

Debt/Equity Swaps: Benefits and Costs
From the Debtor's Viewpoint

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This paper describes the aims and modalities of debt/equity swap schemes and provides a framework for evaluating their costs and benefits from the debtor country's viewpoint. The paper focuses on the Mexican and Philippines schemes but the conclusions have more general applicability. Section 1 describes the main features of debt/equity swap transactions and discusses the reasons for their emergence. Data on the estimated volume of transactions in the large debtor countries are presented. Section 2 evaluates the advantages and disadvantages of the schemes. Section 3 reviews the main features and operation of the Mexican and Philippine schemes, and Section 4 presents concluding remarks.

1. The Debt/Equity Swap Market

Since the onset of the debt crisis in 1982, the bank debt of several developing countries has been traded at a discount in the secondary market. This was initially a market in which banks that wanted to alter their loan mix exchanged claims on one country for claims on another. Claims were often exchanged at par to avoid recognizing losses. The inception of debt/equity conversion schemes in 1983-85 fueled the expansion of the secondary market to an estimated volume of about US\$5 billion in 1987.

Debt/equity swaps typically involve purchases of loan claims from commercial banks at a discount for redemption in domestic currency by the central bank of the debtor country. The domestic currency thereby obtained by the investor must be used to acquire equity in designated private or public sector firms in the debtor country. The redemption price ranges between full face value and the secondary market price of the debt concerned.

Among the debtor countries that have adopted debt/equity swap schemes, the most actively traded bank claims are those on Brazil, Chile, and Mexico. Bank claims on Argentina and the Philippines are also traded regularly. The modalities of the schemes and associated restrictions on the repatriation of dividends and capital differ across debtor countries that have adopted such schemes. Differences include the types of debt eligible for conversion, the modalities of conversion, the types of investments that are eligible for equity participation, and the eligibility of resident investors. The amount of debt that has been converted since 1983 for major debtors that have adopted such schemes is set out in the table below. Most of the transactions shown have occurred since 1985, after the introduction of debt/equity swap schemes in Chile, Mexico and the Philippines.

Table 1. Debt/Equity Conversions, 1983-87 1/

(In billions of U.S. dollars)

	Debt conversion 1983-87	Net direct investment inflows 1980-82	1983-85	1986	Total bank debt end-1987
Argentina	0.5	2.0	1.4	1.0 <u>2/</u>	31.3
Brazil	2.2	6.4	4.2	...	78.8
Chile	2.6	0.9	0.3	0.6	13.9
Mexico	1.8	6.4	1.4	0.9	73.7
Philippines	0.2	0.3	0.1	0.1	15.1
Total of above countries	7.3	16.0	7.4	...	212.8

Sources: IMF, Treasurer's Department; and IMF, Balance of Payments Statistics Yearbook, 1987.

1/ Debt/equity swap schemes were introduced in Argentina at end-1984, Brazil in 1983, Chile in 1985, and Mexico and the Philippines in 1986.

2/ 1985.

The growing number of swap transactions reflects their perceived advantages for all parties concerned. Debt/equity swaps have permitted banks to reduce their exposures to particular debtor countries, and smaller banks to sell their entire exposures rather than participate in new money packages. From the creditors' viewpoint, this approach is consistent with the voluntary market-based approach to resolving the debt problem. Debt/equity swaps have also permitted debtors to reduce their debt while capturing part of the discount in the secondary market, and investors--resident or nonresident--to obtain domestic currency at a better rate than the prevailing exchange rate. Additional benefits could accrue to debtor countries through the substitution of fixed

interest payments by a dividend stream that depends on the profitability of equity investments. Debtor countries have also seen debt/equity swaps as a means of stimulating growth through the implicit subsidy to investment that such transactions involve. Where residents are permitted to participate in the scheme, new investment is seen to be financed through the repatriation of flight capital. The conditions under which debt/equity schemes can be expected to fulfill these objectives are discussed in Section 2.

2. Benefits and costs

From the debtor's viewpoint, the ultimate objective of debt/equity swaps is to provide a mechanism to fund investment at a subsidized rate while reducing external debt. A number of restrictions imposed under the schemes are intended to ensure that their operation results in additional balance of payments finance. Features of the schemes that are intended to ensure additionality include restrictions on: (a) eligible investments and screening of investment applications; (b) debts eligible for conversion, to avoid prepayment through conversion of debt that has not come due; and (c) dividend and capital repatriations. The extent to which these restrictions can be expected to result in incremental resources is discussed under the balance of payments section below. The monetary and fiscal implications of debt/equity swaps as well as the potential gains from the associated reduction of external debt are reviewed next.

a. Impact on balance of payments

The scheme could attract additional external resources insofar as it involves an investment subsidy equal to the difference between the secondary market price and the price at which the debt is converted into local currency. ^{1/} However, the scheme could be used to either finance investments that would have occurred anyway on more favorable terms than would otherwise be available, or to re-export, at a profit, the domestic currency obtained in counterpart of the redeemed debt (round-tripping).

Round-tripping operations exploit the arbitrage opportunities created by the spread between the parallel market rate and the rate at which debt is converted into local currency to acquire equity. Insofar as domestic currency can be obtained at a more favorable exchange rate under the debt/equity scheme, investors have an incentive to divert their planned investments to the scheme. For instance, subsidiaries of foreign companies could repatriate, through the parallel market, dividends that would otherwise have been reinvested, and reimport them through the debt/equity conversion scheme at a more favorable rate. To the extent that the screening of applications does not ensure that the investment is truly additional, the operation of the system thus subsidizes investment that would have occurred in any case. The adjustment in the conversion rate provided for under the Mexican scheme if the spread between the official and parallel market rates deviates

^{1/} Whether the debtor or the creditor pays for the subsidy to the investor depends on the extent to which the secondary market price accurately reflects the debt servicing capacity of the debtor. If so, the debtor bears the cost of the subsidy insofar as the redemption price exceeds the secondary market price.

from a specified norm could reduce, but not remove, this form of round-tripping. The Philippine scheme incorporates no such mechanism.

Another type of round-tripping could occur if residents converted their local currency at the parallel exchange rate and repurchased domestic currency through the debt/equity swap scheme at the subsidized rate. In this case, the total amount of savings available for investment would increase only if the funds would have been invested abroad in the absence of the scheme.

This reasoning applies to the repatriation of resident capital held abroad. Where residents are permitted to participate in the debt/equity conversion scheme, a balance of payments gain may result from the repatriation of resident capital. The limitations typically imposed on capital and dividend repatriations under the schemes do not necessarily constitute an effective way of ensuring that the capital inflow is not re-exported. The fungibility of money implies that residents could borrow an equal amount of domestic currency, or use domestic savings that would otherwise be available for domestic investment, for re-export through the parallel market.

A lasting incentive to hold domestic currency would result only if the return on domestic assets increased. Although the investment subsidy implicit in the scheme raises the return on domestic investment, the same result could be achieved in a more transparent manner through a dual exchange rate or a direct subsidy. Moreover, there is no effective way of (a) ensuring that the subsidy implicit in debt/equity conversions is provided only for marginal investment, as opposed to investment that would have occurred anyway, and (b) preventing round-tripping in cases

where domestic currency can be obtained at a more favorable rate through the debt/equity scheme than in the parallel market.

A net gain for the current account may result from the scheme to the extent that interest payments on the redeemed foreign debt exceed dividend remittances abroad, which are subject to restrictions under most schemes. The schemes have not been in operation long enough to assess whether this has been the case. An additional benefit of equity compared to debt funding is that dividend remittances would be correlated with the return on domestic assets, resulting in a more balanced risk-sharing pattern between creditors and debtors compared to interest payments.

This gain must be set against a potential loss in the capital account that would be incurred if the foreign inflow is not fully additional. If so, foreign debt would effectively be repaid by crowding out domestic investment (if the local currency counterpart of the conversion is funded by issuing domestic debt) or by imposing an inflation tax (if funded through an expansion of base money), reducing the resources available to the economy. The impact of debt/equity swaps on the balance of payment is illustrated in the tabulation below:

Balance of Payments Impact of Debt/Equity Swaps

	<u>Gain</u>	<u>Loss</u>
Current account	interest on debt	dividend on equity
Capital account	investment inflow	debt repayment

A drawback of the scheme from the viewpoint of the availability of future resources to the debtor country is the distortion introduced in investment decisions by the preferential conversion rates offered on selected investments under most existing schemes. The multiple subsidy rates implicit in such schemes introduce a distortion in the sectoral allocation of investment. These distortions could direct investment toward activities with a low rate of return, reducing the country's future foreign exchange earning capacity.

b. Monetary implications

The operation of the debt/equity swap scheme has a monetary impact insofar as public sector debt is converted into equity through the intermediation of the central bank, which issues domestic currency in counterpart to the redeemed debt. The inflationary impact of the additional domestic currency could crowd out domestic expenditure through the inflation tax, reserves losses, or downward pressure on the exchange rate. Alternatively, the central bank could sterilize the monetary impact of this operation by absorbing liquidity through the sale of bonds in the open market. Bond sales could entail a rise in

interest rates, raising the fiscal deficit and crowding out other domestic expenditure. External debt would thus in effect be repaid by using up resources that would otherwise be available domestically, irrespective of whether the conversions are funded by issuing bonds or domestic currency.

A monetary expansion resulting from debt conversions need not have an impact on inflation if it supports a higher level of economic activity. If not, the operation of the scheme has inflationary consequences. On the contrary, a negative monetary impact--or a reduction in domestic interest rates--could result from the reduction in the fiscal deficit that the conversion of external public debt may entail (see below). The conversion of private sector debt into equity, if eligible for conversion, has no monetary impact insofar as it involves the transfer of existing liquidity from the private debtor to the equity holder without the intermediation of the central bank.

c. Fiscal implications

The fiscal implications of debt/equity swap schemes are probably marginal. The operation of the scheme could raise the fiscal deficit if funded through the issuance of domestic debt carrying higher real 1/ interest rates than the redeemed external debt. An offsetting fiscal gain results from the conversion of debt at less than face value. The net budgetary gain would thus equal the difference between the discounted price paid by the debtor to the investor and the real

1/ Differentials in the inflation component of nominal interest rates have no impact on public finances insofar as they reflect expected exchange rate changes that would have raised the local currency value of external debt.

interest rate differential between domestic and foreign obligations.

A gain in fiscal revenue could also arise to the extent that the dividends arising from the investments that occur under the debt/equity scheme are taxable, whereas interest payments to foreign banks are not. An additional gain could arise under schemes that impose conversion fees that accrue to the government (e.g., the Philippines) or auction fees where the government auctions the right to swap debt (e.g., Chile).

d. Effect on market discount

A number of authors have suggested that the absence of a mechanism to subordinate new debt to existing debt deters capital inflows and investment in debtor countries (see Dooley, 1986). In the absence of subordination, creditors assume that the value of any new claims on the debtor will immediately fall to the same discount as existing claims. The investment outlook could therefore be improved if the market valuation of debt were to rise. By reducing external debt, debt/equity swaps would tend to raise the market valuation of debt by increasing the probability that the remaining debt will be serviced. Swaps may consequently improve the country's investment outlook. The same reasoning applies to debt-for-cash swaps.

3. Debt/Equity swaps in Mexico and the Philippines

Debt/equity swap schemes were introduced in Mexico and the Philippines in 1986. Swap transactions in Mexico were explicitly provided for in the 1985 and 1987 restructuring agreements with commercial banks. Operations under the scheme started in April 1986. A few months later the Philippines introduced a similar scheme outside of

the framework of any bank refinancing/new money package, which shared many of the features and objectives of the Mexican scheme. Under the Mexican scheme, only public debt covered by the rescheduling agreements of 1985 and 1987 was eligible for conversion, whereas the Philippine scheme also covered debt of the private sector.

The objectives of both schemes were to (a) stimulate domestic investment by residents and nonresidents; (b) channel this investment in preferred sectors through preferential conversion rates; (c) reduce external indebtedness; and (d) promote the repatriation of flight capital. The last objective was explicitly included in the Mexican scheme since 1987, when residents were permitted to participate in the scheme.

The average rate at which the redeemed debt was converted into domestic currency to acquire equity in local firms was below the face value under both schemes. In Mexico the conversion rate ranged from full face value for investment in priority sectors to 75 cents per dollar of redeemed debt for nonpriority sectors, compared with a secondary market price of 60 cents when the scheme was introduced. In the Philippines, debt purchased in the secondary market was redeemed at full face value into local currency, but applicable conversion fees and new money requirements reduced the average conversion rate to 95 cents for priority sectors and 80 cents for nonpriority investments per dollar of converted debt, compared with a secondary market price of about 70 cents prevailing at the time of the scheme's inception. In contrast to the Mexican scheme, the portion accruing to the Philippine debtor was initially independent of the secondary market price for Philippine

debt. If the market price were to fall, the entire gain would accrue to the investor. The decline in the secondary market price of Philippine debt in mid-1987 following Citycorp's provisioning action and an attempted coup d'état in the Philippines led to a revision of the scheme to enable the authorities to capture a larger portion of the growing discount. A new structure of fees and new money requirements was introduced providing for a 50-50 sharing of the discount between the investor and the debtor at a market price of 60 cents. The sharing of the discount nevertheless continued to depend on the size of the discount.

Unlike similar schemes in other debtor countries, the Mexican and Philippine schemes could only be used for the purchase of new--as opposed to existing--productive assets, to maximize the additional resources available for investment. In line with other schemes, restrictions were also placed on the repatriation of dividends and capital relating to equity conversions, which were stricter than those applied to other foreign investment.

The monetary implications of the schemes were of concern to the authorities of both countries. To the extent that the central bank issued domestic currency in counterpart of the converted debt, the monetary base expanded. Although the monetary impact of the conversion could in principle be sterilized through open market operations, in practice the absence of a long-term bond market in Mexico limited the authorities' ability to place bonds in the market. The Mexican scheme was thus temporarily suspended in November 1987 when a stabilization program was introduced, out of concern over its inflationary

consequences. The Philippine scheme was modified for the second time in February 1988 partly to contain the inflationary impact of conversions.

Until the suspension of the Mexican scheme in November 1987, the face value of the approved conversions amounted to US\$1,322 million, the bulk of which were effected over this period. This compares with total external public debt due to commercial banks of US\$76 billion as of end-1986. ^{1/} In the Philippines, approved conversions from the scheme's inception to early March 1988 amounted to US\$843 million, less than half of which were effected over this period. Although lower than in Mexico, this amount represented a larger proportion of bank debt, which stood at US\$15 billion at the end of 1986. Equity obtained through swaps represented a significant proportion of direct investment inflows during the scheme's operation in both countries.

The impact of debt/equity conversions on the secondary market price of Mexican and Philippine debt is difficult to assess because several other factors were driving the secondary market price. The price fell in both countries since the introduction of the scheme, but this reflected Citycorp's provisioning action in May 1987 which reduced the market price of all sovereign debt, as well as a number of other domestic and external factors (stock market crash; exchange rate action, macroeconomic policies, and political developments in the debtor countries).

^{1/} Including external debt of nationalized commercial banks in Mexico, which has been rescheduled and was eligible for conversion to equity.

The modalities and operation of the two schemes are reviewed in greater detail below.

a. Mexico

Debts eligible for conversion under Mexico's scheme included principal maturities owed by the public sector and covered by the rescheduling agreements of 1985 or 1987. Private sector debt was not eligible for conversion, although such conversions occurred outside the framework of the scheme.

Eligible investments under the scheme included shares in private or public companies in nonstrategic sectors, subject to the approval of the Mexican authorities. To ensure that the domestic currency issued in counterpart of the converted debt resulted in incremental investment and economic activity in Mexico instead of being re-exported, Mexican firms had to use the proceeds of the sale of their share to either invest in new physical assets or repay domestic currency obligations. To enforce this regulation, the local currency counterpart of the debt/equity conversion was paid directly to local suppliers or to the creditor holding the domestic currency claim. Contributions to the working capital of existing firms were not eligible under the scheme, nor was the repayment of obligations of existing firms to foreign creditors, suppliers, and to the parent companies of Mexican subsidiaries. Exceptions to the regulation were permitted only if the proceeds from the conversion were used to purchase shares in public enterprises under the privatization program.

The price at which the redeemed debt was converted into domestic currency to acquire equity in Mexican firms ranged from full face value

for investments in priority sectors to 75 cents per dollar of redeemed debt for nonpriority sectors. Given that the debt/equity swaps which took place while the scheme was in operation were evenly distributed between priority and nonpriority sectors, the average price applied to the conversions was 88 cents to the dollar, resulting in an implicit subsidy of 12 percent to the investory. This compares with an average price in the secondary market for Mexican debt of about 60 cents to the dollar of this period. The implied sharing of the market discount between the Mexican authorities (30 percent) and the foreign investor (70 percent) would vary with the proportion of conversions implemented in the preferred sectors, but not with the secondary market discount for Mexican debt. This is because, in contrast to the Philippine scheme, the Mexican scheme provided for adjustments in the conversion price if the secondary market price at which the investor acquired the debt deviated from a specified norm.

The exchange rate at which the redeemed debt was converted into domestic currency to acquire equity was the parallel market rate. To minimize round-tripping, the scheme provided for adjustments in the conversion price if the spread between the official and parallel market rates deviated from a specified norm. In practice this provision was merely precautionary because the spread between the official and the parallel market rates was negligible during the period in which the scheme operated.

However, round-tripping operations could not be effectively prevented given the more favorable rate at which domestic currency could be obtained through the swap mechanism compared to the parallel market.

The monetary implications of the scheme were significant and led to its eventual suspension in November 1987. While the scheme was in operation, funding of the countries debt/equity swaps through money creation was constrained by an inflation rate in excess of 120 percent. On the other hand, funding through the issuance of additional Treasury bills was constrained by the prevailing high level of real interest rates. These constraints on monetary policy in turn constrained the expansion of debt/equity conversions.

By contrast, the net impact of the scheme on the budget was probably marginal. On the one hand, the high real interest rates prevailing in Mexico since the scheme started operating had an adverse impact on both the conventional and the operational (inflation-adjusted) fiscal deficits. While the scheme operated, the real return on peso-denominated three-month Treasury bills averaged 17 percent, 1/ compared with an average real interest payable on foreign currency obligations of about 5 percent. The cost to the budget arising from real interest rate differentials thus averages 12 percent per dollar of converted debt. On the other hand, an offsetting fiscal gain resulted from the conversion of external public debt into local currency at an average discount of 12 percent from face value. Given that the scheme permits the repayment of domestic obligations of Mexican firms in which

1/ The Mexican authorities' ability to place non-indexed peso-denominated bonds of longer maturity is constrained by the high and rising inflation rate. The substitution of domestic for external debt consequently entails a deterioration in the maturity structure of total public debt. If uncertainty regarding the inflation trend were to rise, the rollover of short-term domestic debt could require higher real interest rates, imposing an additional burden on public finances.

equity is acquired, firms cannot be effectively prevented from re-borrowing an equal amount locally upon the repayment of the original obligation and re-exporting the proceeds through the parallel market.

As originally established under the 1985 restructuring agreement with commercial banks, the scheme limited eligible investors to nonresidents. This provision was amended under the 1987 restructuring agreement to permit the participation of residents. The extension of eligibility to residents was intended to promote the repatriation of resident capital held abroad, and to permit residents to capture the discount at which bank claims could be purchased.

The restrictions on the repatriation of capital and dividends that applied to investments undertaken in connection with a debt/equity conversion were tighter than those applied to other foreign direct investment. Investments undertaken under the scheme could not benefit from guaranteed dividends repatriated irrespective of earnings and profits. To avoid the "prepayment" of debt through its conversion to equity, capital repatriation of the investment could not occur before the due date of the debts it replaced. Moreover, such equity investments were not transferable to any Mexican public or private sector entity before January 1, 1998.

b. The Philippines

Debts eligible for conversion under the original version of the Philippine scheme included all private sector principal maturities, whether covered by a rescheduling agreement or not and irrespective of their due date. Principal maturities owed by public sector borrowers were eligible for conversion provided they were covered by a

rescheduling agreement or fell due before January 1, 1987. This rule was intended to prevent the implicit prepayment through equity conversion of debt that was likely to be rescheduled under the agreement that was subsequently reached with bank creditors. Also eligible for conversion are credits, including deposits, maintained by the central bank and covered by the Trade Facility. 1/ Other obligations could be approved for conversion by the Monetary Board on a case-by-case basis.

To ensure that the scheme results in incremental investment and economic activity in the Philippines--rather than divert via the conversion scheme resources that would have been available in any any case--eligible investments were limited to the purchase of new assets in certain sectors of economic activity, as was the case under the Mexican scheme. Purchases of existing equity from the current stockholders, contributions to the working capital of existing firms, or the repayment of domestic or foreign obligations of existing firms were not eligible under the scheme. Exceptions were permitted if conversion is to be used in part to repay obligations of the Government or its agencies or to purchase existing assets from the Government under the privatization program.

1/ The Trade Facility was established in connection with the 1985 refinancing package. It provided for the maintenance of the outstanding level of trade credits as of a given date, or failing that, the deposit with the Central Bank of any net repayments of credit lines available as of that date.

The scheme provides for conversion of the external claims at full face value at the prevailing exchange rate. ^{1/} However, conversion fees and new money requirements reduce the average rate at which the redeemed debts are converted into domestic currency, enabling the authorities to capture part of the discount. Under the original version of the scheme, conversion fees amounted to 5 percent of the face value of converted debt for investment in preferred sectors ("schedule 2") and 10 percent for less preferred sectors ("schedule 3"), bringing the average conversion rate to 90 or 95 cents to the dollar. This compared to an average price for Philippine debt in the secondary market of between 70 and 75 cents to the dollar at the time of the scheme's inception. For investment in less preferred sectors there was "new money" requirement equivalent to 10 percent of the value of the investment, in addition to the 10 percent conversion fee. The new money requirement thus reduced by 10 percent the implicit subsidy to the investor in nonpriority sectors. All transaction requests were also subject to a nonrefundable application fee of about US\$500.

This structure of fees and new money requirements implied that the entire decline in the secondary market price for Philippine debt to 60 cents in mid-1987 was captured by investors. The October 1987 modification of the scheme introduced a new structure of fees and new money requirements to permit the authorities to capture a larger share of the discount. Moreover, the new regulations prohibited the payment

^{1/} Since 1984, the Philippine peso is market determined and the spread between the official and parallel market rate has disappeared. Certain restrictions on capital account transactions apply, but they do not appear to be effective given the absence of a parallel market.

of the fee out of the local currency proceeds of the conversion. This restriction made the fee equivalent to a new money requirement, unless the investor had access to local currency directly or through the Philippine banking system. The cost to investors per dollar of investment under the revised scheme can be derived as follows:

$$C = n + (1-d) D + f D$$

where:

C = cost to investor per dollar invested
n = new money requirement, in percent of value of investment
D = face value of converted debt
d = market discount, in percent
f = applicable fee, in percent of face value of converted debt.

The conversion fee (f) is a decreasing function of the new money requirement (n) under the revised scheme. The modified fee and new money requirements for "schedule 2" investments in preferred sectors were designed in such a way that a market discount of 40 percent would be shared equally between the investor and the debtor irrespective of the combination of f and n chosen by the investor (Table 2). For discounts different than 40 percent the sharing of the discount depends on the combination of f and n chosen by the investor. Discounts above 40 percent provide the investor with the incentive to fund as little as possible of the investment with new money. The opposite is the case for discounts below 40 percent. A similar sharing of the discount--but less advantageous for the investor--was stipulated for "schedule 3" investments in nonpriority sectors. The further decline in the secondary market price of Philippine debt to 50 cents per dollar in early 1988 therefore provided investors an incentive to pay higher fees

Table 2. Philippines: Shares of Discount Captured by
Investor and Debtor Under Alternative Combinations
of New Money Requirements (n), Fees (f), and Market Discounts (d) 1/

(In percent)

New money	Conversion fee	Cost to investor per dollar invested	Share of discount	
			Investor	Debtor
<hr/>				
<u>d = 50</u>				
50	--	75	50	50
40	6.7	74	52	48
30	11.5	73	54	46
20	15.1	72	56	44
10	18.0	71	58	42
--	20.0	70	60	40
 <u>d = 40</u>				
50	--	80	50	50
40	6.7	80	50	50
30	11.5	80	50	50
20	15.1	80	50	50
10	18.0	80	50	50
--	20.0	80	50	50
 <u>d = 30</u>				
50	--	85	50	50
40	6.7	86	47	53
30	11.5	87	43	57
20	15.1	88	40	60
10	18.0	89	36	64
--	20.0	90	33	67

1/ Applies to "Schedule 2" investments in preferred sectors.

2/ See text for definition of units.

rather than bring in new money. In practice, there is no effective way of ensuring that the conversion fees are fully paid out of "new" money. Investors who have access to local currency either directly or through the Philippine banking system may not fund the fees with new money.

The October 1987 modifications also expanded the coverage of debt eligible for conversion to include the new money package obtained from commercial banks in 1985, and the coverage of eligible "schedule 2" investments to include the banking sector and equity in privatized public sector firms.

Additional modifications were introduced in February 1988, designed to (a) limit the inflationary consequences of the scheme, (b) revise certain aspects of the scheme that may have discouraged the conversion of private debt, and (c) channel equity acquired through debt swaps into sectors that met certain criteria.

The operation of the debt/equity conversion scheme in the Philippines has had a monetary impact insofar as almost the totality of redeemed debts were central bank obligations, in counterpart of which local currency was issued. An indicative limit for conversions via the central bank was therefore introduced under the February 1988 modifications, which was flexibly applied depending on monetary conditions. Given the small size of total transactions under the debt/equity scheme, the operation of the scheme since its inception has not posed serious problems for monetary control. Private debt was not subject to the limit because it could be swapped directly between debtor and investor without central bank intermediation, and consequently had no monetary implications.

The February 1988 revisions waived the conversion fees for private debt swaps, in order to increase the flexibility of private debtors to negotiate the discount directly with the creditors. Revised criteria for evaluating debt/equity swap applications were introduced at the same time, aimed at channeling a greater proportion of the investment to the export sector, generating employment, and achieving regional objectives.

The operation of the scheme is likely to have resulted in a fiscal gain. Nominal and real interest have remained at about the same level as those on U.S. dollar claims, in which the bulk of the converted debt is denominated. Real interest rate differentials are thus unlikely to have had an adverse budgetary impact of any importance, while the conversion of external public debt at a discount has resulted in a fiscal gain.

Certain restrictions on investments undertaken under all versions of the scheme apply to both capital and dividend repatriation. In preferred sectors, capital repatriation is not allowed within the first three years after the investment is made. Capital repatriations in subsequent years are limited to 20 percent of the value of the investment per year. Dividend repatriation out of profits is not restricted. In the less preferred sectors, 20 percent of the capital portion of the investment may be repatriated per year after the fifth year. Dividend payments are allowed only after the fourth year. As is the case with the restrictions on eligible investments, these restrictions were intended to ensure that debt/equity swaps increase the external resources available for the economy. Similar restrictions do not apply to investments undertaken outside the debt/equity conversion framework.

4. Conclusions

The conversion of external debt into equity simply substitutes one type of liability for another and does not per se increase the availability of foreign resources.

An increase in foreign resources available for investment would only result if the return on domestic assets increased. This could be achieved through exchange rate and interest rate movements but is not inherent in debt/equity swap schemes, which provide only temporary incentives to acquire domestic currency. As is the case with exchange restrictions, restrictions aimed at ensuring the additionality of external resources obtained through the scheme may be bypassed. Section 2 describes a number of ways in which this may occur.

Even if additionality cannot be assured, debt/equity swaps benefit the debtor country by permitting it to reduce its external debt and capture part of the discount prevailing in the secondary market. The implicit yield to the debtor of debt/equity swaps consists of two portions: (a) the reduction in interest payments implied by the substitution of a domestic debt for a foreign debt purchased at less than face value, and (b) the reduction in the discount prevailing in the secondary market on account of the reduction in the outstanding debt through its conversion to equity. A lowering of the discount would, over time, improve creditworthiness and reduce the spreads on new borrowing. These two components of the implicit yield of retiring debt through conversion must be set against the cost of crowding out domestic spending through an increase in domestic interest rates, or through an inflation tax and downward pressure on foreign exchange reserves or the exchange rate, depending on the manner in which the local currency

counterpart of the debt conversion is funded. Crowding out would imply that external debt is in effect repaid by using up resources that would otherwise be available domestically.

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