Policy Discussion Paper
Commercial Bank Debt Restructuring--The Experience of Bulgaria

by

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April 1995

Abstract

This paper reviews commercial bank debt restructuring based on the recent experience of Bulgaria. While the deal is shown to have generated substantial debt relief at a remarkably low cost, several lessons are drawn that may be of broader relevance to countries restructuring bank debt. As, from time to time, it has been suggested that Bulgaria should have held out for more favorable treatment, or that it should now seek further debt reduction, the likely costs of these options are identified. Looking ahead, key policy issues are discussed that will determine growth prospects and debt sustainability over the medium term. It is argued that the deal’s success remains to be underpinned in particular by judicious fiscal and debt management policies.

JEL Classification Numbers:
F34, G15

1/ The author is grateful for insightful comments received from Russell Kincaid, Alejandro Santos, Anoop Singh and, at the World Bank, Mariana Todorova.
I. Introduction

A major challenge facing Bulgaria in 1991 when it embarked on its transition to a market-based economy was its external debt overhang to commercial bank creditors. The previously centrally planned system had engaged in large sovereign borrowings during the second half of the 1980s, when production distortions became manifest and consumption was increasingly sustained by recourse to foreign savings. This resulted in an excessive commercial debt burden that prompted the announcement of a debt moratorium in March 1990, leading to a loss of access to trade credits and international capital markets.

On July 28, 1994, after more than two years of intense negotiations with a steering committee representing creditor banks (the "London Club"), Bulgaria completed a market-based Debt and Debt Service Reduction (DDSR) operation. Over three hundred commercial banks participated in the deal on a voluntary basis. The DDSR package was in line with the basic tenets of the so-called Brady Plan and was the first with an Eastern European country. About US$8.3 billion of outstanding bank debt was restructured, resulting in substantial debt relief and a repayment schedule spread over a thirty-year period. The operation involved large upfront costs to provide the necessary guarantees of future payment, to fulfill some downpayment of interest arrears, and to compensate banks that opted for the immediate—albeit heavily discounted—settlement of their claims. These costs were initially financed from Bulgaria's international reserves, which were subsequently replenished by the IMF and the World Bank.

The exchange of old debt for new bonds benefitted both parties. Bulgaria reduced its debt overhang, improved the maturity structure of its
obligations and lessened uncertainties that deterred domestic and foreign investors. For their part, the banks experienced a rise in the market valuation of their outstanding claims, reflecting both the improved prospects for Bulgaria's viability and the collateral that was placed in an escrow account to provide assurance of timely payments in the future. (Indeed, Brady bonds commitments have been honored by all issuing countries to date.) The risk of eligible banks not participating in the package and free-riding without granting debt reduction, was overcome by a Bulgarian covenant that such creditors would not be given more favorable treatment than the terms of the DDSR deal.

As only two important Eastern European commercial creditors (with claims of about US$820 million) opted not to take part in the deal, the restructuring agreement represented a crucial step forwards in normalizing Bulgaria's relations with the international financial community. Pending the implementation of policies that will promote the continued close involvement of banks in its economic revival, the DDSR operation could be viewed as a turning point in Bulgaria's efforts aimed at full integration with the world economy. Some benefits are already evident in the wake of the deal, as several foreign banks have recently established subsidiaries in Bulgaria and as an increasing number of trade credit lines has been reopened.

II. The Menu of Options

As the tenth market-based debt restructuring agreement involving a menu of debt conversion options, the Bulgarian package consisted of relatively
well-tried options (summarized in Annex A). 1/ Banks had the choice between a debt buyback at about one quarter of face value, a discount bond with fifty percent upfront debt reduction and floating market-determined interest rates, and a par bond carrying reduced interest rates during the first seven years (also referred to as a Front Loaded Interest Reduction Bond (FLIRB)). All interest arrears other than those purchased under the buyback option were converted into Interest Arrears Bonds.

Collateral was provided to cover one year's interest payments on the discount bond at a rate of 7 percent per annum, and on the par bond--only during the first seven years--at a reduced rate of initially 2.6 percent rising to 3 percent through retained earnings. In addition, the principal of the discount bonds was fully collateralized by the purchase of zero coupon U.S. Treasury securities that guaranteed payment of the bullet amortization in thirty years (in 2024). The maturities of the other bonds were tailored to a strengthened balance of payments over the medium term: grace periods for principal payments were granted of seven years on the interest arrears bonds and eight years on the par bonds, with full amortization over seventeen and eighteen years respectively.

With these options, Bulgaria achieved net debt reduction in four different ways: (i) the reduction (by about three quarters) of principal and interest arrears through the cash buyback option; (ii) the fifty percent write-off of principal allocated to the discount bond; (iii) the interest

1/ Previous deals had been concluded by Argentina, Brazil, Costa Rica, Jordan, Mexico, Nigeria, the Philippines, Uruguay and Venezuela. Since the Bulgarian restructuring, the Dominican Republic and Poland have also implemented commercial bank agreements.
savings on the par bonds generated by fixed sub-market interest rates during
the first seven years; and (iv) the calculation of interest arrears
accumulation at a reduced annual rate of 3.5 percent since September 1992.
In addition, Bulgaria achieved gross debt reduction by providing collateral
that effectively prepaid future obligations.

In its negotiations with commercial banks, Bulgaria faced a perplexing
dilemma. On the one hand, it had the objective of maximizing the net
present value of debt reduction, in particular by achieving a large
allocation of buybacks or, as a second best alternative, of discount bonds.
On the other hand, it sought to limit the upfront costs of the deal, as it
was constrained by a precarious low level of liquid foreign exchange
reserves. (In November 1993, when agreement in principle was reached with
the banks, liquid reserves amounted to only about one and one half months of
imports.) Since this implied seeking a larger allocation to the par bond
option, which had the lowest immediate cost—reflecting limited collateral
requirements—but generated the least debt forgiveness, these two objectives
were at odds with each other. Under these circumstances, Bulgaria tried to
ease its foreign exchange constraint by mobilizing external resources.
However, ad referendum agreement on prospective IMF-support was reached only
in December 1993—after the agreement in principle with the banks—and it
was not until April 1994 that sufficient commitments had been obtained from
other sources to assure that the program would be adequately financed.

Reflecting the first of these conflicting objectives, Bulgaria’s
Financing Proposals to commercial banks capped the par bond option to at
most 30 percent of eligible principle. This would secure a certain amount
of debt reduction and thereby enhance the sustainability of the restructured debt over the medium term. At the same time, in a bid to gain large savings at limited costs, Bulgaria offered a relatively low price for the buyback option. At 25 3/16 cents per unit of debt, the buyback price announced in March 1994 was significantly lower than the then prevailing secondary market price. (The buyback offer was also below the secondary market price when agreement in principle was reached.) In other words, given limited resources and uncertain external support, Bulgaria chose to risk smothering banks' interest in buybacks.

In the event, banks' allocations to the par bond option—at 27 percent of eligible principal—remained below the predetermined ceiling (Table 1), in part reflecting the relatively low degree of collateralization and the fiscal treatment in some countries that does not allow tax deductions unless the capital loss is recognized (as with the discount bond). Also, as expected by many—but not hoped by Bulgaria—buyback selections were meager. Notwithstanding belated public statements by the Minister of Finance calling for a buyback allocation of at least twenty percent, only thirteen percent was assigned to this option. The remaining sixty percent of principal was offered for conversion into discount bonds.

III. Was it a Good Deal?

The paramount objective of a debt restructuring operation is to bring a country's current and future debt service obligations into line with its capacity to pay, and therewith to normalize relations with its creditors and to improve its growth prospects. In this regard, a first consideration in
Table 1. Bulgaria: Debt and Debt Service Reduction Operation

(In millions of U.S. dollars)

<table>
<thead>
<tr>
<th>Option</th>
<th>Face Value of Allocated Debt</th>
<th>Face Value of Debt Reduction</th>
<th>Present Value of Interest Reduction</th>
<th>Collateral Prepayment</th>
<th>Total Present Value of Gross Debt Reduction</th>
<th>Upfront Costs of Operation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buyback</td>
<td>1,027</td>
<td>1,027</td>
<td>--</td>
<td>--</td>
<td>1,027</td>
<td>257</td>
</tr>
<tr>
<td>Par Bond</td>
<td>1,658</td>
<td>--</td>
<td>465</td>
<td>43</td>
<td>508</td>
<td>43</td>
</tr>
<tr>
<td>Discount Bond</td>
<td>3,730</td>
<td>1,865</td>
<td>-154 1/</td>
<td>352 2/</td>
<td>2,064</td>
<td>352</td>
</tr>
<tr>
<td>Interest Arrears Bond</td>
<td>1,858</td>
<td>243 3/</td>
<td>--</td>
<td>--</td>
<td>243</td>
<td>64 4/</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>8,273</strong></td>
<td><strong>3,135</strong></td>
<td><strong>311</strong></td>
<td><strong>395</strong></td>
<td><strong>3,842</strong></td>
<td><strong>716</strong></td>
</tr>
</tbody>
</table>

Source: Bulgarian Foreign Trade Bank and staff estimates; figures may not add due to rounding.

1/ Estimated cost of value recovery clause.
2/ Includes principal collateral of US$222 million for the purchase of zero coupon U.S. Treasury securities and interest collateral of US$131 million.
3/ Savings from adjusted interest under 1994 Financing Proposals (US$185 million) and interest downpayment at DDSR closure (US$57 million).
4/ Including interest downpayment (US$57 million) and cash payments in respect of multicurrency loan arrangements (US$7 million).
evaluating a debt deal is whether the magnitude of debt reduction and the profile of the restructured debt service give confidence that a country can sustain external viability with growth over the medium term.

Under the Bulgarian debt deal, the gross debt and debt service reduction was about 46 percent in present value terms (about 38 percent net of the resources used to complete the deal), which will significantly alleviate the balance of payments. Projections suggest that, assuming an appropriate policy mix, the servicing of external debt would be consistent with GDP growth rates rising to 4 percent per annum over the medium term and with relatively small external financing gaps before the turn of the century. (These gaps mainly reflect bullet repayments of past balance of payments support, and could be covered by a less ambitious reserves accumulation.)

Judging by the projected ratio of debt service obligations to exports of goods and services, the payments on the restructured debt would also seem sustainable. While the ratio of scheduled total debt service (before reschedulings and deferrals) to export revenues had been around sixty percent during 1991-93, it is now projected to peak in the low twenties over the medium term. 1/ Given on the one hand a relatively low debt service ratio and increasing external receipts, and on the other a high (if not excessive) public sector share in the economy, the issue of sustainability would appear to depend primarily on fiscal rather than on balance of payments constraints.

1/ As a point of reference, this projected debt service ratio is significantly lower than in each of the four previous IMF-supported DDSR operations with Argentina, Mexico, the Philippines and Venezuela.
Another prime indicator of whether Bulgaria concluded a favorable debt deal is the relationship between the implicit price of debt reduction achieved through the deal and the prevailing price of Bulgarian sovereign debt on the secondary market. After all, Bulgaria could—in theory—have chosen to use the resources tied up with the deal for direct debt repurchases in the secondary market. 1/ As the deal had upfront costs of US$716 million and achieved gross debt reduction in present value terms of US$3.8 billion, the buyback equivalent price (that is the cost per unit of gross debt and debt service reduction) was about 19 cents. By comparison, the secondary market price ranged between about 27 cents and 48 cents during the period from agreement in principal in November 1993 through completion of the debt exchange in July 1994. Thus, the implementation of the debt deal was clearly a very efficient use of Bulgaria’s scarce resources.

Alternatively, the deal can be assessed by comparing the market valuation of the debt before and after the deal. Since creditors would not concede to writing off part of their old claims unless there is an offsetting gain that enhances the value of new claims, the market valuation before the deal could be viewed as a floor for the valuation after the deal. The basic question then becomes which side benefits from the collateral, which may indirectly be financed by a third party (such as the IMF or the World Bank). According to this approach, if the market valuation excluding collateral is unchanged following the restructuring operation, the creditors reap the full benefits of the collateral; if this valuation declines, the

1/ In practice, Bulgaria would have needed a waiver from creditors to carry out buybacks. Also, the secondary market price would likely have risen with a comprehensive buyback operation.
debtor gains to the extent that, besides diminished commitments, the present value of expected payments is also reduced.

The difficulty with this approach is that it is impossible to separate out the impact of other domestic and international events on market valuation (including, for example, elections; changes in international interest rates; and the influence of the recent Mexican crisis on emerging market prices) from the impact of the deal itself. Nonetheless, after the deal's conclusion the market valuation of Bulgarian commercial debt (excluding collateral) has remained—at times significantly—beneath the market valuation when agreement in principal was reached. 1/ At the same time, the market valuation including collateral has fluctuated around, or above, its level at this initial agreement. While recognizing the limitations of this approach, it supports the view that the deal was Pareto-improving in that both sides benefitted.

Comparisons between debt restructuring operations should only be made with caution, as capacity to pay is determined primarily by country-specific circumstances. However, comparisons can be instrumental in bringing out the distinct characteristics of a package. In the case of Bulgaria, such a comparison indicates that its debt deal generated slightly above average debt reduction, but at a remarkably low cost (Table 2). More specifically, its ratio of debt and debt service reduction to total restructured debt at 46 percent was between that of Mexico (45 percent) and Poland (49 percent), and higher than the weighted average of all past deals (39 percent). By

1/ At the time of agreement in principle, the market value of the later restructured debt was US$2.3 billion; in the next six months, excluding collateral, it fluctuated between US$1.9 billion and US$2.2 billion.
contrast, its buyback equivalent price at 19 cents was exceptionally low in comparison with most other deals and the weighted average (34 cents). In fact, the ratio between the buyback equivalent price and the prevailing market price was more favorable—from the debtor's viewpoint—than in any previous restructuring agreement (although the subsequent deal with Poland was marginally more attractive).

However, it needs to be borne in mind that Bulgaria's per capita income level is lower than the average of the comparator countries, and its capacity to repay could be correspondingly weaker. In this respect, the deal reflects the Bulgarian circumstances—especially the scarcity of liquid international reserves—that limited the ability to elicit a larger share of buybacks, and thus resulted in a package with low immediate costs, but with relatively less debt reduction over the medium term. In addition, the Bulgarian negotiating position did not have the support of a precedent of debt reduction by official creditors (for example, Poland would seem to have been aided by the Paris Club's far-reaching debt forgiveness and its clause on comparable treatment of creditors).

In short, although Bulgaria negotiated a favorable deal involving substantial debt relief at a very low cost, it remains a heavily indebted country. The sizable secondary market discounts on its Brady bonds are testimony to the fact that the country's capacity to shoulder this burden, on top of the hardships of transition, is doubted by the market. With rising interest costs on the restructured bonds and large principal repayments after the turn of the century, Bulgaria's obligations will remain heavy over the medium term, particularly from the fiscal perspective. In
Table 2. Menu-Based Commercial Bank Debt and Debt Service Reduction Operations

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina (1993)</td>
<td>28.1</td>
<td>3.0</td>
<td>35</td>
<td>29</td>
<td>39</td>
</tr>
<tr>
<td>Bulgaria (1994)</td>
<td>8.3</td>
<td>0.7</td>
<td>46</td>
<td>19</td>
<td>27</td>
</tr>
<tr>
<td>Brazil (1993)</td>
<td>47.2</td>
<td>3.9</td>
<td>25</td>
<td>38</td>
<td>35</td>
</tr>
<tr>
<td>Costa Rica (1990)</td>
<td>1.6</td>
<td>0.2</td>
<td>71</td>
<td>19</td>
<td>19</td>
</tr>
<tr>
<td>Dominican Republic (1994)</td>
<td>1.1</td>
<td>0.1</td>
<td>45</td>
<td>36</td>
<td>36</td>
</tr>
<tr>
<td>Jordan (1993)</td>
<td>0.7</td>
<td>0.1</td>
<td>43</td>
<td>35</td>
<td>39</td>
</tr>
<tr>
<td>Mexico (1990)</td>
<td>51.9</td>
<td>7.7</td>
<td>45</td>
<td>34</td>
<td>44</td>
</tr>
<tr>
<td>Nigeria (1991)</td>
<td>5.8</td>
<td>1.7</td>
<td>76</td>
<td>38</td>
<td>40</td>
</tr>
<tr>
<td>Philippines (1990, 1992)</td>
<td>5.8</td>
<td>1.8</td>
<td>64</td>
<td>49</td>
<td>50, 53</td>
</tr>
<tr>
<td>Poland (1994)</td>
<td>14.4</td>
<td>1.9</td>
<td>49</td>
<td>27</td>
<td>39</td>
</tr>
<tr>
<td>Uruguay (1991)</td>
<td>1.6</td>
<td>0.5</td>
<td>55</td>
<td>50</td>
<td>54</td>
</tr>
<tr>
<td>Venezuela (1990)</td>
<td>19.7</td>
<td>2.6</td>
<td>32</td>
<td>40</td>
<td>46</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>186.2</strong></td>
<td><strong>24.3</strong></td>
<td><strong>39 4/</strong></td>
<td><strong>34 4/</strong></td>
<td><strong>40 4/</strong></td>
</tr>
</tbody>
</table>

Source: IMF staff estimates.

1/ Includes past due interest and debt restructured under new money options for Mexico, Uruguay, Venezuela, and Philippines (1992); the Philippines (1990) new money option was not tied to a specific value of existing debt.

2/ Total costs of principal and interest collateral, and of buybacks.

3/ The buyback equivalent price is the ratio of the upfront costs associated with a given operation relative to the amount of debt and debt service reduction achieved.

4/ Weighted average.
this light, it is by no means assured that Bulgaria's debt difficulties have been resolved once and for all.

IV. Was the Timing Right?

Against this background, it has been argued, on occasions, that the Bulgarian authorities should have waited longer to strike their deal in an effort to obtain deeper debt reduction. From a tactical viewpoint, there was a strong case to wait until external financing sources had been secured and a favorable precedent had been set by the anticipated Polish deal.

Given the validity of these arguments, what were the debtor's incentives to move ahead and conclude the deal? Delay worked against Bulgaria in at least three ways. First and foremost, the protracted negotiations with the banks had high opportunity costs: foreign investors' interest remained minimal (as confirmed by the paucity of such inflows) and access to trade financing and international capital markets was blocked. Although difficult to quantify, the unsettled external debt issues exacerbated existing uncertainties about future macroeconomic policies and financial regulations—in particular prospective taxation policies and exchange restrictions—and thus brought about large real losses.

Second, delay implied the continued accumulation of interest arrears. As banks were keen on avoiding a generous treatment of such arrears (which would create moral hazard), postponement was likely to be costly. 1/

1/ In the event, Bulgaria implicitly obtained debt relief on interest arrears through the ex post calculation of such arrears at a reduced rate of 3.5 percent as from September 1992. The subsequent restructuring agreement with Poland included, for the first time, explicit debt reduction on interest arrears.
Third, secondary market prices for Bulgarian sovereign debt had been on the rise for quite some time, in part reflecting a general rise in prices for Brady bonds and for Eastern European bank debt. After trading at about 15 cents during most of 1991—and notwithstanding major policy slippages and a weakening of fundamentals during 1993—the price of Bulgarian sovereign debt rose steadily to the high twenties when the agreement in principle was reached in November 1993 (Chart 1). By implication, the projected cost of a voluntary, market-based deal was also rising. This had a bearing on the negotiations, where efforts to obtain a lower priced deal were meeting increased resistance by the bank steering committee, which feared losing the support of other creditor banks if the deal was too far "off-market."

Finally, in addition to these economic considerations, there seems to have been a politically driven desire to throw off the shackles of the debt problems inherited from the previous regime.

V. Three Lessons

While the Bulgarian debt deal was successfully completed in a relatively short timeframe, three lessons can be drawn that may be of broader relevance to countries in the process of bank debt negotiations. These relate, first, to the need to gear macroeconomic policies to preserving financial stability throughout the process of debt restructuring; second, to design the deal in a way that ensures the desired outcome of adequate debt reduction at reasonable cost; and third, to seek a clear picture of available external financing before agreeing on the specific elements of the package.
On the first issue, notwithstanding major fiscal slippages, exchange rate and intervention policies during 1993 maintained the objective of fighting inflation, but at the cost of significant real currency appreciation and international reserves losses. Pressure on the exchange market intensified following the agreement in principle in November 1993, when doubts emerged regarding the strength of the external position and the prospects for financing the debt deal. Bulgaria sought to allay these doubts when, in December 1993, it reached initial understandings on IMF support for its program and prospectively for its debt operation. However, parallel EU/G-24 financing commitments were subsequently delayed by burden sharing concerns, thereby calling into question the financing assurances needed for IMF Board approval and critically weakening the balance of payments outlook. In March 1994, reflecting these doubts, heightened political uncertainties and the cumulative impact of lax financial policies, there was a precipitous depreciation of the exchange rate.

While the central bank responded to this crisis by tightening monetary policy, its use of intervention policy was constrained by the need to ensure adequate foreign exchange cover for the upfront costs of the debt operation. In effect, the central bank was forced abruptly to shift the focus of monetary policy from promoting exchange rate stability to building up reserves, with adverse consequences for inflation performance and, more generally, confidence in the national currency. This reinforces the view that countries embarking on commercial debt restructuring need to assign, in
CHART 1
Secondary Market Price of Bank Claims on Selected
Heavily Indebted Countries, 1991–94

1/ Bulgaria, Poland, and Russia.
2/ Fifteen heavily indebted countries: Argentina, Bolivia, Brazil, Chile, Colombia, Cote d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and former Yugoslavia.
3/ Prior to the debt exchange in July 1994 the price includes interest arrears, thereafter the price reflects the market valuation of the discount bond excluding the value of collateral.

Source: Salomon Brothers, ANZ Grindlays, and staff estimates.
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a timely manner, priority in their monetary and exchange rate policies to the accumulation of a comfortable cushion of foreign exchange reserves. ¹/

On the second issue, the Bulgarian authorities offered the banks a debt restructuring package that reflected their objectives of achieving debt reduction (by capping allocations to the par bond) and limiting the upfront costs (by including the possibility of restricting the share of buybacks). But neither the authorities nor the steering committee pressed for inclusion of a rebalancing mechanism or an exit clause that would be linked to a required minimum debt reduction. This was motivated at the time of agreement in principle by the concerns of both sides that there may not be sufficient resources to meet such a requirement. Subsequently, when prospects for external financing from the EU/G-24, the IMF and the World Bank brightened in April 1994, the authorities switched their emphasis to the objective of achieving greater debt reduction, and indicated a minimum allocation to the buyback option of twenty percent. ²/ (This corresponded to the minimum buyback share counseled by IMF staff from the outset.) However, when it became evident that the target would not be reached, this could not formally impede the deal's closure as the package did not include a specific minimum debt reduction requirement.

¹/ It has been suggested that debtors should attach less importance to preserving financial stability in the run-up to a bank deal, in an effort to convince creditors of the need for generous concessions. However, the economic costs of such strategic behavior would likely have been higher than possible gains in terms of additional debt reduction.

²/ The design of the Bulgarian package would generate gross debt reduction of at least 39 percent. While the authorities later implicitly strived to achieve about 51 percent gross debt reduction (corresponding to their objective of a 20 percent buyback share), they finally settled for 46 percent gross debt reduction (13 percent buyback allocation).
The deal did include clauses allowing purchases of restructured bonds in the secondary market after the operation had been carried through. As a result, insisting on a larger immediate buyback lacked credibility. If the authorities wished to buy back more of their debt, they could still do so after the deal—albeit at a probably higher price and without direct support from the international financial institutions. 1/ The lesson to be drawn is that, while pursuing policies that ensure the availability of sufficient resources for its debt operation, a country should also endeavor to incorporate its objectives for debt reduction explicitly into the deal. 2/

The third issue is closely related to the first two. In order to achieve the maximum debt reduction within the constraints set by the scarcity of available resources, the debtor should strive to have a clear picture of likely external financing before agreeing in principle on the design of the package, and certainly before setting the buyback price.

VI. Policy Implications

Bulgaria's commercial debt restructuring operation has greatly enhanced its prospects for viable growth and integration into the world economy. However, the deal's success remains to be underpinned by appropriate future

1/ Bulgaria was unlikely to obtain as favorable a price later: under the deal each additional US$100 million spent on increasing the share of buybacks (assuming commensurately less allocations to discount bonds) generated annual savings of about US$35 million, implying that invested funds earned themselves back within three years.

2/ In the term sheet Brazil distributed to creditor banks in 1992, it retained the prerogative of requesting a reallocation if banks' preferences did not result in a balanced distribution among the various options. Similarly, the Dominican Republic's 1993 term sheet allowed a withdrawal if banks' allocations did not yield a minimum 50 percent debt reduction.
policies. As the total external debt burden (estimated at about 120 percent of GDP at end-1994) is still high, Bulgaria's economic policies, particularly in the fiscal and debt management sphere, should aim at steady further debt reduction in the years ahead. By lessening the fragility of the fiscal situation and strengthening confidence, this would bolster savings, investment—particularly foreign direct investment—and the stability of the exchange rate.

From the fiscal perspective, the restructuring of the commercial debt has placed a clear constraint on expenditure and revenue policies, which will need to be consistent with a medium-term framework yielding manageable public sector debt dynamics. Although it has been argued that the high debt to GDP ratio could also be reduced by inflating away or repudiating the debt, these would be ill-advised options. The first alternative of levying an inflation tax would be largely ineffective, since about four-fifths of public debt is denominated in foreign currencies and is thus resistant to domestic inflation erosion. At most, the inflation tax could be used to generate the required resources for the transfers to foreign creditors, but this should be squarely ruled out on grounds of efficiency and equity.

Regarding the second option, repudiation or forced renegotiation of outstanding bonds would have sharply adverse consequences for the country's credibility and would likely precipitate capital flight. Bulgaria's reputation in financial markets and with trading partners would be fundamentally damaged at a time when re-entry into global capital markets is in the offing, links with the EU are being strengthened, and accession to the WTO is imminent. Moreover, from a technical viewpoint, there would
hardly be scope for an orderly rescheduling of the outstanding commercial
debt as the issuance of easily tradeable Brady bonds has undoubtedly
increased the diversity and geographical dispersion of creditors.

A fiscal policy that ensures timely payment of future debt service thus
seems the least costly alternative. In operational terms, securing the
viability of the deal and containing the need for inflationary financing to
the budget imply aiming for a budgetary surplus on the primary accounts that
covers the bulk of interest obligations. 1/ In addition, since the costs
of servicing the restructured debt will rise as grace periods on
amortization payments expire and the concessional interest rates on par
bonds are phased out, a frontloading of fiscal adjustment is called for.

Next to action on the fiscal front, the sustainability of the
restructured debt would be greatly enhanced by monetary and exchange rate
policies that buttress confidence in the domestic currency. A credible
monetary policy, to which adoption of a visible nominal anchor for domestic
price developments could be instrumental, will be essential to avoid an
undervalued real exchange rate from increasing the domestic currency costs
of servicing the Brady bonds. (In this respect, it is noteworthy that
although the sizable real depreciation in 1994 led to an impressive
improvement in the external accounts, it placed a large additional burden on
fiscal policy.) At the same time, by reducing capital flight, strengthened

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1/ On the Brady bonds alone (which constitute about 40 percent of
outstanding Government debt) such interest payments will amount to about
3 percent of GDP in the foreseeable future. While the 1994 primary surplus
(excluding both interest expenditures and central bank profit transfers) was
3 1/2 percent of GDP, current estimates indicate that a surplus of about
6 percent of GDP over the medium term would yield sustainable debt dynamics.
confidence would increase the resources available to meet external debt service obligations. It would also broaden the scope for a noninflationary intervention policy aimed at augmenting official reserves. In that context, Bulgaria should aim not only to accumulate a comfortable reserves cushion providing adequate coverage for current account outflows, but also to expand its options for possible debt buybacks in the secondary market.

While tight macroeconomic policies would ensure fiscal sustainability and external viability, vigorous structural reforms will be crucial in enabling Bulgaria to outgrow its debt. Such reforms would unleash the country’s considerable growth potential and thereby help bring about a decline in the debt overhang relative to GDP. More specifically, accelerated privatization will be key both for attracting non-debt creating inflows and for reducing directly the external debt stock through the Government’s fledgling debt for equity swap program. 1/ The privatization of state-owned enterprises will also support efforts to reduce related quasi-fiscal deficits and to secure a sufficiently strong non-interest current account.

Active debt management policies could further alleviate the burden of the restructured debt. As regards the still unsettled outstanding debts to institutions of the former CMEA and Eastern European banks (totalling about US$1.6 million at end-1994), Bulgaria should assiduously strive to obtain

1/ The first privatization based on a swap of Brady bonds for equity occurred in December 1994. While it is doubtful whether the debt conversion program will generate additionality in investment—in the sense that investment is higher than it otherwise would have been—the nominal value of swapped bonds should be appropriately marked down under the program to ensure that the benefits of the market discount are in part acquired by Bulgaria (rather than accruing fully to the investor).
debt reduction on at least as favorable terms as the 1994 package, and with
debt service profiles that are compatible with existing obligations. These
requirements would seem to be met by the Russian-Bulgarian Protocol,
initialled in Moscow in October 1994, proposing to cancel all bilateral
commercial and clearing account debts (with residual Russian exports to
Bulgaria for the equivalent of US$100 million).

But more directly, given the heavy discounts on its sovereign debt in
the secondary market, there is an obvious case for Bulgaria to free
resources and quietly purchase back its own Brady bonds (the restructuring
agreement has explicit provisions allowing this). This would be similar, in
its effects, to debt repurchases through privatization. In deciding which
of the three debt instruments to retire, the authorities would have to weigh
the relative debt reduction costs against the cash flow implications. This
trade-off is determined on the one hand by the secondary market price and
the attached collateral (which the debtor can claim back upon repurchase),
and on the other by the debt service profile of the different bond types
(Chart 2). The objective of achieving the greatest debt reduction at the
lowest cost would suggest that Bulgaria should concentrate repurchases on
the debt instrument with the lowest "stripped" price. 1/

1/ The par bond
would then be the first candidate for repurchase (at a stripped price of

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1/ To compare the cost of repurchasing each bond type, it is necessary to
strip from the secondary market price the value of the collateral, and to
adjust the par bonds for the temporary interest reduction and the discount
bonds for the estimated cost of the value recovery clause (which increases
interest payments once GDP exceeds 125 percent of its level in 1993). In
theory, arbitrage should tend to equate the stripped prices of different
instruments; in practice there are significant variances.
Chart 2

BULGARIA

Debt Service Profiles on DDSR Bonds, 1995-2025

Source: Staff Estimates.

1/ Includes rolling interest guarantees and interest mark-up on bond issues related to short-term debt.
2/ Includes estimated payments related to value recovery clause starting in 2003.

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about 28 cents per unit of debt reduction), followed by the discount bond (31 cents) and, lastly, the interest arrears bond (40 cents).

However, cash flow considerations would prioritize retiring discount bonds, since this would maximize budgetary relief in the near term (par bonds repurchases only generate large savings after seven years). Specifically, if account is taken of released collateral, discount bond repurchases would pay themselves back within four years, against a break-even point after about 7 1/2 years for the par bond. 1/ Although the preference for retiring one bond type rather than another thus depends on a combination of price and cash flow considerations (the latter being primarily determined by near-term budgetary constraints), a strategy involving repurchases of both par and discount bonds could be advised to spread buying pressure over more than one instrument.

Lastly, consideration could be given to loosening controls on gross capital outflows in order to allow residents to invest in Bulgarian Brady bonds. While this would not reduce the debt service burden on the budget, it would provide relief to the balance of payments.

VII. Conclusions

Commercial bank debt restructuring has greatly improved Bulgaria’s prospects for external viability, growth, and integration into the world

1/ These calculations have been based on the secondary market prices in early February 1995 and projected interest rates (WEO). While the annual return on repurchases of discount bonds would be about 27 percent and on interest arrears bonds about 21 percent, the same amount spent on par bonds would generate annual interest savings rising from 11 percent to 16 percent in the first seven years, and to about 44 percent thereafter.
The restructuring package that was implemented after protracted negotiations yielded substantial debt and debt service reduction at limited cost. Viewed from the country's perspective, sufficient debt relief has been obtained to warrant tempered optimism that, given appropriate policies, the restructured debt will be sustainable and allow durable growth. The deal can also be considered an efficient use of scarce resources as the debt reduction was achieved at a much cheaper price than that prevailing on the secondary market. The banks, in turn, have benefitted from improved repayment prospects and an increased market value of their remaining claims.

However, even after the deal, the external debt stock remains high. Owing to rising obligations on the restructured bonds and in part to a smaller than targeted allocation to the buyback option, sustained policy efforts will be required over the medium term to bring the remaining debt stock to a more manageable level. Looking ahead, upfront fiscal action is needed not only to break the adverse debt dynamics, but also to reduce uncertainty by sending an early signal that debt problems have been resolved in a lasting manner. This will be similarly crucial—perhaps in conjunction with the adoption of a more transparent intermediate target—to restore credibility to monetary and exchange rate policies. This credibility will, in turn, help stem capital flight, avoid an unduly weak exchange rate (thus lessening the domestic costs of external debt service), and allow a lowering of domestic interest rates (thereby reducing the internal debt burden).

An active debt management could complement efforts to ease the debt burden. In particular, given the sizable secondary market discounts, it is hard to imagine that retiring Brady bonds would not rank amongst the fiscal
expenditures with the highest rates of return. At the same time, accelerated structural reforms will be vital to bolster productivity—especially foreign exchange earning potential—before heavy repayments start to fall due after the turn of the century. In that respect, Bulgaria will need to fit macroeconomic policies, debt management and structural reform judiciously together in order to capture fully the potential gains heralded by the commercial debt restructuring.
Bibliography


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<tr>
<td>1. Buy-back</td>
<td>--</td>
<td>--</td>
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<td>Cash buyback at 25 3/16ths percent of the face value of eligible principal and related adjusted interest arrears.</td>
</tr>
<tr>
<td>2. Par Bond</td>
<td>18 years (8 grace)</td>
<td>Year 1: 2.00%</td>
<td>No principal collateral.</td>
<td>Bearer bonds. Limited to no more than 30 percent of allocated principal. 30 percent of bonds issued for short-term debt will carry a 0.5 percent higher interest rate. Amortization is payable in twenty-one equal semi-annual installments. Eligible at 50 percent discount in a Debt for Equity or other Conversion Program.</td>
</tr>
<tr>
<td>(Front Loaded Interest Reduction Bond)</td>
<td>Year 2: 2.00%</td>
<td>Year 3: 2.25%</td>
<td>Year 4: 2.25%</td>
<td>Year 5: 2.50%</td>
</tr>
<tr>
<td>3. Discount Bond</td>
<td>30 year bullet</td>
<td>LIBOR +13/16</td>
<td>Principal guaranteed by zero coupon U.S. Treasury securities. One year's interest is collateralized at 7 percent.</td>
<td>Registered bonds. 30 percent of bonds issued for short-term debt will carry a 0.5 percent higher interest rate. A value recovery change increases interest payments once GDP exceeds 125 percent of its level in 1993. Eligible at par in a Debt for Equity or other Conversion Program.</td>
</tr>
<tr>
<td>(50 percent discount on face value)</td>
<td>none</td>
<td>none</td>
<td>none</td>
<td>none</td>
</tr>
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</table>

**INTEREST ARREARS**

| 1. Penalty cash downpayment on interest arrears | -- | -- | -- | 3 percent of interest arrears, paid on the closing date. |
| 2. Interest Arrears Bond (par exchange) | 17 years (7 grace) | LIBOR +13/16 | None. | Bearer bonds. Amortization payable semi-annually on the following schedule: installments 1-6, 1 percent; 7-11, 3 percent; 12-16, 6 percent; and 17-21, 9.8 percent. |

1/ Denominated in U.S. dollars.
2/ Payable semi-annually.