects on the local economy, particularly via lower investment, higher taxation and/or higher inflation but also indirect ones, for example, by discouraging capital flight repatriation. Furthermore, it was argued that by forgiving part of a country's debt creditors may increase expected payments; by decreasing debt they may increase the

incentive for orderly adjustment and desirable structural reforms, which will increase future debt service capacity.

The Brady Plan included a number of innovative elements. The first important innovative element was precisely that it explicitly recognised the need for commercial debt reduction and for reducing debt service. The second important element in the Brady initiative was that IMF and World Bank funds (as well as contributions by governments and, particularly, that of the Japanese) were made available to support debt reduction operations. The IMF Board agreed in late May 1989, guidelines for its own role in the new Third World debt strategy. The guidelines produced separate funds to be devoted by the IMF to debt reduction (25 per cent of a country's extended fund facility or stand-by loan arrangement to be "set aside") and extra resources to be devoted to interest support (equivalent to a maximum 40 per cent of a debtor country's quota). A final innovative aspect of the Brady Plan was its recognition of the need to loosen existing legal, regulatory, tax and accounting constraints that limited the possibility of debt/debt service reduction. This included the waiving by banks of provisions such as sharing and negative pledge clauses in existing agreements; more importantly, it included a review of creditor countries' regulatory, accounting and tax provisions so as to eliminate disincentives (or create incentives) for debt reduction.

We will now evaluate in some detail some of the deals approved in the context of the Brady Plan (for detailed descriptions of these deals and the techniques used, see Appendix 1).

#### Evaluation of Brady Deals

Amongst the countries that have already signed Brady deal, in Latin America, are Mexico, Venezuela, Costa Rica and Uruguay.

As it would be difficult to evaluate each of these deals in depth, we will put more emphasis on that of Mexico (the first deal signed, for which there is therefore a longer period in which to assess results and which influenced and will influence other deals), with some reference also to Costa Rica, due to its special characteristics.

In December 1988, the Mexican government initiated talks with its various external creditors. Amongst its important objectives<sup>7</sup> were: 1) a reduction of the flow of net external resource transfers, and 2) the

obtainment of a multi-annual agreement to reduce uncertainty caused by recurrent negotiations.

The need to reduce negative net transfers was linked to the need to provide more external savings to fund investment and growth. Increasingly emphasised in the academic literature and in ex-post evaluation, have been the positive indirect effects of what is widely accepted as a satisfactory deal, on both the domestic and the foreign private sector. A multi-annual deal, which not only reduced debt service, but also shifted amortizations for an important number of years, was seen to reduce uncertainty and provide confidence, for example on perceived sustainability of the exchange rate; it was hoped that a satisfactory debt deal would significantly lower high domestic interest rates; it was also hoped that it would attract additional private flows from abroad (not linked to the deal) and encourage private capital to return. As we will see, it is this second category, of indirect benefits, on domestic interest rates and on capital flows (by foreign and domestic private actors) which have been especially positive in the case of the Mexican deal.

The details of the Mexican deal have been described elsewhere,<sup>a</sup> and are summarised in detail in Annex 1. The estimates of resulting cash flow savings, based on figures produced by the Mexican Minister of Finance, can be seen in Table 5.

TABLE 5:

CASH FLOW SAVINGS FROM THE 1989 DEBT AND DEBT SERVICE REDUCTION AGREEMENT  
(\$ billion)

	Average 1990-94
Interest savings	\$ 1.6
New money cash flows	\$ 0.3
Savings from restructuring of amortizations <sup>(1)</sup>	\$ 2.1
Total Cash Flow Savings	\$ 4.1

<sup>(1)</sup> This includes the deferment of amortizations, originally falling due in this period, to 2019.

Total average cash flow savings for the 1990-94 period are estimated to reach around \$4 billion, of these over half are due to restructuring of amortization, and new money, which could have been achieved through the previous conventional restructuring process. However, taking the savings on interest payments, at around \$1.6 billion, this is reported<sup>9</sup> to have provided sufficient financing to accommodate a growth target of an average of 4 per cent over 1990-94; naturally, the validity of such a link is based not only on the realism of the econometric macro model used, but also on developments in the world environment relevant to Mexico, such as the price of oil and international interest rates.

So though the Brady deal obtained by Mexico implied a fairly limited external debt and debt service reduction, and a significantly smaller reduction than Mexico had initially requested,<sup>10</sup> it did seem to provide enough additional foreign exchange liquidity to sustain meaningful growth, given certain assumptions. It should be stressed that debt service reduction was relatively limited, representing only around 6 per cent of the country's exports and only around 20 per cent of average interest payments on medium and long term debt in the 1983-88 period.<sup>11</sup>

The indirect positive effects, linked to the removal of uncertainty and restoration of confidence generated by a deal which implies no repayment of amortizations until the one-shot payment in 2019, have at least in the short-term, been more important.

Firstly, soon after the announcement of the Mexican Brady package, domestic interest rates fell by almost 20 per cent presumably because of a reduction in pressure on the exchange rate; they remained low for a very long period.

Given that the Mexican government's domestic debt reached \$54 billion, domestic interest payments were reduced by over \$9 billion (around 4.5 per cent of GDP) as a result of the decline in interest rates. This allows both for higher public investment and encourages higher domestic private investment. Van Wijnbergen estimated the additional positive effect on GDP growth of the decline in domestic interest rates at around 1 per cent initially, increasing to more than 2 per cent by 1994. A note of caution needs to be sounded here; there is room for debate about the extent to which it was just the debt deal which has pushed interest rates down in Mexico.

A final, but extremely important indirect positive effect, is that on increased foreign private flows, especially foreign direct investment, and return of capital flight. There has been substantial return of capital flight to Mexico; additionally, private capital flows have also increased very significantly. Indeed, by 1991, according to a study by Salomon Brothers, private capital flows to Mexico reached a massive \$16.1 billion, in sharp contrast with the mere \$0.7 billion, which entered in 1989. The debt deal thus was a very important factor helping to catalyze new flows and return previously fled capital; however, as pointed out above, other factors (such as prospects of the North American Free Trade Agreement with the US and Canada, prudent macro-economic policies, successful export performance, and the large differential between Mexican and very low US short-term interest rates) also played an important role.<sup>12</sup>

Thus, though clearly very welcome and valuable, these latter indirect beneficial effects will not necessarily continue, especially at the same high levels of inflows.

Finally, as regards other, especially smaller and poorer countries that may sign similar debt deals, some doubts must remain whether these indirect positive effects would be as important as have occurred in Mexico.

The Brady deals reached by Venezuela and Uruguay (for details see Appendix 1), seem to follow roughly the pattern set by Mexico. The Venezuelan deal had some interesting innovations, such as a new instrument offered, (called "step-down, step-up bonds") designed to provide debt service relief in the medium term by temporarily reducing interest to below-market fixed rates in the first five years after the deal. As regards cash flow relief of the Brady deal, the Venezuelan operation seems even less favourable than the Mexican deal, with relief estimated by the World Bank to reach only \$460 million, for the 1990-94 period, which amounts to only 2.5 per cent of the country's exports. There is, however, evidence that at least as regards new private capital inflows there has been a positive effect of the debt deal in 1990, as private capital flows to Venezuela are estimated to have increased from \$1 billion in 1989 to \$4.8 billion in 1991.

The Costa Rican debt deal, even though in the context of the Brady Plan, was significantly different from the Mexican, Venezuelan and other packages. The two main features are: a) the deal has only the options of debt/debt service reduction (and not a new money option), and b) the level

of debt/debt service reduction, in relation to contractual obligations is very large, being estimated at around two thirds of contractual obligations. As regards cash flow savings on interest payments, it should be stressed that they are very close to zero (the World Bank estimates an average yearly net reduction of \$.07 billion for the 1990-94 period) because the country had not been servicing the debt in full for several years. However, the major reduction of debt and debt service achieved seems to have improved private sector expectations (both domestic and foreign) and also eliminated a highly demanding and time-consuming activity, such as external debt negotiations, particularly costly for small countries, from senior policy-makers' agenda.<sup>13</sup>

The interesting deal achieved by Costa Rica, the bargaining tactics used by the Costa Rican authorities to achieve its debt management objective (including large arrears accompanied by a permanently conciliatory approach to bargaining with creditors), and simultaneous sustained efforts at carrying out prudent macro-economic policies, seems to offer other small country debtors interesting lessons. Indeed as Devlin and Guerguil<sup>14</sup> correctly point out, unilateral action to reduce or stop debt servicing is likely to yield better results, if it is seen as a step towards reaching a consensual and definitive deal with the creditors, if it is accompanied by a coherent macro-economic programme and if a conciliatory attitude is adopted with different categories of creditors, including the commercial banks. Costa Rica skilfully met these pre-conditions, which seems to have helped it achieve a successful definitive deal. It should perhaps be mentioned that Costa Rica had at the time of the deal certain specific geopolitical features, which made the US government wish to maintain friendly relations.

Outside the context of the Brady Initiative, more traditional reschedulings of commercial debt slowed down. An important exception was Chile's rescheduling in September 1990. The unique approach by the Chilean authorities was largely explained by certain particularly favourable features of Chile's recent economic evolution. Chile has had for several years prudent macro-economic policies; its export growth has been extremely dynamic since 1985, which was one important factor why the debt service ratio fell; the other factor was that Chile had (as described above in Section III, A) drastically reduced, before the Brady Plan was announced, its commercial debt, mainly through an active programme of debt-equity



swaps and debt buy-backs; indeed, using 1989 data, Chile's debt indicators had improved enough for the World Bank to take Chile out of the severely indebted country category!

Chile's rescheduling deal was special, not only because it did not include debt and/or debt service relief (but merely postponing amortization payments), but also because of the different mechanism through which "new money" was raised. Instead of obtaining new money via so-called "involuntary new money", distributed more or less proportionally among existing back creditors, Chile placed bonds (for \$320 million) amongst a small number of large creditor banks, which have a long-term commitment to funding the country.

It is interesting that Chile's debt deal (like that of Mexico) contributed to triggering off very important private capital inflows into the economy, which - together with other factors - had led by mid 1992 to a sharp increase in foreign exchange reserves. Another indicator of this return to creditworthiness is of course the secondary price of the debt, which is at over 90 per cent of face value for Chile. Indeed, Sachs and Kneer<sup>15</sup> define full re-establishment of creditworthiness of a debtor country as occurring when its debt is once again trading at 100 per cent. Chile seems very close to that aim!

The overcoming of the debt crisis in Chile is naturally not only measured by Balance of Payments indicators, more important is the ability of the Chilean economy to grow at a fairly rapid pace in recent years.

The recent experiences of Chile, Mexico, Venezuela and Costa Rica described above seem to show that in the Latin American context there was perhaps not single optimum path or modality for debtors to return to creditworthiness and growth, but that different paths are better suited to different countries, according to their specific circumstances. However, common features of countries apparently returning to creditworthiness and growth after the debt crisis is their fairly prudent macro-economic policies and their relative clarity and consistency about the modality in which they wish to handle their external debt problems.

There are a group of other countries in the region, where neither conditions are still fully met, though significant efforts are being made in both directions. This is particularly well illustrated by the case of Brazil, where at the time of writing there still were serious fiscal and

other macro-economic imbalances and where an agreement in debt had not yet been reached with the creditor banks, even though negotiations between Brazil and its creditor banks are progressing towards a Brady type agreement,<sup>16</sup> and where a preliminary agreement to clear Brazil's arrears with the commercial banks has already been reached. However, even if Brazil were to reach an agreement with its creditor banks for debt/debt service reduction of the type and orders of magnitude of the Mexican or Venezuelan deal, it is not yet clear - given the magnitude of existing imbalances - if this would be by itself sufficient to restore creditworthiness and growth. Parallel efforts would be required on the domestic front to reduce macro-economic imbalances. It is encouraging in this sense that there already has been a general increase in private flows to Brazil in 1991, (though of a fairly short-term nature) in spite of the difficult macro-economic and political conditions and the unresolved debt situation.

### C. Extra-Brady techniques

Even before the Brady Plan was launched, several commercial debt reduction operations had been fairly successfully launched. One of the most interesting ones, especially in a Sub-Saharan African context, was the Bolivian buy-back.

Bolivia is a low-income country which had, since mid-1984, unilaterally suspended its debt service. After rescheduling its Paris Club debt in 1986, bolivia started to negotiate a buy-back of its commercial debt, reaching around \$670 million (excluding interest on arrears), or aorund 15 per cent of the country's total public foreign debt. The secondary market price had been around 6 cents on the dollar, but news of the buy-back drove it up to 11-12 cents.

A year later, in 1987, Bolivia obtained waivers of restrictive clauses on debt reduction, introduced in a previous rescheduling. Conditions for the buy-back included: resources for the purchase had to come from third party donors, had to be placed in an IMF Trust Fund, and the same price had to be offered to all bank creditors. Banks also obtained the option of getting, instead of cash, 25-year collateralised peso-denominated zero-coupon bonds, indexed to the US dollar and eligible for conversion into local equity at a 50 per cent premium.

The buy-back was announced in January 1988, with an offer price of 11 cents on the dollar. In March 1988, it was announced that the outstanding debt was reduced by half; nearly \$270 million was exchanged for cash and \$64 million was exchanged for notes.

This buy-back clearly illustrated how assistance from the international public sector could accelerate a sharp reduction of outstanding bank debt. In fact, what made the operation feasible was the resources provided by government donors and the IMF's good offices.

There were, however, some shortcomings in this operation. One was that only over 40 per cent of the country's creditor banks participated in this particular operation, even though the price offered was nearly double that prevalent in the secondary market.<sup>17</sup> Another shortcoming was the rise in the secondary market price itself. When the price was 6¢ on the dollar, the country's \$670 million debt had a value of \$40 million. At a price of 11¢ on the dollar, the remaining debt (of \$336 million) had a market value of \$37 million. Thus, in the short-term, \$37 million of cash and Bolivian notes had bought only \$3 million of reduction in market value of outstanding obligations. However, the fact that donor foreign exchange resources were solely earmarked for the purpose of a buy-back, and would not have been otherwise available, made this operation particularly attractive. Furthermore, other operations (including one being finalised with IDA support) later further diminished the stock of Bolivian commercial debt; obviously, the fact that the face value of Bolivia's commercial debt had previously been reduced facilitated such operations.

#### IV APPLICATION OF DEBT CONVERSION TECHNIQUES TO OFFICIAL BILATERAL DEBT

As mentioned in Section II, a number of debt reduction measures have been implemented, as regards official bilateral debt (in the context of Houston, Venice, Toronto and "enhanced" Toronto terms). Overall these debt reduction techniques are simpler to implement technically for official bilateral debt than for commercial debt, as they mainly depend on political decisions of creditor governments, and do not therefore require the complex interactions between governments and private actors needed to achieve "voluntary" commercial debt reduction. Differential regulations, especially of an accounting and budgetary nature,<sup>18</sup> and particularly

differential political commitment to such debt reduction make it harder for agreement to be reached on sufficient official bilateral debt reduction.

An interesting new opportunity is opening up to achieve debt reduction via debt conversion for bilateral official debt in ways that parallel what has been done with commercial debt (see III A above). Such measures are currently only available for severely indebted low-income (SILICs) and lower-middle-income countries (SILMICs); they are very relevant for these countries (many of them in Sub-Saharan Africa), because of the very high proportion of total debt, which for them official bilateral debt represents (see again Section II for data).

Indeed, as regards both SILICs and SILMICs, the Paris Club has agreed to the introduction of a debt conversion clause, which says that: "creditor countries can, on a voluntary basis, swap part of the claims for debt-equity swaps, debt-for-nature swaps and debt-for-development swaps for up to 10 per cent of bilateral official or officially guaranteed non-concessional loans, and (where relevant) for up to 100 per cent of ODA loans; there is also a value limit (\$10 million or \$20 million, depending on the case), which can be used if it is higher than the 10 per cent of non-concessional bilateral debt". This clause has been granted, if requested, to SILMICs since September 1990 and to SILICs since December 1991.<sup>19</sup>

Initially, debt conversion efforts were focussed on commercial debt, with swaps of official bilateral debt practically non-existent; indeed, there were limitations on creditor governments selling their debt.

Such operations potentially open debt conversions for these 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.

By early 1992, among the countries that had already had this clause approved by the Paris Club were: Benin, Congo, Côte d'Ivoire, Ecuador, Egypt, El Salvador, Honduras, Jamaica, Morocco, Nicaragua, Nigeria, Peru, Philippines, Poland and Senegal.

At the time of writing, relatively limited activity had actually taken place in finalising official debt conversions in the framework of the "10

per cent clause". However, a number of transactions are reportedly being considered or about to be implemented, including the following:<sup>20</sup>

- Poland has presented a detailed request to its creditors for funding of a \$3bn Environment Fund, with the "10 per cent clause". This was discussed at a large conference with creditor governments in mid-1991. Reportedly, the US and France have made commitments to such a Fund.
- 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 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 the Paris Club debt.
- For Nigeria, different creditor governments are reportedly considering using official debt-equity swap conversions to support privatisation.

It should be noted that certain European and North American 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 debt-equity swap 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.

Furthermore, a number of individual creditor governments have recently launched initiatives relating mainly to their ODA bilateral debt, which imply either debt reduction and/or debt conversion. These include for example the Swiss, German, French and Canadian governments. Such initiatives open new interesting opportunities for heavily indebted countries; they require agile action by their governments to maximize developmental benefits from such opportunities and to press for further opportunities to be opened.

## V CONCLUSIONS

The need for additional debt/debt service reduction remains a major issue, particularly for the severely indebted countries in Sub-Saharan Africa. Large debt overhangs continue, in those countries, to be major obstacles to their growth and development prospects.

A number of debt/debt service reduction and debt conversion techniques have been developed since the mid-1980s, particularly but not only for commercial debt in Latin America.

Many of these techniques can be applied and are slowly beginning to be applied, where relevant, to the reduction of commercial debt in Sub-Saharan Africa. Such techniques include buy-backs and collateralisation of commercial debt with funds from creditor governments and/or international financial institutions leading to debt reduction.

It is also important that debt conversion techniques (either for debt-for-equity or debt-for-development) can now increasingly be applied to official bilateral debt. Such transactions are particularly attractive to debtor governments if they imply, as is likely, additionality to the debt reduction that would have otherwise been obtained and if they imply direct efficiency gains for the debtor economy, such as may be obtained via facilitating privatisation or funding high priority social and environmental spending. Furthermore, such debt conversions (and indeed some other forms of debt reduction) may help encourage new private flows (e.g. via foreign direct investment) into those countries.

Naturally, care must be taken, in the case of debt conversions, to avoid any undesirable negative effects, such as increasing the potential for future inflation. However, the lessons from Latin America, and especially Chile, show that negative effects (if relevant) can be fairly easily neutralised by appropriate macro-economic policies.

More broadly, it is hoped that the lessons from Latin America's too slow but fortunately fairly steady progress towards the reduction of its debt overhang, return to creditworthiness, contributing to the apparent restoration of favourable growth prospects, can offer relevant lessons for other countries, which are still severely debt-distressed. Such lessons relate not only to the debt reduction techniques described above, but also

to broader policy stances, such as the pursuit of prudent macro-economic policies and the emphasis on export diversification, which indirectly play also an important role in the reduction of debt overhangs.

## APPENDIX 1

DEBT DEALS WITHIN THE "BRADY PLAN" SCHEME:  
MEXICO, COSTA RICA AND VENEZUELA

Mexico (February 1990)

Mexico's debt deal was the first comprehensive deal within the Brady initiative. Three options were offered to banks involved in the negotiations. First, old loans could be exchanged for new bonds at a discount of 35 per cent of their face value, keeping interest rates at market levels, equivalent to LIBOR + 13/16 points. Second, as an alternative old debt could be exchanged for new bonds at face value, (called par bonds) bearing fixed interest rates of 6.25 per cent. The level of interest payments was reduced in both cases. Both alternatives encompassed 30 year bonds, whose principal was guaranteed (collateralised) with loans provided by the IMF, World Bank, Japan and Mexican reserves used to purchase US Treasury zero-coupon bonds; official support was also used to guarantee (collateralise) interest payments for 18 months (rolling). Both bonds had 30 year "bullet" maturities - they had no annual amortization payments, and principal was repaid only at the end of 30 years - which also reduced debt service.

Also, the bonds carried a novel feature; they included a clause of value recovery, making the link between debt service payments and oil prices, the country's main source of foreign exchange. From July 1996 onwards, in case the oil price surpassed the barrier of US\$14 dollars per barrel, (adjusted for US inflation), up to 30 per cent of the additional revenues would accrue to creditors. This additional payment, however, could not exceed 3 per cent of the nominal value of the debt converted into new bonds.

Finally, new money could be provided. These would have to be equivalent to 25 per cent of the banks' medium and long term loans.

At the time the deal was signed, the country's total debt stock was US\$95.6 billions (World Debt Tables 1990-91), being only the share of the long-term debt with the commercial banks subject to restructuring. The debt value involved in the agreement was about US\$49 billions, that is, roughly half of the total debt.

Most banks opted for the parbond implying interest rate reduction (holding US\$22.8 billion of debt, or 46.7 per cent of the total), other banks (holding US\$19.7 billion, that is 40 per cent of the total) chose to reduce the principal and few offered new loans (US\$6.4 billion, or 13.1 per cent of the total).

Banks participating in the debt-relief package were eligible.

Costa Rica (May 1990)

Costa Rica's debt deal was far more successful in that it reduced the country's debt with commercial banks by 61.5 per cent, according to the World Debt Tables 1990-91. It was basically a pure debt/debt service



reduction operation, as there was no new money option. At the time the deal was signed, there was little expectation that the country could access long-term credit flows, as it had been in arrears with the banks since the mid 1980s.

The buyback mechanism was employed at an effective discount of 84 per cent. From a total of US\$1.61 billion of debt (this excludes the unregistered debt converted into local currency), US\$1.2 billion was negotiated within this option; this value includes past-due interest. Banks which tendered over 60 per cent of their claims for buyback could exchange the remainder of their debt for bonds at par-value, for 20 years, with 10 years grace and interest rates of 6.25 per cent. Arrears on interests could be exchanged for 15 years bonds, yielding interest at market levels (LIBOR plus 13/16 per cent). In both cases interest payments were collateralised; the first from 12 to 18 months for converted past-due interest and the second for 36 months interest for converted past-due interest. This option (principal plus past due interest converted) involved US\$290 millions, what corresponded to 18 per cent of the total debt. Banks, with less than 60 per cent of their claims were sold, received bonds with no collateralisation, and a longer maturity (25 years, with 15 of grace). The converted principal would bear a fixed 6.25 per cent interest rate and arrears LIBOR plus 13/16 per cent.

Finally, a recovery clause was included. Payments on interests of bonds resulting from interest arrears would be accelerated and other bonds would receive higher interest rates, once the country's GDP went above 20 per cent of its 1989 level, in real terms. However, such additional payments were limited.

Costa Rica also agreed to set up a debt/equity conversion programme involving a minimum of \$20 million, per annum for the next five years.

It is important to note that to ensure sufficient debt reduction, Costa Rica announced that it would proceed with the operation only if banks holding 95 per cent of eligible claims participated, amount that was exceeded when the operation was concluded.

#### Venezuela (August 1990)<sup>21</sup>

The Venezuelan agreement was similar to that of Mexico, however comprising a wider menu of options.

The first option consisted of debt buybacks. Short-term bills (91 days) were offered in exchange, at 55 per cent discount, fully collateralised. Only US\$1.4 billion was finally involved in this option or, in other terms, 7.2 per cent of the debt eligible to restructuring.

Like in Mexico's deal, the second and third options consisted of discount bonds and par bonds, respectively, fully collateralised. The second option had a discount of 30 per cent, bearing interest rates of LIBOR plus 13/16. A guarantee for interest of 14 months was provided. US\$1.79 billion was chosen within this option, that is, 9.2 per cent of debt subject to negotiation. A par bond was offered in the third option with interest rates of 6.75 per cent, interest payment having also a guarantee of 14 months. US\$7.4 billion (37.9 per cent of total) were involved in this option, the most preferred of all.

The fourth option was the offer of "step-down, step-up" bonds, that is, bonds with temporarily lower interest rates. They would bear an interest rate of 5 per cent in the first 2 years; 6 per cent in the following two years and 7 per cent in the fifth year. From the sixth year onwards the bonds would bear LIBOR plus 7/8 per cent. Unlike the other options, the principal was not collateralised, but would have an interest-guarantee for 12 months during the period with fixed interest rates. The debt retired under this option amounted the value of US\$2.9 billions, or 14.9 per cent of the total involved.

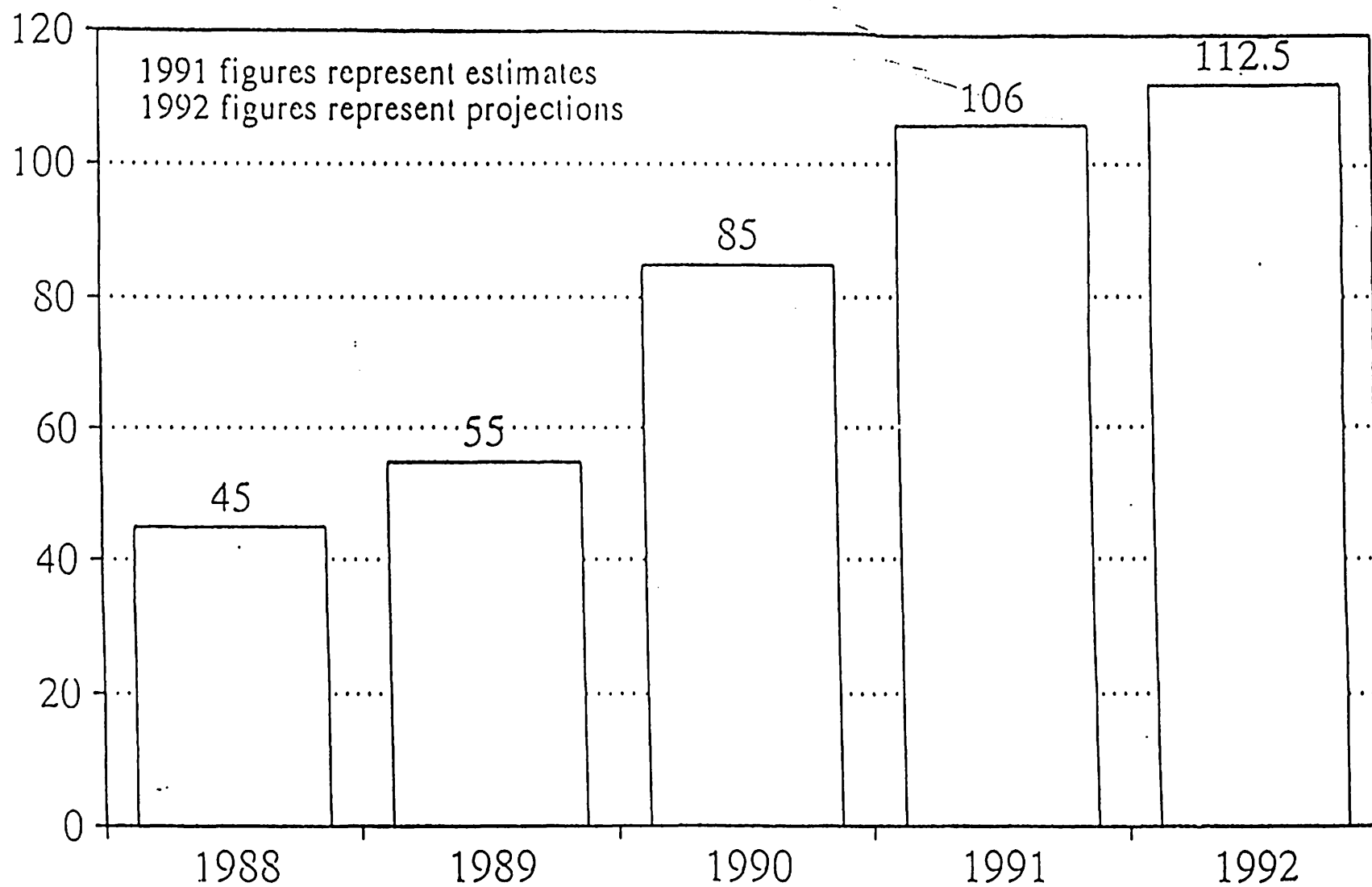
The fifth option encompassed new money, which would have to be provided by creditors at the amount of 20 per cent of the value of their restructured debt. The conversion rights for debt-equity swaps were also included. This option attracted 30.7 per cent of the total debt retired.

Finally, as the cases cited above, a recovery clause associated with the oil prices fluctuation was included. Part of the interest payment could be recovered by creditors in case the oil prices went above US\$26 per barrel, from 1996 onwards.

- <sup>1</sup> See, S. Griffith-Jones with A. Marr and A. Rodriguez "The Return of Private Capital to Latin America: the Facts, an Analytical Framework and some Policy Issues" in J.J. Teunissen (ed.) Fragile Finance. FONDAD, Holland, 1992.
- <sup>2</sup> For good discussion, see, for example, World Bank World Debt Tables 1, 1989-90 and 1991-92; P. Mistry, African Debt Revisited. FONDAD. The Hague, 1992.
- <sup>3</sup> For a more detailed discussion, see, for example, P. Mistry and S. Griffith-Jones Conversion of Official Bilateral Debt. 1992. Report prepared for UNCTAD, especially Chapter I.
- <sup>4</sup> For a useful history and review of debt-equity conversions, see UN UNCTC Debt Equity Conversions. A Guide for Decision-Makers. New York. 1990.
- <sup>5</sup> 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.
- <sup>6</sup> For a more detailed discussion, see P. Mistry and S. Griffith-Jones, op. cit., especially Chapter II and IV.
- <sup>7</sup> See, for example, P. Aspe "The Renegotiation of Mexico's External Debt", in M. Faber and S. Griffith-Jones (eds) Approaches to Third World Debt Reduction, IDS Bulletin, Vol 21, No 2, April 1990.
- <sup>8</sup> See, for example, Aspe, op. cit, several CEPAL publications, World Bank, World Debt Tables, 1990-91, Washington DC, Van Wijnbergen, op. cit.
- <sup>9</sup> Van Wijnbergen, (1991) "Mexico and the Brady Plan", Economic Policy, April.
- <sup>10</sup> The Mexican government initially requested 55 per cent debt relief; the final agreement reached included a debt relief option with 35 per cent debt relief.
- <sup>11</sup> The former figure is based on World Bank, op. cit, calculations; the latter on own calculations.
- <sup>12</sup> For a more detailed analysis of this, see S. Griffith-Jones with A. Marr and A Rodriguez, op. cit.
- <sup>13</sup> For a description of how time-consuming, distracting and costly, Costa Rican debt negotiations were, see E. Rodriguez "Costa Rica: A Quest for Survival", in S. Griffith-Jones (ed) Managing World Debt, Wheatsheaf (UK), St. Martin's Press (US) and FCE (Mexico).
- <sup>14</sup> R. Devlin and M. Guerguil (1991) "America Latina Y las nuevas corrientes financieras y comerciales" in Revista de la CEPAL, 43; see also, S. Griffith-Jones (ed), op. cit, "Conclusions" chapter.
- <sup>15</sup> J. Sachs and J. Kneer (1990) "Debt reduction: The Basis and Shape of a New Strategy", Inter-economics, January/February.

- <sup>16</sup> For details, see for example, The World Bank, Debt and International Finance Division, Financial Flows to Developing Countries. Quarterly Review, June 1992.
- <sup>17</sup> For good discussion of the reasons for banks' attitudes at the time, see, for example, R,. Devlin "Development vs. Debt: Past and Future" in M. Faber and S. Griffith-Jones (eds.), op. cit., above.
- <sup>18</sup> For an analysis of this, see P. Mistry and S. Griffith-Jones, op.cit.
- <sup>19</sup> For more details, on the conversion of official bilateral debt, see S. Griffith-Jones "Conversion of Official Bilateral Debt: the Opportunities and the Issues" World Bank Annual Conference on Development Economics. 1992. Proceedings; see also P. Mistry and S. Griffith-Jones, op. cit., for a more detailed analysis.
- <sup>20</sup> Based on interview material.
- <sup>21</sup> Additional Source: Alvarez, A.M., (1990) "Venezuela En Los Anos Noventa: Acuerdo De Reduccion De Deuda Y Politica De Ajuste", in Seminario sobre Reconversion Productiva con Equidad, prepared by el Foro sobre Deuda y Desarrollo (FONDAD) jointly with la CEPAL and PREALC. Santiago de Chile 18 - 24 November 1990.

# Total trading volume (US\$ billion)



Source: Latin Finance (October 1991)

FIGURE 2:

CONDITIONS UNDER WHICH DEBT CONVERSIONS ARE MORE OR LESS DESIRABLE

	INITIAL LOW INFLATION I	INITIAL HIGH INFLATION II
Debt that would be serviced	<u>Very</u> 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.	Only desirable if conditions in both II and III are met.