

# EXTERNAL DEBT, AND DEBT-FOR-EQUITY SWAPS: A PROSPECTIVE ANALYSIS FOR PERU

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## 1. Introduction: Setting the Problem

Since the outbreak of the external debt crisis in 1982, managing this issue has primarily focused on both the implementation of macroeconomic adjustment policies in debtor developing countries and the rescheduling and refinancing of their commercial bank debt obligations. Indeed, the focal point of this strategy was to allow the necessary conditions for the debtor countries to secure their debt service as timely as possible.

However, this process has proved to be extremely inefficient. On the part of the heavily indebted developing countries, they have devoted a substantial proportion of their export earnings and domestic savings to service their debt obligations at the cost of slowing down their domestic economic growth. As a result, their debt-servicing capacity has not strengthened on solid grounds so that both considerable arrears and recurrent rescheduling negotiations with commercial banks have become a common practice while some unilateral suspensions in debt-servicing payments have also taken place. On the other side, commercial banks have continuously appeared to be more reluctant to increase their exposure in the developing world and found themselves compelled to build up their loan loss reserves in order to cope with possible defaults.

As a heavily indebted developing country, Peru has not been exempt from these developments. In practice, this country has been postponing its public external debt service since 1984 when an agreement with the International Monetary Fund broke down. Soon after, medium - and long - term commercial bank disbursements were severely restricted, while a complete curtailment of capital inflows from this funding source took place from 1985 onwards. It should be noted that commercial bank disbursements accounted for an average of 40% on total public external debt disbursements in 1979-1983<sup>1</sup>.

In July 1985, the by-then new government officially announced the decision to limit public medium and long-term external debt service up to the equivalent to 10% of total export earnings claiming that such a decision was based on two key conceptual grounds: the acceptance of a shared responsibility between debtors and creditors and the consideration of debtor countries' debt-servicing capacity. This policy, which implied a unilateral decision to reschedule principals and to capitalise interests on outstanding debt, was also intended to give priority for repayment to those lenders willing to provide the coun-

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\* The author, is grateful to Lynne Hall and Günther Held for their helpful comments on earlier drafts of this paper. The usual disclaimer applies.

1 Banco Central de Reserva del Perú, *Análisis de largo plazo del sector externo de la economía peruana 1975-1986*, Lima, June 1987, p. 58.

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try with net positive cash flows. As a further step, the government announced in July 1986 its decision to keep this policy in effect but, in addition, its scope was revised so as to include private sector medium - and long - term external debt<sup>2</sup>.

Although this decision allowed the country to build up its foreign exchange reserves and to foster high rates of economic activity in 1986 and 1987, two major constraints soon emerged against continuing economic growth: a foreign exchange shortage (because of a high import/product ratio, particularly in the manufacturing sector), and an (almost) exhausted installed capacity. Needless to say, the conflicting situation with creditor commercial banks remained unsettled.

Bearing this background in mind, Peru now faces the need for resuming a sustained path of economic growth for which capital inflows from international lenders will continue to be required. The latter suggests that much more than unilateral decisions will be necessary in order to normalise as far as possible the country's relations with commercial banks. Thus, it appears clear that efforts towards securing economic growth cannot successfully be made aside from policies which are intended to manage the debt problem to the same extent that having paid attention to the latter without properly dealing with its impact on economic growth has been a futile strategy.

In this regard, Peru has a unique experience in a particular approach to managing its commercial bank debt service with an explicit consideration of its impact on economic growth: the so-called "2 + 1 scheme" or the exchange of debt for goods. In general terms, deals under this scheme, which is a sort of countertrade, allow Peru to export US\$3 of non-traditional goods for US\$1 of debt amortised, which means that US\$2 will be paid back to the country in cash. Up to date, such pioneering deals have been signed with a number of creditor commercial banks of that country (e.g., Chase Manhattan Bank, Midland Bank, and First Interstate Bank of California, among others), all of them aimed at repaying short-term working capital debt. In order to arrange future deals, Peruvian authorities have stated some procedures and a list of potential goods for these payment-in-kind initiatives.

While this device has proved to be beneficial to the extent that it has allowed the coun-

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2 It is worth noting that the government itself recognised in 1987 that the 10% limit had not been accomplished since total debt service equalled 17% and 16.3% of export earnings during the first two years following the announcement of such a policy. While the position of government officials is to stress the need for a more strict application of the limit, they also claim that the conceptual grounds underlying such a decision have in fact prevailed.

try to pay back outstanding debt, to generate additions to current non-traditional exports, and to increase the inflows of foreign exchange, the application of this scheme will notably be limited by exportable supply of non-traditional goods. Another major shortcoming is that the exchange of debt for goods has only been feasible as long as banks with individual loans (normally short-term loans or trade credits) have been involved because of legal obstacles (e.g., sharing clauses) to apply the system to syndicated loans<sup>3</sup>.

Thus, stepping into a more developmental perspective, there remain two aspects clearly related to the debt problem to be dealt with: first, expanding productive capacity of the economy, especially that export oriented; and second, managing medium - and long-term commercial bank debt. The alternative of debt-for-equity swaps appears rather appealing in order to simultaneously tackle these issues.

Debt-for-equity swaps are the most widely applied form of debt conversion. They offer potential benefits to all of the parties commonly involved in such arrangements: creditor banks, debtor countries, and resident and/or foreign investors<sup>4</sup>. Up to date, a number of developing countries — namely Argentina, Brazil, Chile, Ecuador, Mexico, the Philippines, and Venezuela — have designed specific schemes to govern these deals. The degree of success of each scheme varies from country to country and, as a result, there exists a valuable experience which might be of benefit to those countries assessing the possibility to launch the application of a debt-for-equity conversion programme. Peru is certainly among the countries that might take advantage of this experience<sup>5</sup>.

3 Direct, short-term working capital debt by Peruvian banks totals a bit over US\$900 million ("Global debt: the equity solution", *Euromoney*, Special supplement, January 1988, p. 110).

4 See, for example, Michael Blackwell and Simon Nocera, "Debt/equity swaps", *IMF Working Paper* (Washington, D.C.) No. Wp/88/15, February 1988; Juan Carlos Echeverry, "Mecanismos de transformación de deuda externa. La experiencia latinoamericana", *Ensayos sobre Política Económica* (Bogotá), N° 11, June 1987, pp. 135-157; and Eugenio Lahera, "La conversión de la deuda externa vista desde América Latina", *Revista de la CEPAL* (Santiago de Chile), N° 32, August, 1987, pp. 105-125.

5 A few reference studies dealing with this issue are the following: Joel Bergsman and Wayne Edisis, "Debt-equity swaps and foreign direct investment in Latin America", International Finance Corporation/Foreign Investment Advisory Service (Washington, D.C.), August 1988; M. Blackwell and S. Nocera, *op. cit.*; J.C. Echeverry, *op. cit.*; Juan Andrés Fontaine, "Los mecanismos de conversión de deuda en Chile", paper presented at the Mesa redonda sobre mercados de capital internacionales, Oxford, England, February 1988; E. Lahera, *op. cit.*; Miguel Rodríguez Mendoza, "Debt-equity swaps: the Latin American experience", paper presented at the UNCTC/SELA Workshop on Debt-Equity Swaps, Caracas, April 1988; Padej Sukachev, "Statistical issues of debt conversion", *IMF Working Paper* (Washington, D.C.), No WP/88/28, March 1988; and David Suratgar, "Debt-equity conversions", paper presented at the UNCTC/SELA Workshop on Debt-Equity Swaps, Caracas, April 1988.

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Within this framework, this paper aims at discussing some relevant issues for the implementation of a debt-for-equity conversion programme (hereafter simply referred to as conversion programme) in Peru taking into account the application of similar schemes in other heavily indebted developing countries. The paper proceeds as follows. After this introductory section which sets the problem this paper is concerned with, section 2 reviews, from the perspective of a debtor country, the potential benefits and pitfalls that may arise from a conversion programme. In section 3 every effort is made in order to highlight some issues and to provide some guidelines that might be useful in developing a conversion programme in Peru<sup>6</sup>. Finally, section 4 states some concluding remarks concerning this topic.

## 2. Debt-for-Equity Swaps: Potential Benefits and Pitfalls

A debt-for-equity swap is basically a deal whereby a developing country's debt is converted into an equity investment in a domestic firm of the debtor country. Broadly speaking, there are a number of steps involved in this sort of transactions. Firstly, either a foreign investor or a resident (if debtor country's regulations allow the latter to participate) purchases a developing country's debt paper at a discount of face value on the secondary market. Then, the purchaser presents the debt to the central bank or the original borrower in the debtor country for redemption; a discount of face value is also applicable but this is lower than that obtained on the secondary market. Finally, the local currency proceeds (or the local-currency debt papers) are used to finance an equity investment in a domestic firm accordingly to the regulations established by the debtor country.

The implementation of a conversion programme has a number of potential advantages to the debtor country. We now proceed to refer to them briefly<sup>7</sup>.

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6 At the time the present version of the paper was being completed, the government officially announced a decree to govern the application of a conversion programme in Peru, though its code of regulations was still pending to be set forth. It should be stressed that the aim of this paper is not to discuss the specific contents of such a regulation though the guidelines provided in this paper might well be considered for the completion of such a programme's design.

7 This review is extensively based on the above-mentioned references as well as the following ones: Andrew C. Quale, "Structuring a debt/equity conversion programme: issues to consider", paper presented at the UNCTC/SELA Workshop on Debt-Equity Swaps, Caracas, April 1988; and David L. Roberts and Eli M. Remolona, "Debt swaps: a technique in developing country finance", in *Finance for developing countries: alternative sources of finance debt swaps*, New York and London, Group of Thirty, 1987, pp. 15-40.

1. *Reducing the debt burden.* A primary objective of debt-for-equity swaps is to reduce the debtor country's outstanding commercial bank debt with no foreign exchange outflow. This has two important implications. Firstly, it allows the debtor country to alleviate its foreign exchange cash flow by reducing interest payments due on a cancelled debt. Of course, this beneficial impact will take place in the short-term only if foreign investment, which is usually an integral part of debt-for-equity swaps, is not shortly withdrawn by foreign investors and if dividend remittances do not more than compensate decreased interest payments on commercial bank debt<sup>8</sup>.

On the other side, when redeeming an outstanding debt paper at a discount of face value, the debtor country is capable to capture, either fully or partly, the partial forgiveness on its outstanding debt which arises when this is sold off at a discount on the secondary market. It is worth mentioning that forgiveness on commercial bank debt has occurred to a very limited extent up to the present time (for instance, Bolivia's debt buy-back).

2. *Increasing productive investment.* It is maintained that debt-for-equity swaps provide incentives to foreign investors (and when allowed, resident investors), to make new productive investments in the debtor country. Some critics of conversion programmes contend, however, that such conversions do not necessarily encourage additional investment beyond that which would have been undertaken in the absence of the subsidisation incentive inherent in debt-for-equity swaps. It is worthwhile noting that additionality is a key factor in determining decisive advantages to the debtor countries when debt-for-equity conversions are implemented<sup>9</sup>.

Although additionality is difficult to be measured, it is likely to expect that the investment that had been planned before be larger and/or be made sooner as a result of the application of a conversion programme; that is to say, that such programmes do bring

8 In line with this fear, swap programmes usually contain provision that explicitly restrict both capital repatriation and dividend remittance on foreign investments made under such programmes in order to avoid exceeding the payments the cancelled debt would have demanded for the first several years.

9 Roberts and Remolona present a useful, hypothetical illustration of the impact of debt-for-equity swaps on the reduction in debt burden, the increase in foreign liabilities, and the ratio of new equity to total new liabilities, when such conversions are undertaken with and without additionality. See Roberts and Remolona, *op. cit.*, pp. 28-32.

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in new money to some extent. Moreover, this contention seems to be supported by empirical evidence available<sup>10</sup>.

3. *Restructuring capital liabilities.* Since debt-for-equity swaps become a tool for substituting external debt for foreign or domestic equity, they are in a position to put underway changes in the capital structure of both the overall economy and the recipient firm, thereby encouraging more reliance on equity rather than debt finance and enhancing risk sharing between debtor countries and foreign or resident investors. A major beneficial result of such a capital restructuring is that the servicing of new liabilities can better fit the country's ability to pay.

Although a need for future foreign exchange outflows is generated when a foreign investment takes place as a result of a debt-for-equity swap, the subsequent dividend remittance can be matched more suitably with the overall performance of both the country and the firm involved; that is to say, obligations to pay dividends on equity claims would only arise if the investment involved proved to be sound, which, in turn, is more likely to occur within a non-recessionary scenario. This is not certainly the case of interest payments on commercial bank debt claims which are scheduled on a fixed basis and must be met regardless of the business cycle.

If resident investors are allowed to participate, a new domestic investment may take place as a result of a debt-for-equity swap. In this case, a foreign debt liability which requires service in foreign currency is substituted for an equity liability which will demand service in local currency only, thereby easing the burden of servicing external liabilities of the debtor country.

4. *Attracting new investment for priority purposes.* Debt-for-equity swaps may also be used to attract and direct new investment to (presumably) priority economic sectors, notably those export oriented capable to generate foreign exchange, for which some incentives, such as differing discount rates at which debt papers are redeemed, have been allowed.

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<sup>10</sup> Bergsman and Edisis have investigated the prevalence of additionality in 99 debt-for-equity swaps undertaken in four developing countries. Their results suggest, but do not prove conclusively, that additionality increases as a swap programme continues over time. Out of the total, 30 swaps were made by banks and every single one was additional; of the 69 made by multinational companies, 23 (33%) would not have been made unless a swap programme was available and another 7 (10%) were made sooner or for larger projects than they would have been without a programme. Thus, for 69% of the transactions, swaps made a difference. See Bergsman and Edisis, *op. cit.*, pp. 7-8. Also see Rodríguez Mendoza, *op. cit.*, pp. 17-19.

More particularly, debt-for-equity swaps may be pursued in order to enhance privatisation programmes of the debtor country's government by means of the acquisition of shares in publicly-owned firms. It is claimed that these conversions can serve as a vehicle to put more effective management in these firms and ameliorate the fiscal burden they mean to the government.

5. *Encouraging repatriation of flight capital.* Debt-for-equity conversion programmes can be monitored to provide incentives for the repatriation of flight capital. In effect, when residents are allowed to participate in such programmes, they may use their foreign exchange-denominated assets held abroad to convert an external debt paper into an equity in a domestic firm.

Nevertheless, this favourable effect will hardly take place within a framework of economic instability and recession, even though the incentives inherent in the conversion programme are rather attractive. A countercontention may also be stated since such incentives may provide flight capital holders with rewards for having caused foreign exchange outflows in the first place.

6. *Fostering capital market development.* When debt papers denominated in local currency are used in order to redeem external debt papers purchased on the secondary market under the application of a swap programme, the issuance of such debt instruments is expected to contribute to an expanded size and deepening of the domestic capital market. A similar effect does hold when new investments associated with debt-for-equity swaps provide greater incentives to the issuance of stock notes which are to be transacted on the domestic stock market.

7. *Other potential benefits* New investments undertaken as an integral part of debt-for-equity swaps may foster a multiplier effect on the economy by generating domestic employment, increasing tax revenue, expanding exports and foreign exchange earnings, and facilitating access to new technology.

In opposition to all of these potential benefits, the implementation of a conversion programme may also give rise to a number of pitfalls which are useful to be borne in mind<sup>11</sup>.

i. *Monetary and fiscal consequences.* The need for redeeming external debt papers with local currency proceeds may lead the central bank to expand the domestic money

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11 Background references are the same as those listed in notes 5 and 7.

supply, thereby contributing to exacerbate the inflationary pressures<sup>12</sup>. A similar effect on inflation may be caused if the government determines to allocate a share of its budgetary resources to finance such redemptions, thus increasing fiscal deficit and eventually inducing the printing of new money.

Alternatively, the issuance of debt instruments denominated in local currency can be used in order to counteract the above-mentioned inflationary impact. Nevertheless, this issuance should drive the domestic interest rate up and if the government's interest payments on such debt instruments exceed the local currency cost of servicing the external debt, there will be a direct effect on the fiscal policy of the debtor country by adding to budget deficit. Moreover, this sterilisation device is not always viable when the market for domestic government debt lacks deepening or when there exist fiscal constraints on servicing such debt obligations.

ii. *Round-tripping*. The conversion of a foreign debt paper purchased at a discount on the secondary market into local assets implicitly involves a preferential exchange rate or a subsidy to these specific transactions<sup>13</sup>. As a result, they give room to engage in an arbitrage activity known as round-tripping which causes official exchange reserves to deplete.

Round-tripping occurs when residents of the debtor countries purchase foreign exchange on the parallel market or take foreign exchange funds out of the economy through under - or over - invoicing in order to buy external debt papers at a discount on the secondary market for subsequent conversion into local currency, thereby benefitting from the preferential exchange rate inherent in debt-for-equity swaps. Since these transactions create additional demand for foreign exchange, they exert pressure on the exchange rate and make official exchange reserves diminish since reserves are lost with capital

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12 It should be noted that the same monetary consequence arises when new direct foreign investment generate capital inflows. Furthermore, as Bergsman and Edisis maintain, a swap programme leads to an inflationary impact only to the extent that investments made through it have been additional; in other words, lack of additionality and inflationary impact logically cannot simultaneously arise from a debt-for-equity swap. See Bergsman and Edisis, *op. cit.*, p. 4 of Annex 1.

13 This preferential exchange rate can be illustrated by the following example. Assume that the official exchange rate is 30 units of local currency per dollar, debt papers can be purchased at a discount of 40% of face value, and redemption is done at a discount of 20% of face value. Then, the ratio of the local currency proceeds which the purchaser receives when redeeming the debt paper to the discounted foreign exchange outlay that he makes when purchasing the debt on the secondary market, yields an effective exchange rate of 40 units of local currency per dollar, higher than the official one.  $((0.8 \times 30) / 0.6 = 40)$ .



flight while no reserves are gained for returning capital is used to cancel external debt. For this source of round-tripping to avoid, some may advocate to ban residents to participate in the conversion programmes. However, this also causes criticism on the part of local investors since they feel discriminated in favour of foreign investors when being precluded from exploiting the implicit subsidy in such programmes.

iii. *Denationalisation of capital ownership.* A usual criticism of conversion programmes is that these may cause a (substantial) transfer of business ownership from local investors to foreigners. The fear of such a denationalisation process is of major concern particularly in those countries whose conversion programmes do not allow residents to participate. The above criticism is also reinforced by arguing that the transfers are undertaken at subsidised prices as a result of the preferential exchange rate involved in debt-for-equity swaps.

As a matter of fact, it this denationalisation did occur to a considerable extent, new foreign investments would create a need for subsequent capital repatriation and dividend remittance which, in case of not being properly managed, may exert adverse pressure on foreign exchange reserves and even counterbalance the reduction of interest payments on cancelled debt. However, this also has to be weighed against the potential foreign exchange depletion that may arise, as explained above, if residents are allowed to participate.

iv. *Resource misallocation.* It has been suggested that this problem may emerge since debt-for-equity swaps rely on preferential exchange rates. In effect, the investment that occurs because it takes advantage of a subsidised exchange rate does not necessarily mean that such an investment is profitable for the overall economy. As a result, the investment involved may be made in protected sectors, thereby worsening existing distortions and inducing a resource misallocation. In particular, this would seem to be the case when conversion programmes make use of a scale of redemption discount rates in order to attract investment to predetermined sectors.

However, it has also been claimed<sup>14</sup> that debtor countries are far from holding a Pareto optimal resource allocation so that a subsidy does not necessarily cause a misallocation. In fact, such a preferential exchange rate may be taken as a means of offsetting the resource misallocation which, for instance, emerges from imposing controls on capital repatriation and dividend remittance. In this regard, it is also maintained that such

14 See, for example, Fontaine, *op. cit.*, pp. 28-29.

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resource misallocations might be prevented by not limiting investments to specific sectors or purposes.

In short, the above review shows that debt-for-equity swaps offer the opportunity for debtor countries to capture some potential benefits. However, the advantages associated with these deals are brought at some cost. Then, a need arises for properly managing the debt-for-equity conversions through a carefully shaped programme in order to maximise benefits and deter pitfalls.

### 3. Towards Developing a Debt-for-Equity Swap Programme in Peru

This section, which constitutes the core of the essay, is intended to make a contribution to policy practice by highlighting some key issues and some proposals that might be useful in developing and implementing a debt-for-equity swap programme in Peru.

To begin with, there are three major factors that may notably influence the scope and success of the application of a conversion programme in Peru. Firstly, commercial banks may appear to be increasingly reluctant to sell off their claims at loss on the secondary market since banks must keep losses aligned with their allowed provisions. This may particularly be the case of Peru for the prices on the secondary market of Peruvian commercial debt have recorded percentages as low as 2-7% of face value recently<sup>15</sup>. These average discounts are certainly much lower than commercial bank provisions in percentage terms with respect to their loans.

It should, however, be noted that the implementation of the very conversion programme may serve to boost the prices of Peruvian debt papers on the secondary market since it may be taken as a catalyst towards normalising the relations of the country with its creditor commercial banks. In this regard, Sachs and Huizinga have estimated, on a cross-country basis, that the prevalence of more than two years of a unilateral suspension in debt-servicing payments, as is the case of Peru, has a predicted effect equivalent to about 35 percentage points of discount in secondary market prices<sup>16</sup>.

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15 These very low market prices undoubtedly reflect the loss of credibility that the Peruvian government has incurred before the commercial banks. In July 1985, prior to the announcement of the 10% debt-servicing limit, Peruvian debt papers traded at about 45-50% of face value. Since then, a sharp downward tendency has recorded, particularly during 1987.

16 See Jeffrey Sachs and Harry Huizinga, "U.S. commercial banks and the developing-country debt crisis", *Brookings Papers on Economic Activity* (Washington, D.C.), N° 2, 1987, p. 563.

Secondly, legal constraints may derive from the fact that the debt which is usually the basis for debt-for-equity conversions lies in the field of syndicated loans or restructuring and new money agreements. In effect, such debt agreements often contain the so-called mandatory prepayment and sharing clauses<sup>17</sup>, which may, in turn, raise some difficulties for the redemption of a debt paper, even if this is done in local currency. In order to face these constraints, an unavoidable, though a tedious, step to follow may be to request the necessary waivers from the creditors benefitting from these provisions; or alternatively, there would be a case to specify that such clauses will only apply whenever foreign currency is used to effect prepayments or payments.

Thirdly, since productive investments are expected to be involved in the implementation of debt-for-equity swaps, the availability of a wide range of opportunities for equity investments may turn out to be a constraining factor. Of course, this will be closely associated with the existence of a favourable economic environment and investment climate, the latter being dependent to a great extent on the macroeconomic policies prevailing in the debtor country. As is widely known, the Peruvian economy is currently facing huge macro-economic disequilibria which may pose severe restrictions to the utilisation of a conversion programme if those are not tackled with sound economic policies, particularly in the short run.

Bearing all of this in mind, there are a number of key issues which must be dealt with carefully in shaping a conversion programme in Peru suitable to the country's needs. These are now highlighted and, concomitantly, every effort is made in order to provide specific proposals for policy practice.

1. *Eligible debt.* Types of debt eligible for debt-for-equity conversions vary from country to country. In principle, eligibility should focus on medium-and long-term commercial bank debt, both original or rescheduled debt papers, and due, unpaid debt papers, though it may also comprise short-term working capital debt.

Although in the case of Peru public external debt is substantially larger than non-publicly guaranteed private external debt, private sector medium-and long-term external debt should also be eligible for such conversions since, as stated in section 1, this kind of debt is also subject to the 10% limit of debt service currently underway<sup>18</sup>.

17 Mandatory prepayment clauses require each (public sector) obligor to prepay all lenders on a rateable basis if an obligor prepays any credit covered by a (public sector) agreement. On the other side, sharing clauses require that any disproportionate payment received by one lender must be shared with all the rest. See Suratgar, *op. cit.*, pp. 40-41.

18 As we will see later on, conversions of private external debt should not pose major constraints from the monetary/fiscal viewpoint.

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Furthermore, the country should limit eligible debt to those categories with shorter maturities (say, within a five-to-ten year period) in order to avoid undertaking the rescheduling negotiations on these debt papers which will likely be necessary if they are not swapped.

There are a number of potential uses of debt-for-equity swaps. Broadly speaking, they are the following: (a) buy-outs in which only ownership changes while the physical plant is largely unaffected; (b) financial restructuring which is intended to improve a company's balance sheet without altering production facilities; (c) the addition of new productive capacity; and, (d) the creation of a new firm.

Since a deliberated purpose of conversion programmes is commonly to foster either expanded or new productive capacity, using swaps for either buy-outs or financial restructuring is usually banned or restricted. However, based on a research conducted over 104 debt-for-equity swaps, Bergsman and Edisis found a few swap transactions that were originally limited to buy-outs but led quite soon to increases in capacity and, often, to start-ups of entirely new lines of production<sup>19</sup>. Similarly, a financial restructuring may serve to remove the related constraints on a local firm, thereby leading to additional investments. Thus, on the basis of these observations, it may prove to be recommendable to allow the conversion programme to apply to both uses in order to take advantage of the above-mentioned benefits.

According to official sources, a rough estimate of potentially eligible debt for a conversion programme in Peru would total US\$1 billion for the next four years. Were this figure actually swapped, this would mean that the implementation of such a programme would allow the country to further relief on about 6-7% of total external debt. While this percentage is far from being disdainful, particularly in the current circumstances, it clearly sheds lights on the fact that much more than isolated instruments will be needed if other quantitatively important categories of debt for which this scheme is not applicable or sufficient, are to be properly managed. It also reinforces the widespread acceptance that debt-for-equity swaps are expected to reduce external overindebtedness only to a limited extent.

**2. Participating investors.** A key issue to be determined in shaping a swap programme in Peru is whether or not resident investors will be allowed to participate. As noted before, their participation may bring beneficial effects though a number of pitfalls may arise as well.

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19 See Bergsman and Edisis, *op. cit.*, pp. 13-14.

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In this regard, it may prove to be useful to assume an eclectic position and launch the implementation of the programme on a flexible basis. The objectives of encouraging repatriation of flight capital, avoiding denationalisation of capital ownership, and not discriminating against resident investors in favour of foreign investors may be good reasons so as to allow the former to participate.

As suggested in the former section, the conversion programme in Peru may actively be used in accordance with a privatisation programme, for which the participation of resident investors may be useful in order to avoid denationalisation of publicly-owned firms. Moreover, a helpful device so as to mitigate pitfalls which might arise from the participation of resident investors, provided that those turn out to be fairly substantial, would be to confine their participation to those debt-for-equity swaps related to privatisation deals.

If residents are permitted to become involved in debt-for-equity swaps, the round-tripping phenomenon is expected to occur. In this regard, Chile has made use of an auction system for "cupos", which are fixed by the monetary authorities, that has proved to be useful to mitigate this adverse effect and to control excessive pressures on the parallel exchange rate. While the application of this system may be considered rather successful, a tendency for round-tripping seems unavoidable. Furthermore, the incentives for engaging in round-tripping may be hampered with an adequate management of discounts and exchange rates applicable for redemption purposes. Concurrently, by carefully monitoring how the redemption proceeds of debt-for-equity swaps are invested, the country should be in a better standing to ensure that they are used for the authorised purposes only.

3. *Target direction for investments.* Another issue to be tackled in establishing a swap programme concerns whether or not specific economic sectors or types of investments will be given priority for such conversions. As noted in the former section, there are contentions favouring both options. For example, Chile and Ecuador are two countries whose conversions programmes do not contemplate priority areas; on the contrary, both the Mexican and the Philippine programmes are designed to direct new investments under such conversions to determined priority sectors.

If the swap programme is taken to contribute to the efforts towards restructuring the Peruvian economy, seeking to foster a more export-earnings raising, more value-added generating, more sectorally linked, more technologically advanced, more geographically decentralised, productive capacity, then it seems reasonable to include within the programme some incentives towards the achievement of these targets. However, the appraisal process to elucidate whether or not the proposed investments do fulfill the above-mentioned purposes, may turn out to be an unintended, restrictive

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factor and, in the end, impose severe limits for the effective utilisation of the programme.

In addition, if both foreign and resident investors are to be allowed to participate, the application of differing treatments may be reasonable to some extent. For instance, in those swaps in which foreign investors are involved, the investment must fulfill the requirement of being a net foreign exchange generating project since, as a foreign investment, it will later on demand foreign exchange for capital repatriation and dividend remittance purposes<sup>20</sup>. A premium may be useful to encourage such investments but need not be the case since the Peruvian authorities may reserve for themselves the right to only allow those investments meeting such a requirement. Moreover, even if the option of establishing a premium is chosen, this need not be a lower discount for redemption purposes; an alternative could, for instance, be either a shorter period of time for allowing dividend remittance or, as is being contemplated in Brazil, a percentage of net export instead of capital to calculate dividend remittance.

On the other side, whenever resident investors are involved in debt-for-equity swaps, other criteria than being a foreign exchange generating project may be more determinant. As stated before, the participation of resident investors may, for instance, be confined to those cases in which debt-for-equity swaps would be used to boost privatisations deals, thereby mitigating the fears of denationalising publicly-owned firms. In these cases, the greatest efforts of the appraisal process on the side of Peruvian authorities should be made in order to ensure both a resident investor and not a foreign one is effectively participating in the conversion, and the redemption proceeds will effectively be used for equity investment in a publicly-owned firm and not for speculative purposes. It is our contention that the former may prove to be more rewarding than to predetermine specific sectors and other requirements such as export-earnings generation, technology utilisation, and so on, all of which may give rise to tedious, detrimental appraisal and approval processes<sup>21</sup>.

**4. New money requirement.** As has been stated before, additionality becomes a key factor in determining the favourable impact of debt-for-equity swaps on the debtor coun-

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20 The imposition of such a requirement gains additional ground since it appears to be a strong positive association of export-oriented investments with additionality. See Bergsman and Edisis, *op. cit.*, p. 11.

21 In a poll carried out by *Euromoney* among more than 40 corporate treasurers of multinational companies with commercial links in Latin America, an overwhelming majority cited timing delays as the main drawback in debt-for-equity swaps. See "Global debt: the equity solution", *Euromoney*, Special supplement, January 1988, p. 34.

try's economy. For this reason, some may advocate to shape the conversion programme in such a way to request investors to bring in new foreign exchange along with the proceeds from the debt-for-equity swap.

For example, Argentina is one country that initially included in its conversion programme a requirement whereby 50% of a proposed debt-for-equity investment had to be supported by new foreign exchange. Such a requirement, however, proved to be so restrictive that made the Argentine programme quite unattractive since the advantage of the discount for the investor was correspondingly diluted<sup>22</sup>. As an effort to overcome this problem, the Argentine authorities introduced a modification whereby a debt-for-equity swap may be used to finance up to 70% of total investment, while new money must support the remaining balance.

Again, assuming a flexible attitude in developing a conversion programme in Peru, it does not appear to be rewarding to require the investment of new money along with the proceeds of a debt-for-equity swap. However, the option of investing new money should remain open; moreover, when the investor provides new foreign exchange, a premium may be contemplated by reducing the discount at which the debt paper is redeemed in the debtor country, as is the case of the Philippines.

*5. Discounts and exchange rates.* The management of discounts and exchange rates applicable to debt-for-equity swaps are of paramount importance in order to implement a beneficial conversion programme to the debtor country.

The first thing to be determined is whether a fixed or a flexible schedule of discounts is to be applied. Taking into account that the discounted prices of debt papers on the secondary market may vary in relatively short periods of time, the alternative of adjusting the redemption discounts from time to time seems to be rather appealing, especially if capturing the maximum share of the discount realised on the secondary market is of primary concern for the debtor country. The attainment of this objective may be enhanced by putting in effect a system of adjustable discounts on the basis of auctioning off the right to take advantage of predetermined quotas for making these conversions within a given period of time. Moreover, using auctions has the additional advan-

22 This effect can be illustrated by the following example. Assume that secondary market price is 50% of face value, redemption discount is set at 30% of face value, and exchange rate used is 200 units of local currency per dollar. If there were no new money requirement, effective exchange rate would be 280 units of local currency per dollar  $((0.7 \times 200) / 0.5 = 280)$ . With 50% out of total investment as new money requirement, effective exchange rate would only be 233 units of local currency per dollar  $((0.7 \times 200 + 0.7 \times 200) / (0.5 + 0.7) = 233)$ .

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tage of giving greater transparency to the redemption process *vis-à-vis* the alternative of either using negotiations or setting prices administratively.

The exchange rate to be used for redemption purposes poses another issue to be tackled in an aligned way with respect to redemption discounts. For instance, it is commonly contended that the main flaw of the conversion programme in Venezuela arises from the requirement for investors to redeem the debt papers at the official exchange rate instead of the free market exchange rate, the latter having remained at more than twice the former.

In spite of the huge discrepancy prevailing between the official and the parallel foreign exchange rates in Peru, and taken for granted the current exchange rate structure in this country, it is feasible to apply the official exchange rate for redemption purposes and to simultaneously provide the investor with sufficient incentive to undertake a conversion, due to the very low prices at which Peruvian commercial bank debt papers are currently traded on the secondary market. Furthermore, carefully aligned redemption discount rates may allow the country to capture a substantial share of the discount realised on the secondary market and to prevent investors from taking disproportionately high profits from these conversions<sup>23</sup>. All other things being equal, the shorter the official parallel exchange rate gap is, the larger the discount captured by the country will be without penalising the exchange rate incentive for the investors.

6. *Monetary and fiscal consequences.* The potentially adverse monetary and fiscal consequences of a conversion programme remain to be one of the most constraining factors. For instance, the Mexican programme has temporarily been suspended since November 1987 because of the budgetary difficulties and the inflationary impact derived from these deals.

In principle, whenever private external debt is involved in debt-for-equity swaps, there should not arise monetary consequences in redeeming the debt papers, since it is expected that the local (private) original borrower be in the condition of raising the redemption funds out of its existing assets. In Chile, this has extensively been the case, thereby

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23 At this stage, an illustration may be quite useful. Assume that the average discount of Peruvian debt papers is 90% of face value. If the redemption discount is set at the 80% level and the official exchange rate is used (250 intis per dollar), it follows that the investor will obtain an effective exchange rate of 500 intis per dollar, a rate which nearly equals the parallel market rate. In this case, the most important share of the discount realised on the secondary market would be captured by the country (about 89% out of the total discount), and there would still be sufficient incentive for the investor to participate.



avoiding the need for money creation on the side of the central bank. However, it should be recalled that the existence of a fairly deep capital market in that country has played a critical role in the success of the issuance of local debt instruments for fund-raising purposes. This, by far, does not seem to be the case of Peru so that a constraining factor arises in this regard.

Taking account of the fact that the bulk of eligible debt for conversions in Peru is public or publicly-guaranteed external debt, it is expected that official authorities will directly be involved in redeeming debt papers purchased on the secondary market. In principle, the central government or the publicly-owned firms also have the possibility to issue their debt instruments in order to procure the money needed for redeeming their debt papers. However, the above-mentioned contention that the Peruvian economy lacks a sophisticated capital market (of course, due to reasons not inherent in debt-for-equity swaps), is also applicable in this case to prevent us from expecting a successful utilisation of this sterilisation device to a great extent.

In Peru, it appears more reasonable to launch a conversion programme by allocating a share of budgetary resources to meet the financial needs of such deals, as is the case of the exchange of debt for goods. Of course, this option may add to the hardly manageable fiscal deficit and, ultimately, exert pressure for money creation as well, but it is difficult that much more can be done at present given the current stage of capital market development.

As a means of limiting the inflationary impact of debt-for-equity swaps arising from money creation, it may prove to be necessary to set the magnitude of the conversion programme at a reasonable size relative to the monetary base of the economy so as to avoid incurring in an exaggerated inflationary pressure. For this purpose, the authorities may impose limits and quotas on the amount of debt which can be converted within a given period of time (e.g., a year, a month)<sup>24</sup>. In addition, an auction system may also be used to allocate the limited budgetary funds for conversion purposes.

Although it is recognised that the former option would adversely impact on fiscal deficit, it should also be borne in mind that as a result of debt-for-equity swaps, it is expected to alleviate the fiscal burden whenever privatisation deals are involved, and to generate

24 The effect of a dollar exchange for local currency on monetary aggregate M1 and on inflation has been estimated for a number of heavily indebted developing countries-namely, Argentina, Brazil, Chile and Mexico. Assuming that these four countries' governments would tolerate only a 15% increase in inflation, on average only a 1% reduction of external debt per year would appear to be manageable. See Wolfgang Spieles, "Debt-equity only swaps and the heavily indebted countries", *Intereconomics* (Hamburg), vol. 22, N° 3, May-June 1987, pp. 120-124.

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increased sources of taxation on new or expanded investments. The latter may perform as offsetting factors from the viewpoint of fiscal budget.

7. *Capital repatriation and dividend remittance.* All countries which have developed a conversion programme have provided restrictions to govern capital repatriation and dividend remittance related to foreign investments. As stated in the former section, these restrictions are to some extent intended to offset the subsidisation incentive of a preferential exchange rate underlying in a debt-for-equity swap.

In this regard, the central point to deal with is to restrict capital repatriation and dividend remittance in such a way that they do not more than counterbalance the foreign exchange outflow which the debt swapped would have demanded. Thus, capital repatriation should follow as strictly as possible the amortisation maturities of the converted debt paper. However, it should be recognised that the former is hard to materialise since amortisation payments are rescheduled in any case under conditions of overindebtedness, as is effectively the case. A similar restriction can be imposed as regards dividend remittance *vis-à-vis* the interest payments which would have derived from the debt swapped.

According to the experience of developing countries with swap programmes underway and taking into account the minimum time limit to match amortisation and interest amounts and schedules of debt converted, in principle capital repatriation could be permitted after 10 years or so from the date of conversion, while dividend remittance 4 years or so after the original investment, as is in the case of Chile, the country which has converted the largest percentage of debt in the developing world.

Concurrently, the remittance of dividends accumulated during the first years should be allowed in annual or semi-annual installments not exceeding a predetermined percentage of the total accumulated as is the case of Chile, in order to avoid exerting too much pressure on the foreign exchange cash flow of the country. When dividends are not to be remitted, they could be permitted to be reinvested freely as is in the case of Ecuador.

In addition, foreign investments following debt-for-equity swaps could be monitored in such a way to allow either shorter periods of time or larger amounts for dividend remittance provided that such investments boost foreign exchange earnings (far) beyond those which would have been necessary to service the debt swapped. For example, the Brazilian programme is contemplating the authorisation of dividend remittance based on a percentage of net exports, generated by the foreign investment rather than on a percentage of capital. By this way, restrictions on dividend remittance, instead of additional redemp-

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tion discounts, could be used as a device to stimulate the implementation of export-oriented projects under the swap programme.

8. *Legal framework.* It is of paramount importance that the conversion programme be shaped from the legal viewpoint in accordance with other concurrent legal provisions. This has to be the case with respect to any rescheduling and refinancing agreement with creditor commercial banks that may currently be in effect so as to include clauses which allow to undertake debt-for-equity swaps; for instance, the explicit exemption of mandatory prepayment and sharing clauses in such agreements when debt papers are redeemed in local currency.

Also, the specific provisions governing capital repatriation and dividend remittance have to be stated in full accordance with those included in the Andean Group's Decision 220 which refers to a common regime for the treatment of foreign investments in this regional area. The same is applicable whenever there exists a restriction for foreign investments or domestic private initiatives to participate in some economic activities. Taxation and exchange regulations relevant to debt-for-equity swaps should also be carefully matched with those already being applied.

On the whole, the primary objective is to build up a legal framework to govern debt-for-equity swaps which is to be clearly defined and, above all, compatible with other related regulations.

#### 4. Concluding Remarks

Put within a developmental framework, a debt-for-equity swap programme may result to be a useful instrument in order to contribute to the management of the medium-and long-term commercial bank debt problem and to simultaneously pay proper attention to its impact on economic growth. Its most paramount effect seems to be qualitative rather than quantitative as a catalyst to foster productive investments and economic activity. However, the implementation of a sound debt-for-equity swap programme requires that it be shaped so as to maximise its potential benefits and mitigate its inherent pitfalls. In this regard, every effort has been made in this paper to contribute to policy practice by stressing the key issues and some proposals for further consideration towards developing a conversion programme in Peru suitable to the country's needs and current circumstances.

A few additional remarks are in order. Firstly, in order to enhance a utilisation of the

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conversion programme as wide as possible, it may prove to be helpful to the country to launch the programme on a relatively flexible, simple basis with the possibility to monitor its scope so as to ensure an adequate volume of transactions; on the contrary, a highly restrictive programme from the start-up will likely be unable to attract those investments needed for accomplishing its minimum targets.

Secondly, both the prevalence of a stable, non-recessionary economic scenario and the availability of sound investment opportunities are as crucial as a carefully structured conversion programme is to the success of the implementation of such a programme. Then, suitable economic policies and instruments should be conducted so as to restore macroeconomic equilibria and to build up a favourable investment climate, which, all other things being equal, reinforce a beneficial utilisation of the swap programme.

Finally, it appears clear that although a successful conversion programme in Peru may become quite useful to contribute to the re-integration of the country into world business and the management of its medium-and long-term commercial bank debt problem, it will be by itself unable to provide overall relief on external debt burden and to restore access of the country to voluntary credits in the international capital markets. As has been noted, other quantitatively important categories of total external debt are not subject to the application of a conversion programme and, in addition, it is not feasible to confine the management of all the outstanding commercial bank debt to the utilization of such instrument. As a result, an overall, growth-oriented debt strategy should be pursued considering the possibility to make use of other concurrent instruments such as, for instance, debt buy-back or debt securitisation deals, along with an increased support of multilateral development banks and governmental international aid agencies.

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## Abstract

*This paper is concerned with the issue of structuring and implementing a successful, beneficial debt-for-equity swap programme in Peru. To begin with, it is claimed that a need for a revised management of the debt problem arises from the fact that the recurrent strategy based on adjustment policies and rescheduling negotiations has proved to be costly and futile. Thus, within a developmental perspective, new initiatives have to be pursued so as to contribute to the management of medium-and long-term commercial bank debt and to properly deal with its impact on economic growth. Debt-for-equity swap appear rather appealing to simultaneously tackle both aspects.*

*The implementation of a debt-for-equity conversion programme has a number of potential benefits to the debtor countries but it may also give rise to a number of pitfalls. The paper provides a brief, but comprehensive, review of such elements inherent in debt-for-equity swaps. Furthermore, based on the experience of other heavily indebted developing countries which keep conversion programmes underway, the paper highlights some issues and proposals for further consideration as a contribution to policy practice towards developing a debt-for-equity conversion programme in Peru suitable to the country's needs and current circumstances.*

*The paper concludes that a debt-for-equity swap programme in Peru may become a useful, successful instrument provided that: (a) it be carefully shaped as suggested, so as to maximise its potential benefits and mitigate its inherent pitfalls; (b) it be launched on a relatively flexible, simple basis with the possibility to monitor its scope so as to ensure an adequate accomplishment of its targets; (c) both a stable, non-recessionary scenario and the availability of sound investment opportunities prevail in the Peruvian economy; and (d) it be implemented within the framework of an overall, growth-oriented debt strategy in order to provide relief on other quantitatively important categories of total external debt, for which a debt-for-equity conversion programme is not applicable or sufficient.*

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## DETTE EXTERIEURE, CROISSANCE ET CONVERSION DE LA DETTE EN CAPITAL: UNE ANALYSE PROSPECTIVE POUR LE PEROU

### RÉSUMÉ

*Cet article analyse les différents aspects de la mise en oeuvre et de la gestion d'un programme fructueux et nécessaire de conversion de la dette extérieure en capital au Pérou. Il faut toute de suite reconnaître que le besoin urgent d'une nouvelle approche au problème de la dette extérieure découle du fait que les stratégies jusqu'ici suivies basées sur l'ajustement des paiements courants et sur les accords de restructuration de la dette ont enregistré des résultats négligeables et coûteux.*

*Dans le contexte d'une stratégie de développement, de nouvelles initiatives doivent être envisagées pour contribuer à la gestion de la dette commerciale à moyen et à long terme et pour influencer positivement son impact sur la croissance économique. Les projets de conversion de la dette en capital semblent pouvoir faire face de façon avantageuse à tous les deux aspects sous-mentionnés.*

*La mise en place d'un programme de conversion de la dette en capital présente de nombreux aspects positifs sur le plan de potentialités pour les pays endettés: ces avantages doivent toutefois être comparés avec les nombreuses conséquences négatives. Cet article met en lumière même si de façon extrêmement synthétique, l'ensemble de ces aspects qui sont liés aux programmes de conversion de la dette extérieure.*

*En se basant sur l'expérience des pays en voie de développement largement endettés qui ont acceptés des programmes de conversion de la dette on cherche à analyser les problèmes sous-jacents et à avancer des solutions pour améliorer le schéma. Ces aspects sont analysés tout spécialement dans le cas du programme de la conversion en capital de la dette du Pérou pour le rendre plus adéquat aux besoins et à la situation du pays.*

*L'article conclut en mettant en relief que le programme de conversion peut être un instrument utile et efficace à certaines conditions qui peuvent être résumées de la façon suivante:*

- 1) le programme doit être soigneusement étudié et appliqué pour maximiser les bénéfices potentiels et pour en minimiser les caractéristiques négatives;*

- 2) le programme doit être envisagé de façon flexible et souple toujours avec la possibilité de contrôler ses objectifs et de se rendre compte si ces objectifs peuvent être atteints;*
- 3) la présence dans l'économie pérouvienne de perspectives macroéconomiques stables et non-inflationnistes ainsi que d'opportunités valables d'investissements;*

- 4) une stratégie de la dette extérieure axée sur la croissance de l'économie du Pérou pour réduire le poids des autres importantes catégories de la dette pour lesquelles on ne peut pas envisager des programmes de conversion en capital.*

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