

# Working Paper

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INTERNATIONAL MONETARY FUND

WP/88/28

INTERNATIONAL MONETARY FUND

Bureau of Statistics

Statistical Issues of Debt Conversions

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March 23, 1988

Abstract

This paper examines two aspects of debt conversions. First, it examines general aspects of secondary markets of developing countries' bank debt, and the debt conversions that have taken place in a number of developing countries experiencing debt servicing difficulties. Second, by using common characteristics of debt conversion transactions, the paper analyzes the effects of debt conversions on monetary, balance of payments, and fiscal accounts in the debtor countries. It concludes with discussions on implications of debt conversions for reports of external debt statistics.

JEL Classification Numbers

3220; 4330; 4410; 4430; 5410

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1/ This paper was prepared in response to a request by the International Working Group on External Debt Statistics in its 1986 meeting. The contents of the earlier version of the paper (titled "Debt-for-Equity Conversions") were designed for the work of the Working Group, and compilers of external debt statistics in general; it had been discussed in the December 1987 meeting of the Working Group in Washington, D.C. The present version incorporates substantive comments and suggestions made by Arie C. Bouter, M. S. Gill, K. W. O'Connor, B. Gurgun, R. J. Puig, A. K. Siddique, G. H. Hoozee, M. A. Wasfy, F. van Beek, E. Decarli, J. E. Leimone, and D. J. Goldsbrough. The author is grateful to R. T. Stillson and G. Russell Kincaid who made invaluable suggestions and comments on both the earlier and present versions of the paper. All errors are the responsibility of the author.

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### Summary

This paper examines two aspects of debt conversions. First, it discusses general aspects of secondary market activities for transactions involving developing countries' bank debt. Second, it analyzes the monetary, balance of payments, and fiscal impact of debt conversions. The paper uses a simple debt conversion scenario in which resident or nonresident non-bank investors are assumed to purchase a country's bank debt from banks in a secondary market and to exchange the debt claims with the debtor country's central bank for local currency, which is then used to acquire equity or financial instruments.

If the debtor country's central bank allows debt to be exchanged for local currency at full face value, the country's outstanding debt is reduced by its full face value, while foreign equity investment increases by the same amount in local currency. If, however, the central bank allows debt to be exchanged for local-currency funds at less than the full value of the debt, it earns an amount equal to the differential between its claim on the debtor entity and its liability to foreign investors. In both cases debt conversions have reduced the country's external debt by its full face value, but in the second foreign equity investment has increased by less than the full face value of the debt.

The paper also shows that, if debt conversions involve resident investors, the capital account of the balance of payments will record a decrease in foreign assets equal to the value of debt claims. This amount corresponds to a decrease in the country's foreign-currency-denominated liabilities. Because the recording of a country's balance of payments is based on a transaction value concept, however, the difference between the central bank's claim on the country's debtor entity and its liability to nonresident investors is recorded as a valuation adjustment to the increase in stock of direct investment liabilities.

Finally, the paper analyzes the impact of debt conversions for the government's fiscal deficit and its related financing requirements. It concludes with a discussion of the implications of debt conversion for reports on debt statistics.

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## I. Introduction

This paper examines two aspects of debt conversions. First, it examines general aspects of secondary markets of developing countries' bank debt, and the debt conversions that have taken place in a number of developing countries experiencing recent debt servicing difficulties. <sup>1/</sup> Second, by using common characteristics of debt conversion transactions, it analyzes the implications of debt conversions for monetary, balance of payments, and fiscal accounts, and for reports of external debt statistics.

A secondary market for the existing bank debt of certain developing countries has emerged since the international debt crisis began in 1982. The market has played a major role in shifting some international banks' exposure to nonbank investors, who purchase this debt at a discount and convert it into equity or financial instruments in the debtor countries. In addition, this market is utilized by banks to adjust their portfolios through debt swaps.

A number of debtor countries experiencing debt servicing difficulties have instituted debt conversion programs. These programs vary from one debtor country to another. Some countries have instituted formal programs as part of their debt restructuring agreements with creditor banks. While others may not have a formal program, the debt conversion is allowed within the existing laws governing foreign investment. The type of debt permitted by the countries for debt conversion purposes usually involves sovereign bank debt, although private debt may be allowed for debt conversion by some countries.

The next section examines debt conversion transactions in the secondary market and the individual countries that have instituted, formally or informally, the debt conversion programs. Section III analyzes the effects of the conversions on the monetary, balance of payments, and fiscal accounts in the debtor countries; section IV examines implications of debt conversions for reports of external debt statistics. Section V gives concluding remarks. Appendix I describes features of debt conversion programs for Chile, the Philippines, Mexico, Brazil, and Venezuela.

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<sup>1/</sup> See Steven M. Rubin, Guide to Debt Equity Swaps (London: The Economist Publications, September 1987); this publication contains voluminous materials written by experts involved in debt conversion transactions. It covers debt transactions and related information in secondary markets, and detailed debt conversion programs of Mexico, the Philippines, Chile, Argentina, Brazil, Nigeria, and Venezuela.

## II. Mechanism of Debt Conversion

In general debt conversions entail a purchase at a discount by nonresident or resident nonbank investors of international bank debt either from the selling bank directly, or through the secondary market. The investors exchange the debt at the debtor country's central bank for local-currency funds, which are then used to acquire equity or financial instruments. The redemption of debt claims is governed by a number of rules of the debtor country's legal system such as foreign investment laws and foreign exchange controls.

### 1. The secondary market

The secondary market for existing bank debt has emerged since the international debt crisis began in August 1982. A number of investment banks and commercial banks in New York and London arranged a sale of sovereign debt mainly on behalf of smaller European banks and U.S. regional banks. <sup>1/</sup> The major U.S. banks have avoided participation in the debt sale or swap from their own portfolio, preferring only to broker transactions in the secondary market. This is partly because of the fear that the discount in the face value of the debt instruments would be taken as an indication of the current value of their entire loan portfolio to the same debtor country. The volume in the secondary market for the existing external debt has become larger. It was estimated by some investment banks in New York that the secondary market's volume had doubled in 1986 to about US\$5 billion, and reached US\$10 billion in 1987. The increase in the volume may also reflect a rise in the number of debt conversion transactions permitted by more debtor countries.

#### a. Impact of loan-loss provisions

Since May 19, 1987, when Citibank announced its decision to increase its loan-loss provisions against its claims on developing countries, other U.S. banks have followed suit. In effect, virtually all major U.S. banks now have increased substantially their loan-loss provisions against their claims on developing countries. <sup>2/</sup> The plans by major U.S. banks to possibly dispose of some claims from their loan portfolios may imply that the supply of debt instruments available for debt conversion in the secondary market could grow substantially.

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<sup>1/</sup> This action may be interpreted as an attempt by creditor banks to reduce the size of their debt portfolios in relation to primary capital.

<sup>2/</sup> Because the loan-loss reserves taken out of future retained earnings are part of primary capital, the effect of the increased loan-loss provisions is an increase in the banks' primary capital, and a potential decrease in the size of their debt portfolios due to swap or sale at a discount in the secondary market. The overall effect of the action is a reduction in the size of their debt portfolios in relation to primary capital.

The secondary market prices on bank debt vary significantly. Different loans to the same debtor country may be sold in the market for different prices because loans extended to a debtor country by a single bank are easier to sell than syndicated loans. Table 1 shows examples of trading range of sovereign debt prices quoted by investment banks in New York. The price may cover more than one category of debts, e.g., direct government debt and public sector company debt. Also, volume data are not available, so the figures in the table may reflect very shallow market activity. Prices of existing debt in the secondary market shown in the table have fallen during much of 1987, although they recovered somewhat late in the year. The announcement of loan-loss provisions appears to have reduced secondary market prices somewhat, although country specific factors, such as Brazil's suspension of interest payments and market perceptions of the balance of payments prospects of the individual countries, strongly affect the prices.

Table 1. Indicative Discounts of External Debt in the Secondary Market

(In cents per US\$ of original loan value)

	April-December 1987									
	Prior to loan-loss provisions by Citibank				After the loan-loss provisions announcement					
	4/17	4/24	5/15	5/20	9/11	9/18	9/25	10/9	10/16	12/31
Brazil	63	63	63	62	41	40	37	35	35	46
Chile	67	67	67	67	56	55	53	50	49	62
Mexico	57	57	57	57	46	46	46	46	47	51
Philippines	70	70	70	70	61	57	57	55	53	51
Venezuela	71	71	72	71	55	55	53	49	49	58

Sources: Journal of Commerce, various issues; Shearson Lehman Bros., Inc., and Merrill Lynch Capital Markets. These figures represent the minimum trading range of sovereign debt prices quoted in the secondary market, although it is not clear that there are substantial transactions occurring at these prices.



b. Trading of existing debt instruments

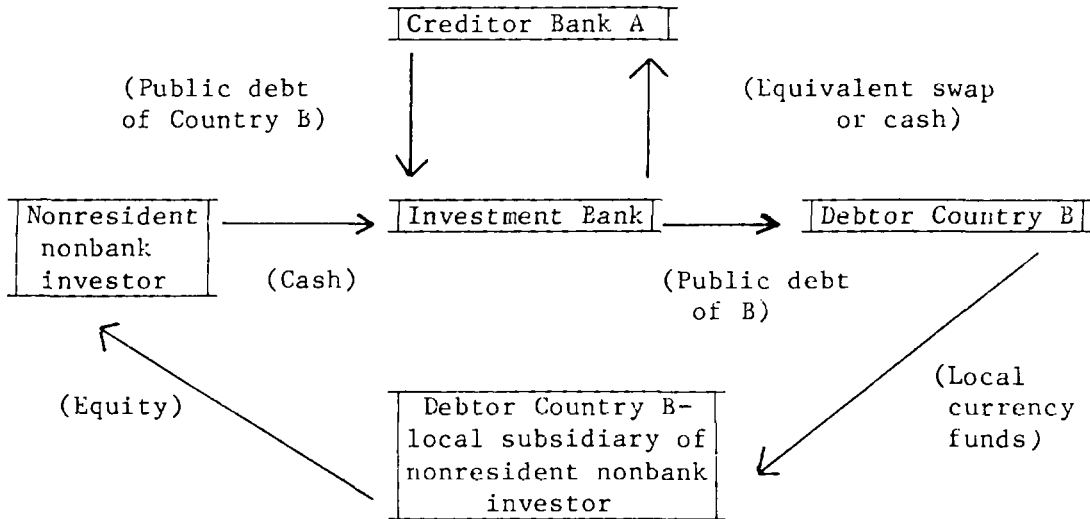
The trading of bank debt in the secondary market primarily involves an exchange or a swap of existing bank debt among banks that hold debt claims and want to adjust the country composition of their loan portfolios. Direct sales of existing debt instruments for cash are less common, and may occur at different relative discounts than are shown by debt swaps. There are reasons for this. Banks that have made loan-loss provisions may not have made sufficient provisions against the debt claims to sell at current market prices; they may not have adequate earnings to absorb losses on a current basis. With the exception of U.S. banks, cash sales of a part of their loan portfolios may require additional provisions against the remaining debt claims that are still in the portfolios. Equally important is the fact that the secondary market for bank debt is characterized by the thinness of trading activity, which means that transactions in existing debt may only be accomplished by the use of multiple swaps involving many market participants.

The swap transaction of existing bank debt among market participants often requires a matching of debt instruments from various bank creditors with intermediation of an investment bank. <sup>1/</sup> The trading of bank debt and the debt conversion transaction may be illustrated in the following diagram. A common debt conversion transaction involves an investment bank which brings together all market participants in the secondary market. The investment bank arranges an acquisition of debt either through swap or cash sale of the eligible bank debt instruments in the secondary market for nonbank investor clients, and presents the debt claims to the debtor country's central bank on behalf of its clients in exchange for the local-currency funds.

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<sup>1/</sup> For example, a nonbank investor seeks to acquire a certain amount of external debt of Country A from creditor Bank X for debt conversion in Country A. But Bank X will swap the debt claims on Country A only for debts of Country B, Country C, or Country D, without any additional cash transaction of the part of Bank X. The investment bank acting on behalf of the nonbank investor will, therefore, have to assemble a debt transaction package that has a composition of debt instruments of the specified countries from various creditor banks that hold and are willing to unload the debts of these countries from their loan portfolios.

DEBT CONVERSION TRANSACTION



2. Individual debtor countries

The nonresident nonbank investors' decision to choose the debt conversion option will be strongly affected by the debt conversion terms specified by the debtor countries. The debt-conversion terms of some debtor countries allow the nonbank investors to exchange the bank debt claims for local-currency funds at their full face value. Other countries allow the debt conversion only at some discount to the debt face value. For example, an exchange of debt claims at a 100 percent of the debt face value will be allowed if the proposed equity investment falls into the high priority category. <sup>1/</sup> A discount to the face value of the debt may be applicable if the proposed equity investment falls into the low priority. Some debtor countries may permit the debt-equity exchange without any discount; instead, a transaction fee is imposed on the debt conversion. The amount of the transaction fee is dependent on the priority of investments specified in the debt conversion program. After an approval by the debtor country's central bank the investors may then proceed to invest the local-currency funds.

The role of a country's central bank in the debt conversion transactions is fourfold. First, the central bank performs the role of a mediator between nonresident or resident <sup>2/</sup> nonbank investors who exchange debt

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<sup>1/</sup> As in Mexico's program.

<sup>2/</sup> It is assumed that the resident investors will use their external financial assets to purchase the country's international bank debt for the debt conversion purpose.

claims for local-currency funds with the central bank, and the country's debtor entity whose foreign-currency denominated debt has been bought by the investors in the secondary market. Second, the central bank approves the proposed equity investment by the nonbank investors, and determines the proportion of foreign-currency debt claims to be exchanged for local-currency funds. Therefore, all debt conversion transactions will be subject to the central bank's prior approval. Third, the central bank carries out the basic exchange control policy related to applications for repatriation of equity capital, and remittance of profits and dividends. Fourth, the central bank monitors the possible consequences of a resulting increase in domestic liquidity, and takes relevant monetary policy action to avert any undesired monetary impact of debt conversion on domestic economy.

Table 2 summarizes the main features of the debt conversion programs for five debtor countries that have instituted, formally or informally, such programs, including Chile, The Philippines, Mexico, Brazil, and Venezuela. The detailed features of debt conversion for these countries are described in Appendix I.

### III. Monetary, Balance of Payments, and Fiscal Impacts of Debt Conversion

The debt conversion may affect domestic monetary conditions, and a transfer of external liabilities between institutional sectors in the countries that have debt conversion programs. Furthermore, it replaces foreign-currency denominated liabilities to nonresidents with local-currency denominated foreign liabilities, and may affect the government's fiscal deficit and its related financing requirements.

#### 1. The Monetary Impact a. Direct conversion

When nonresident or resident investors directly exchange debt claims for equity in the debtor entity, the domestic liquidity is unaffected by the debt conversion, which involves the exchange of ownership in the entity. An example of this case is where nonresident investors capitalize their loans to the debtor country's private-sector company.

Table 2. Features of Debt Conversion Programs

	<u>Chile</u>	<u>Philippines</u>	<u>Mexico</u>	<u>Brazil</u>	<u>Venezuela</u>
Formal program	yes	yes	yes	yes	yes
Part of debt restructuring	yes	yes	yes	no	no
Debt claims-exchanged at book value for local currency	no	yes	yes <u>1/</u>	yes	yes <u>1/</u>
Conversion transaction fee	no	yes	no	no	no
Additional foreign exchange funds required	yes <u>2/</u>	yes <u>3/</u>	yes	no	yes
Type of debt:					
general gov't	yes	yes	yes	yes	yes
other public	yes	yes	yes	yes	yes
Maturity:					
more than one year	yes	yes	yes	yes	yes
Investors:					
residents	yes	yes	yes	no	no
nonresidents	yes	yes	yes	yes	yes
Required type of investment	yes	yes	yes	yes	yes
Restriction on use of local-Currency funds	yes	yes	yes	yes	yes
Limitation on capital repatriation	yes	yes	yes	yes	yes
Limitation on remittance of dividends and profits	yes	yes	yes	yes	yes
Debt-for-equity funds	yes	yes	yes	yes	no

Sources: See detailed programs in Appendix 1.

1/ Dependent of the type of proposed equity investment.

2/ Only for debt conversion with remittance rights.

3/ For investment in lower priority categories.

b. Indirect conversion

When investors exchange the debt claims for equity in an entity other than that of the debtor, and the local-currency funds are paid out by the central bank or other bank, domestic liquidity will increase. Consider the case where nonresident nonbank investors purchase US\$100 million of a public-sector company's foreign-currency denominated external debt at a discount in the secondary market. The nonbank investors present the debt claims to the central bank which, in turn, credits these investors with the full face value of the debt, that is, the equivalent of US\$100 million in local-currency.

Table 1 of Appendix II shows the process of exchange at the central bank level. When the exchange of debt claims for the local-currency funds is completed, the nonbank investors now have the equivalent of US\$100 million in local-currency claims on the central bank. The external debt of the public-sector company has become a domestic asset in foreign currency of the central bank which, in turn, has issued US\$100 million in local-currency. The nonbank investors then use the equivalent of local-currency funds of US\$100 million to purchase equity in a private-sector company.

Table 2 of Appendix II shows the transaction process at the equity investment level. At this stage the private-sector company's equity capital has increased by the equivalent of US\$100 million in local currency. When the company deposits this amount with its commercial bank, both banks' reserves and money supply will increase; without countervailing action by the central bank, the money supply will continue to increase because of the multiplier effect. At the country's level the debt conversion has reduced the outstanding external debt by US\$100 million, 1/ the foreign equity investment has increased by the local-currency equivalent of US\$100 million, and the money supply has increased by more than this amount.

As an alternative to the above scenario, the debt claims may be exchanged for local-currency funds at a discount to the face value of the debt instruments. Using the same numerical example, the central bank's issuance of domestic currency to the nonbank investors is, therefore, less than the equivalent of US\$100 million in local currency, whereas its claims on the public-sector company are the equivalent of US\$100 million in local currency. In effect, the central bank earns an amount equal to the differential between its claims on the public-sector company and its liabilities to the nonresident investors. In this case the effect of debt conversion on the outstanding foreign-currency denominated debt will still be the reduction of US\$100 million as above. Banks' reserves, the money supply, and the foreign equity investment will still increase, but by less than in the above example.

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1/ The external debt is reduced because equity holdings by nonresidents are not normally included in the stock of debt (see External Debt: Definition, Statistical Coverage and Methodology, a joint publication of the IMF, IBRD, OECD and the BIS, March 1988).

## 2. Balance of Payments Impact

### a. Direct impact

The debt conversion can potentially effect a transfer of external liabilities between institutional sectors of a country; furthermore, it can directly replace foreign-currency denominated liabilities to non-residents with local-currency denominated foreign liabilities. Using the above scenario, nonresident nonbank investors exchange the debt claims at the face value of US\$100 million with the central bank, and the local-currency funds are paid out by the central bank to the investors who use them for equity investment in the private-sector company. Tables 1, 2, 3, and 4 of Appendix III show the balance sheet approach to the balance of payments transactions in the debtor country. The following balance of payments analysis for the debt conversion of public-sector company's debt may be equally applied to direct government debt with the same conclusion.

Table 1 of Appendix III shows the external transaction of the central bank and the public-sector company, when the central bank decides to accept nonresident nonbank investors' bank debt claims of US\$100 million. First, the central bank assumes the external debt of the public-sector company; as a result the external liabilities of the public-sector company have decreased by the local-currency equivalent of US\$100 million, whereas the central bank's external liabilities to nonbank investors have increased by the same equivalent amount.

Table 2 of Appendix III shows how this transaction affects the balance-sheet of the central bank. The local-currency denominated external liabilities of the central bank have increased by the local-currency equivalent of US\$100 million because of the investors' exchange of debt claims for local-currency funds. Correspondingly, the foreign-currency denominated liabilities of the central bank have decreased by the equivalent amount because of its acquisition of the public-sector company's debt instruments. The nonresident investors obtain the funds in the local-currency equivalent of US\$100 million from the central bank, which they then invest in the equity of a private-sector company.

Table 3 of Appendix III shows the external transaction of the central bank and the private-sector company at the equity investment stage. The local-currency denominated foreign liabilities of the central bank have decreased by the local-currency equivalent of US\$100 million, whereas the local-currency denominated foreign liabilities of the private-sector company have increased by the same amount.

At the country's level, Table 4 of Appendix III shows the consolidated external transaction. The foreign-currency denominated liabilities of the country have decreased by the local-currency equivalent of US\$100 million, whereas the local-currency direct investment liabilities to nonresident

investors have increased by the same equivalent amount. In effect, the debt conversion has replaced the country's foreign-currency denominated debt liabilities to nonresidents with local-currency denominated equity liabilities to nonresidents.

Based on the foregoing analyses, the debt conversions have the following results:

- (1) there is a transfer of the developing country's bank debt from creditor banks to nonbank investors in the secondary market;
- (2) there is a potential transfer of external liabilities between bank and nonbank in the country, even though the above scenario only illustrates the transfer of external liabilities from public-sector nonbank to private-sector nonbank;
- (3) the debt conversion replaces foreign-currency denominated liabilities to nonresidents with local-currency denominated foreign liabilities.

If the debt conversion involves resident investors, 1/ the capital account of the balance of payments will record a decrease in foreign assets of US\$100 million, which corresponds to the decrease of US\$100 million in the country's foreign-currency denominated liabilities.

A possible alternative to the above scenario is the case where the investors' debt claims on the public-sector company are exchanged for local-currency funds at less than the face value of the US\$100 million external debt. The nonresident investors redeem the debt claims of US\$100 million with the central bank for the funds in local-currency equivalent of, perhaps, US\$90 million. The investors, then, use the funds for the equity investment in a private-sector company. The following is a sequence of exchange transactions:

- (1) The nonresident investors present the debt claims of US\$100 million to the central bank which, in turn, has the same equivalent amount of local-currency claims on the public-sector company. However, the local-currency denominated foreign liabilities of the central bank have increased by the local-currency equivalent of US\$90 million, because the US\$100 million external debt claims have been exchanged for local-currency funds at the local-currency equivalent of US\$90 million. In effect, the central bank earns the local-currency equivalent of US\$10 million; this "profit" has no balance of payments implications;

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1/ It is assumed that the resident investors use their external financial assets to purchase the country's international bank debt for the debt conversion purpose.

(2) The nonresident investors use the local-currency funds of the equivalent of US\$90 million to purchase equity in the private-sector company. The central bank's local-currency denominated liabilities to nonresident investors have decreased by the equivalent of US\$90 million, while the private-sector company's local-currency denominated liabilities to nonresident investors have increased by the same equivalent amount;

(3) The country's direct investment liabilities, that is, the local-currency denominated liabilities to nonresident investors, have increased by the local-currency equivalent of US\$90 million; because the recording of a country's balance of payments is based on a transaction value concept, its foreign-currency denominated liabilities have declined by the same equivalent amount, that is, the US\$100 million debt claims have been valued at the equivalent of US\$90 million by the central bank.

On the stock basis, because the country's stock of external debt has declined by US\$100 million, the increase in the central bank's net assets of the equivalent of US\$10 million in local currency is, therefore, recorded as a valuation adjustment to the increase in the stock of direct investment liabilities of US\$90 million (that is, credit in the balance of payments account is equal to US\$10 million valuation adjustment plus an increase of US\$90 million in the stock of investment liabilities to nonresidents, and debit in the account is equal to US\$100 million decline in the stock of external debt).

b. Indirect impact

(1) In the above example, the interest payments in the current account and the principal repayments in the capital account of the balance of payments will be reduced by the scheduled or rescheduled amount for the US\$100 million external debt that has been converted into equity investment.

(2) Remittances of profits and dividends may increase the debits in the current account of the balance of payments in the future.

(3) The repatriation of equity capital by nonresident investors is subject to foreign investment law and foreign exchange control, and may not be applicable during the first few years of investment. For example, some debtor country will not allow an equity repatriation during the first ten years of investment.

3. Fiscal Impact

Debt conversion has implications for the government's fiscal deficit and the related financing requirements. If the government's external debt instruments are involved in the debt conversion, the government has two options in financing the retirement of the US\$100 million in local currency:



First, the government may finance the debt retirement by increasing its indebtedness to the central bank, which means that the level of government's domestic debt has increased by the local-currency equivalent of US\$100 million.

Second, the government may borrow in the domestic capital market to retire the external debt of US\$100 million in local currency. In doing so, it will incur extra interest cost equal to the differential between the local-currency equivalent of interest cost on foreign-currency denominated debt and the domestic interest cost. In effect, if the domestic interest rates are higher than those on foreign-currency denominated debt, the government's current expenditures may be increased by the differential at the prevailing exchange rate. However, because principal repayments for the retired external debt are no longer necessary, the government's financing requirements will be reduced by the scheduled or rescheduled principal repayments for the US\$100 million. The borrowing in the domestic capital market to retire the external debt will raise the level of government's domestic debt by the local-currency equivalent of US\$100 million. Therefore, the government may incur additional financing requirements if the principal repayments of the domestic borrowing are greater than the scheduled or rescheduled repayments of the external debt that has been retired. As such, the interest payments on the domestic debt may also be higher.

#### IV. Implications for Reports of External Debt Statistics

The foregoing analyses have implications for the work of compilers of external debt statistics. Based on the above example of the public-sector company's external debt of US\$100 million, debt conversions have the following impact on reports of external debt statistics:

(1) The level of overall external debt of the country has been reduced by US\$100 million, whereas the nonresident investors' equity investment in the country has increased by the same equivalent amount in local currency, or the equivalent of US\$90 million in the case where there is a discount to the debt face value;

(2) The level of external debt service is immediately reduced by the foreign-currency debt service payments of principal and interest on the US\$100 million;

Moreover, the debt conversion has important implications for the sectorization by banks and nonbanks in reports of both international banking statistics by creditor banks, and external debt statistics by debtor countries. On the creditor side, the existence of the secondary external debt market indicated that there is a potential transfer of developing countries' bank debt between banks and nonbanks. On the debtor side, there is a potential transfer of foreign liabilities between banks

and nonbanks, even though the above scenario only illustrates the transfer of foreign liabilities from public-sector nonbank to private-sector nonbank. For both creditor banks and debtor countries, debt conversions have changed the types of foreign claims and liabilities from debt instruments to non-debt claims and liabilities.

## V. Conclusions

Since the international debt crisis began in August 1982, creditor banks have been trying to reduce the size of their developing countries' debt portfolios in relation to primary capital. Small banks, especially the U.S. regional banks, had accomplished this by reducing the debt claims through debt sale or swap in the secondary market for existing debt instruments, while there was little participation in the debt transactions by the major U.S. banks. After May 1987 when Citibank announced the plan to set aside a large amount of loan-loss reserves against its debt claims, it also sought to sell or swap the debt from its loan portfolios. For creditor banks, the effect of the increased loan-loss provisions is an increase in the banks' primary capital, that is, the loan-loss reserves taken out of retained earnings are part of primary capital. The increased loan-loss reserves will also allow potential decrease in the size of their debt portfolios.

For the debtor countries, the debt conversions may have undesired monetary and fiscal consequences. The degree of monetary and fiscal impacts on domestic economy is dependent on the level of domestic financial market development and the current fiscal imbalances. In effect, the monetary and fiscal impacts of debt conversion on the domestic economy should not be much different, if at all, from the impact caused by other modes of foreign direct investment.

The debt conversion has implications for reports of external debt statistics:

(1) The level of overall external debt of the country has been reduced by the converted amount;

(2) For an immediate external debt impact, the foreign-currency debt service payments of principal and interest have been reduced by the scheduled amount of the converted debt.

In addition, the debt conversion has important implications for the sectorization by banks and nonbanks in reports of both international banking statistics by creditor banks, and external debt statistics by debtor countries. On the creditor side, the existence of the secondary external debt market indicates that there is a potential transfer of debt claims between banks and nonbanks. On the debtor side, there is a potential transfer of foreign liabilities between banks and nonbanks. For both creditor banks and debtor countries, the debt conversion has changed the types of foreign claims and liabilities from debt instruments into non-debt claims and non-debt liabilities.

### Debt Conversion Programs

This note examines the features of the debt conversion programs for the individual debtor countries that have instituted, formally or informally, debt conversion programs.

#### 1. Chile

Chile has instituted a debt conversion program within the framework of the 1985 debt restructuring agreement with international banks. The program was later amended in May 1986. It is the most comprehensive debt conversion program instituted by a debtor country to date.

Under the program both nonresident and resident investors are allowed to purchase Chile's external debt instruments in the secondary market and exchange the debt claims at a discount to the debt face value for local-currency funds or local-currency denominated assets at market exchange rate. The local-currency funds can be utilized for a wide variety of investments, or used to repay local-currency debt.

There are two types of debt conversion which have different effects on the future repatriation of capital and remittance of profits and dividends.

The first type of debt conversion involves investment with remittance rights. Under Chapter XIX of the Chilean Compendium of Rules on International Exchange, 1/ nonresident investors may exchange Chile's external debt instruments purchased in the secondary market for either local-currency funds or local-currency denominated assets, and then use them for equity investment in Chilean corporations. The conversion transactions must be carried out through the intermediation of financial institutions authorized to operate in Chile. External debt instruments with an original contractual or a rescheduled contractual maturity of more than one year are qualified for the conversion. The Central Bank of Chile may specify the need for the nonresident investors to bring in additional foreign-currency funds from abroad, if the proposed equity investment requires imported capital goods. The equity investment in a Chilean corporation must be in accordance with the existing foreign investment statute.

The capital may not be repatriated within the first 10 years of investment; the local-currency funds necessary to purchase the foreign exchange for repatriation purpose must come from the sale of the equity investment. Profits may be remitted after the fifth year of investment.

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1/ Prior to Chapters XVIII and XIX of the Compendium of Rules on International Exchange, Chapter XIV of the Compendium has permitted a debt-equity conversion by Chile's original creditors.

The second type of debt-equity conversion involves investment without remittance rights. Under Chapter XVIII of the Chilean Compendium Rules on International Exchange, nonresident investors not requesting remittance rights and resident investors may purchase Chile's external debt instruments in the secondary market, and exchange them for local-currency funds or local-currency denominated assets. External debt instruments with an original contractual or a rescheduled contractual maturity of more than one year are eligible for the debt conversion.

The conversion transactions must be intermediated by the financial institutions authorized to operate in Chile. The value of conversion transactions undertaken by any financial institution in a given month is limited by a quota, expressed in U.S. dollars, that is allocated by the Central Bank's monthly auction. Once the financial institutions' offers are made, the Central Bank determines the overall quota value, and allocates it according to the offers made by the individual financial institutions. They must pay for their offers with local-currency funds. The assigned quotas are valid for a given month, but they may be traded within the month between the financial institutions.

## 2. The Philippines

The Philippines' debt conversion program allows both nonresident and resident investors, who hold or purchase external debt instruments of the Philippines, to redeem the debt claims with the Central Bank of the Philippines for the local-currency funds at book value of the debt instruments for approved long-term equity investments.

For investments in priority sectors such as export industries and agriculture, the Central Bank charges a five percent conversion transaction fee. There is no restriction on remittance of dividends paid out of profits, and capital may be repatriated in installments after the third year of investment; no more than 20 percent of the capital may be repatriated in each of the 4th through the 8th years of investment.

For investment in lower priority categories, the Central Bank charges ten percent for the conversion transaction fee. No dividend remittance is allowed within the first four years of investment, and repatriation of capital can only begin after the 5th year of investment; no more than 20 percent of the capital may be repatriated in each of the 6th through the 10th year of investment. In addition, the investors must bring in new foreign-currency funds equivalent to ten percent of the total equity investment.

As part of the Philippines' recently agreed debt restructuring of the US\$13.2 billion external debt with international banks, the Government of the Philippines has a plan to expand the current debt-equity program to include an issuance of investment notes (called Philippine Investment Notes) in the form of non-interest bearing, U.S. dollar denominated, debt certificates with a six-year maturity.

The creditor banks will have an option of accepting the investment notes as partial interest payments for the existing external debt plus a higher rate of interest on the remainder portion of the debt. Furthermore, the banks may either hold the notes to maturity, or exchange them with the Central Bank for local-currency funds which can be used for equity investment. Alternatively the banks may sell the notes to nonbank investors who may purchase the notes and redeem them at their face value with the Central Bank for local-currency funds, which can be used for investments in the country's debt conversion program.

### 3. Mexico

Since August 1985, Mexico's debt conversion program has been made an integral part of multi-year restructuring of the public-sector external debt. Nonresident investors are allowed to purchase Mexico's public-sector debt in the secondary market, and exchange the debt claims for local-currency funds with the Bank of Mexico to be used for approved equity investments, which include non-strategic public-sector companies, and private-sector companies. Such investments may not be sold or transferred to any private or public entity before January 1, 1998.

The debt claims are allowed to be exchanged with the Central Bank for local-currency funds, ranging between 70 percent to 100 percent of the face value of the debt. The redemption proportion is dependent on the proposed utilization of the local-currency funds. The highest priorities and, therefore, the highest redemption proportion are for investment in state enterprises, and for new investment or capital expansion that generates export proceeds.

Under the terms of Mexico's 1985 public-debt restructuring accord, the debt conversion option was restricted to nonresident investors. Mexico's new debt restructuring agreement with international banks, which was concluded in April 1987, contains provisions permitting debt conversion participation by Mexico's resident investors. Under the proposed mechanism resident investors will be required to demonstrate that the foreign-currency funds used for the purchase of Mexico's external debt in the secondary market originated from prior business transactions abroad and have not been transferred out of Mexico for that purpose. The debt claims then can be exchanged with the Central Bank for local-currency funds, which can be used for the equity investments as specified in the original debt conversion program.

#### 4. Brazil

Prior to November 11, 1987, when a formal debt-equity conversion program was instituted by the government, debt conversion was permitted under the Foreign Investment Law (No. 4131). Nonresident investors were permitted to convert foreign-currency debt into equity investments, provided that the local-currency funds are invested directly into the obligor's equity. For example, multinational corporations can convert inter-company loans into equity in their Brazilian subsidiary. Remittance of dividends is restricted to the terms of the original loan. In effect, remittance of dividends may not exceed the scheduled interest payments that would have been made to foreign creditor banks had the equity investment remained a loan.

Remittances of income from foreign direct investments are governed by Decree No. 55762 of February 17, 1965, which contains the regulations for implementation of the Foreign Investment Law. Remittances are permitted only when the equity capital is registered at the Department of Foreign Capital Supervision and Registration in accordance with the established rules; they are normally authorized in the currency of the country of domicile or of the head office of the beneficiaries.

Under the new debt-equity conversion program, nonresident investors will be allowed to convert Brazil's external debt into equity investment in new ventures or an expansion of existing enterprises, subject to approval by the central bank and other government agencies that have jurisdiction over the proposed investment. The investment priority will be given to export-oriented industry, high-technology industry, and tourism and hotel ventures. The National Monetary Council, which includes the Finance Minister, the Governor of the Central Bank, and senior officials from the Ministries of Trade, the Interior, and Finance, expects to approve about US\$125 million a month for debt-equity conversion under the program.

#### 5. Venezuela

Venezuela's new debt conversion program involves two basic mechanisms for converting debt claims into equity investment:

(1) Direct conversion of debt for equity permits nonresident investors to exchange their claims on private debtor companies for their equity. In effect, the investors and the company simply agree on converting the company's external debt into equity of the company.

(2) The second mechanism allows nonresident investors to purchase public-sector external debt in the secondary market and exchange it for the equity of an existing company or a new enterprise. Preference is given, for example, to equity investments in agriculture, agro-industry,

export-oriented, and import substitution industries. In addition, the nonresident investors must agree to utilize external financing sources to purchase necessary foreign components for the installation or the expansion of the proposed equity investment.

Capital repatriation is not allowed during the first five years of investment, and is restricted to 12.5 percent annually for the following eight years. After that there are no limits on the capital repatriation. Remittance of dividends is limited to ten percent annually for the first three years of investment.

The authorization of the debt conversion and the approval of equity investments is given by a commission which comprises the ministers of Finance and of Development, the President of the Central Bank, and the superintendent of foreign investments who acts as executive secretary for the commission. The commission makes the decision whether the Central Bank can exchange debt claims at face value or at discount, and whether the nonresident investors will receive local-currency funds or national public debt bonds in exchange for the debt claims. Resident investors are not allowed to participate in the debt conversion program.

Table 1. Debt Transactions at the Central Bank Level

(In local-currency equivalent of U.S. dollars)

Debtor country's public-sector company		Debtor country's central bank		Foreign sector-- nonresident nonbank investors	
<u>Assets</u>	<u>Liabilities</u>	<u>Assets</u>	<u>Liabilities</u>	<u>Assets</u>	<u>Liabilities</u>
US\$100 million other claims	US\$100 million due to the central bank in local- currency	US\$100 million claims on public sector company in local currency	US\$100 million due to nonbank investors in local- currency (restricted deposits)	US\$100 million claims on the central bank in local- currency	US\$100 million other liabil- ities.



Table 2. Debt Conversion Transactions in the  
Debtor Country

(In local-currency equivalent of U.S. dollars)

Debtor country's private-sector company		Debtor country's central bank		Foreign sector-- nonresident nonbank investors	
<u>Assets</u>	<u>Liabilities</u>	<u>Assets</u>	<u>Liabilities</u>	<u>Assets</u>	<u>Liabilities</u>
US\$100 million claims on the central bank in local currency	US\$100 million investment liability in local currency to nonbank investors	US\$100 million claims on public sector company in local currency	US\$100 million due to private- sector company in local currency	US\$100 million equity invest- ment in local currency	US\$100 million other liabilities

Table 1. External Transaction of the Central Bank and the Public-Sector Company

(In local-currency equivalent of US\$ millions)

	Credit	Debit
Official sector--the central bank (foreign-currency denominated liabilities have increased because of public-sector company's external debt)	100	
Other sector--public-sector company (Foreign-currency denominated liabilities have decreased)		100

Table 2. Balance-Sheet Position of the Central Bank

(In local-currency equivalent of US\$ millions)

	Credit	Debit
Local-currency denominated foreign liabilities have increased because of nonresident nonbank investors' claims	100	
Foreign-currency denominated liabilities have decreased because of redemption of public-sector company's external debt		100

Table 3. External Transaction of the Central  
Bank and the Private-Sector Company

(In local-currency equivalent of US\$ millions)

	Credit	Debit
Official sector--the central bank (Local-currency denominated foreign liabilities have decreased)		100
Other sector--private-sector company (Direct investment--local-currency denominated foreign liabilities have increased)	100	

Table 4. Consolidated External Transaction  
of the Debtor Country

(In local-currency equivalent of US\$ millions)

	Credit	Debit
Other sector (private-sector company) (Direct investment--local-currency denominated liabilities to nonresident nonbank investors have increased)	100	
Other sector (public-sector company) (Foreign-currency denominated liabilities have decreased because of the debt conversion)		100

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