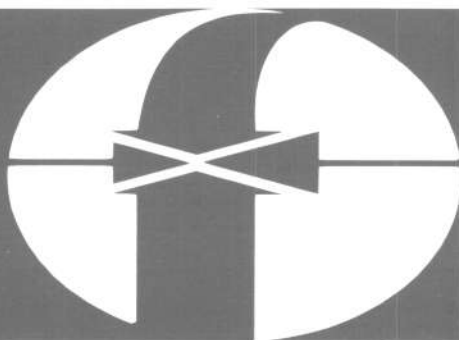


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Quarterly Review - No. 3 - 1990 - XIV



Savings and Development

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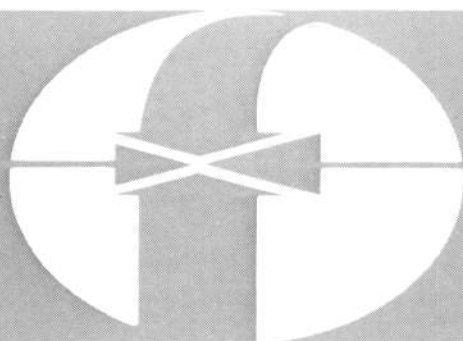
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DEBT-EQUITY-SWAPS: SOLUTION OR ILLUSION?

Kálmán Dezséri

Institute for World Economics of the Hungarian Academy of Sciences

1. Introduction

The total foreign debt of LDCs grew by the end of 1988 to approximately US\$ 1.200 bn. The need to reduce the level of indebtedness has increased for the last 6-7 years. Since the world debt problem exploded in 1982, behind the scene of a continuing stream of emergency and partly involuntary capital to the debtor countries and a developing debate over the merits of several proposals to alleviate the debt burden, the international capital market has been quietly at work in a different direction.

In recent years a few types of debt-reducing transactions¹ — other than repayments — have been introduced. These are by no means novel practices in heavily indebted countries. Such practices have retired some US\$ 27 bn of LDCs debt during the past six years. Along with debt swapping mechanisms² and debt for trade schemes, debt-equity-swapping is the most important antidote yet developed to relieve a part of the debt burden, stimulate new investment, and liquify the frozen debt situation.

Debt-equity-swap³ (DES) is a scheme developed by the marketplace, not governments, and may have wide implications for future economic development. DES has been significant in all countries seeking equity capitalisation of new and existing firms so that their

1. They encompass corporate restructuring, debt buy-backs by private and public sector companies as well as governments, debt-equity-swaps and exchanges of debt for collateralized securities.

2. Different kinds of swaps:

— risk swaps: swapping of sovereign debts because of the changing assessment of the relative value of these assets

— tax swaps: these involve the sovereign debt of two countries, or different categories of sovereign debt of the same country or private sector debt. This debt has a provision called a tax receipt, conceding certain tax credits to the institution holding it.

— par swaps: direct exchange of equivalent face amounts of debt papers, the difference between their value at secondary market prices is balanced by cash payments.

— ratio swaps: exchange of debt papers with different face amounts so that the exchange premium is based on the ratio of one debt instrument's market value relative to another's. The gap between the relative discounts is equalised by cash payment. As the gap widens, the cash amount required grows and the debt component shrinks. The size of gap depends on the ratio of the two discounts.

3. Debt-equity-swaps or conversions involve the purchase by a firm, usually foreign, of sovereign debt at a discount in the secondary market from the bank holding it. The issuing country then buys back the debt in local currency at close to its face value (usually special exchange rates are used and special taxes and fees are levied). The firm spends the local currency received in an approved manner within the country, usually to finance a fixed equity investment. Since the debt is purchased at a substantial discount, firms can realise a significant gain on the spread. The related debt capitalisation involves direct conversion of existing debt into equity, wiping out the interest and amortisation obligation and substituting an equity obligation (i.e. foreign ownership of assets).

Table 1
DEBT-EQUITY CONVERSION

	Cumulative 1983-88 (bn US \$)	As % of end-1985 debt to commercial banks
Argentina	1.32	5%
Bolivia	0.06	10%
Brazil	5.89	8%
Chile	2.35	16%
Mexico	2.40	3%
Nigeria	0.04	1%
Philippines	0.53	4%
Venezuela	0.35	1%
Total	12.94	5%

Note: Table excludes conversions outside formal programs

Source: World Financial Markets, J.P. Morgan 1988 issue 7 p. 7

economies may rely less on debt financing. Since the outset of the debt crisis, DESs have reduced the debt of eight LDCs by about US\$ 13 bn. Clearly the volume of these transactions is small relative to the size of outstanding debt.

The intention to begin DES program is usually accompanied by policies which liberalise foreign investment. If it is viewed favourably by creditor banks this program will have an impact on the pricing of loans in the secondary market, as well. There is an important caveat — the level of liberalisation which is engaged in at the inception of the conversion program is unlikely to be maintained. This is a disadvantage since it involves mixed signals. The effect on the volume of foreign direct investment is unclear, especially since the announcements of plans to participate in a conversion program cannot be assumed to be synonymous with its execution.

Swaps have already taken many different forms and new variations will certainly evolve over time. In the case of certain forms of swaps the main difficulty lies in finding a partner with opposite expectations, since assessment of trends usually tend to coincide. However, there is enough outstanding debt and enough lack of unanimity at the margin to allow an active swap market to develop⁴.

4. Roberts D.L. - E.M. Remolona (1987)

2. The Secondary Market of LDCs Debt

An important prerequisite for the emergence of DES as a response to the on-going debt crisis was the development of a secondary market for LDC loans. Only with a mechanism which provided liquidity and pricing function could debt-equity techniques become a viable alternative.

Before 1982, there existed among banks a small swap market involving portfolio assets (e.g. trading loans). After 1982 there was no primary market for loans, since they represented impaired assets. However, in this time a *de facto* secondary market has developed, which of necessity involves valuation but seldom results in cash transactions. Cash is used to balance swaps only. The worldwide interbank swap market has since increased, while the cash market has remained relatively small.

There is ambivalence on the part of financial institutions regarding the secondary cash market for sovereign debt. The banks see the secondary market as an institution which gives them the chance to get out of some debt and earn fees. However, the secondary market can only work if it is large enough to be liquid. The more players there are, the greater the efficiency and the lower the spreads. The market has, so far, become more price-efficient but not more operationally efficient. Therefore, more effort is required for a shrinking return in servicing debt conversion clients.

Discount rates, in the secondary market are determined by several factors, some of which are quite arbitrary. Although it cannot be considered broad, deep, liquid or regulated at all, this secondary market has developed a seemingly fairly consistent market valuation.

The theory of pricing behaviour in the secondary market for LDCs loans is not well developed. Although many explanations of the movements in the prices of loan obligations have been advanced; for the most part these are partial and non-reconcilable⁵.

As in all markets, prices are ultimately determined by supply and demand⁶. However, on this market even relatively small transactions (approximately US \$ 20-30 mn) can cause sharp swings. Moreover, in practice there is often a premium placed on keeping deals quiet so as not to drive up prices. Some firms try to buy the necessary papers over an extended period of time to avoid moving the market⁷. The more deals are

5. See: e.g. G. Bird (1987), Euromoney (1988), G. Franke (1987) and (1988), L.O. Laney (1987), D.L. Roberts - E.M. Remolana (1987), etc.

6. See: Debt-Equity Swaps, How to Tap an Emerging Market (1987)

7. The risk involved is that if the deal falls through, the buyer is stuck with the paper. As a consequence, few intermediaries hold an inventory of such debt.

done, the less eligible debt is available for sale. This usually results in an increase in the cost of purchasing and assembling required debt.

The market and market rates are influenced in a number of ways. First, the current and expected economic performance of the indebted country may influence both the demand for debt conversion and supply of debt for conversion. An improvement in economic performance and prospects will tend to increase the demand for debt conversion. However, it will also tend to reduce the supply of debt for swaps because the price of debt will rise as its discount falls.

Second, the discount can be decreased or increased, creating a disincentive or incentive for DESs, by regulating the differential between official and effective exchange rates. This is almost solely within the competence of the debtor country's government.

The literature analysing the determinants of LDC portfolio value suggests that these include economic performance as gauged by the standard indicators (real economic growth, inflation, trade and current account balances, that is balance of payments and their changes) and measures of debt servicing capacity (ratios of outstanding debt to GDP, exports, or international reserves). Other approaches⁸ attempt to extend this list of points by analysing sociostructural variables which also play a role in determining the price of debt. Thus, sometimes included among the points listed above are measures of debt "nuisance" (the number of reschedulings and renegotiations), capital flight and country risk. The impact of social indicators such as food security, the level of foreign economic and military aid, the quality of life, political stability, literacy, as well as ethnic and linguistic homogeneity are discussed as well. The underlying hypothesis is that economic factors weigh heavily on debt pricing and that the process is value neutral.

Conversely, political economy analysis explicitly argues that the judgement of creditor banks, as influenced by international monetary institutions, is at worst ad-hoc, and best certainly not value neutral. The plummeting value of Peru's outstanding loans is cited as evidence. This dramatic fall is felt to have less to do with an objective assessment of the Peruvian economy's prospects than it is a reflection of disfavour with the Peruvian government's unilateral limiting of external debt payments.

8. See: e.g. Laney (1987)

Table 2
SECONDARY MARKET VALUE OF DEBT (IN % OF THEIR BOOK VALUE)

	July 1985	January 1986	January 1987	January 1988	Dec. 1988	January 1989
Argentina	60-65	62-66	62-65	30-33	20-22	21-22
Brazil	75-81	75-81	74-77	44-47	42-46	38-40
Chile	65-69	65-69	65-68	60-63	55-56	58-60
Ecuador	65-70	68-71	33-66	33-37	14-16	13-14
Yugoslavia	74-77	78-81	77-81	53-55	45-80	44-46
Colombia	81-83	82-84	—	62-65	56-68	58-60
Mexico	80-82	69-73	54-57	50-52	47-49	40-41
Peru	45-50	25-30	16-19	2- 7	2- 7	5- 8
Philippines	—	—	72-76	50-52	50-53	48-50
Poland	55-60	50-53	41-44	42-44	35-36	33-35
Romania	85-89	91-94	86-89	81-83	—	—
Venezuela	81-83	80-82	72-74	55-57	45-48	38-39

Source: Shearson Lehman Hutton

3. The Rational for Debt-Equity-Swaps

A number of advantages for all parties involved have been claimed for DES schemes. Debtor countries, financial institutions, and foreign investors supposedly all benefit. Against this impressive array of advantages it is always possible to raise certain counterarguments.

The contribution of DES technique to alleviating the debt problem of LDCs can be evaluated by the approach of game theory. The debt conversion program is actually a three party frame. It can be a better solution as compared with traditional methods of financing investments if it improves the economic situation of all parties. These programs, however, always generate negative externalities at the expense of at least one of the parties. The balances of gains and losses shows the usefulness of these programs.

Pin-pointing to these negative externalities can take the form either of critically questioning the assumed advantages, or of suggesting that there are additional problems and issues which need to be addressed⁹. These pros and cons are briefly summarised below.

9. The advantages and disadvantages of DESs are discussed in more detail by e.g. G. Bird (1987), K. Dezseri and G. Marcelle (1988).

A) From the Debtor Country's Perspective:

1) It is a widely held view that the DES mechanism is an effective means of cancelling foreign debt, of eliminating interest payments on the converted debt and of conserving international reserves.

2) The other most appreciated element of conversion is that it is seen as a means of attracting much-needed foreign investment.

3) The conversion of foreign debt into internal debt can be a powerful inducement to an economy short on foreign exchange, but the remaining domestic debt can create problems with monetary policy and local credit availability;

a: the conversion may induce inflation by increasing the money supply. This monetary expansion is acknowledged to be a real problem, but it is considered to be controllable by new¹⁰ and traditional sterilisation techniques.

b: the conversion reduces external debt, but there is a matching increase in domestic debt¹¹. The reduced interest payments on external debt are offset by increased domestic debt service. The net result is likely to be an increase in debt service because real interest rates in debtor countries are usually higher.

4) Reduced external interest payments are potentially matched by increased remittances of dividends or profits and additional import requirements.

5) If the program is open to nationals — which is not the case in many countries — the DESs can be used to recycle funds abroad, that is to roundtrip flight capital. This practice can put unwanted pressure on the parallel exchange rate. However, excluding nationals puts them in a disadvantageous position with respect to their foreign competitors.

6) While conversion can have a local impact it is unlikely to offset new borrowing in most LDCs.

7) DESs are not necessarily a means of drawing in extra investment. It is likely that many investments which would take place anyway are financed by this method.

8) The conversion may create or intensify political and economic fears regarding foreign control because the debtor country effectively sells some of its capital stock to the foreign investor.

10. The main tools currently in use are monthly quotas and limits on the rate of local currency disbursement. These dissipate the impact by spreading it over time.

11. This is why Dornbusch (1987) views DESs as being primarily balance sheet operations.

B) From the Financial Institution's Perspective

1) Since the beginning of the debt crisis there have been few ways for banks to reduce their LDCs loans or realise a real return on them. Since restructuring, and interest payments on old debt has often been financed by borrowing new money, the profit on interest shown in the books of lender banks was questionable. DESs can provide an opportunity to get out of some debt and possibly realise income from fees for financial advice and intermediation.

2) The sale of debt at steep discount on the secondary market may be the only way for many banks to reduce their holdings of non-performing LDC debt¹². One of the first effects of the decision by leading US banks and other money centre institutions to create additional LDC loan-loss reserves was the falling value of LDC debt on the secondary market.

3) The DES technique was not originally fully consistent with certain US accounting rules¹³. The practice raised several valuation questions (historical booking price versus market value and writing down) to which generally accepted answers have yet to be found. Some banks were locked into their position because of the conversion's balance sheet consequences. Any further progress on securitisation and the use of devices such as DESs must deal with these accounting issues. This will require cooperation between banks, bank regulators, and the accounting profession. In order to bridge the difference between historical booking prices and the market values of Third World loans, a number of countries' regulatory authorities have already ordered their banks to make reserves against their sovereign loan exposures (usually ranging from 2 to 20%).

C) From the Investing Foreign Company's Perspective

1) The conversion programs can have a major impact on a company's business decisions, particularly on investment questions. The availability of discount funding improves the potential return of a project.

2) In certain cases even cheaper financing cannot fully guarantee the higher return required because of the greater inherent risk. There are basically three principal risks involved into debt-equity swaps: political, commercial, and convertibility. The investors have to rely on the same techniques used in other cases (e.g. capital hedging, block

12. Many non-US banks and smaller, regional US banks have already done so because they thought that it was the time to act, regardless of the cost.

13. See: Debt-Equity Conversion (1987) and Debt-Equity Swaps (1987)

funding and innovative trade financing, etc.) and base their decisions on a number of important criteria¹⁴.

Analyses of DESs have come to different conclusions although, most of them emphasise the mutual advantages to the parties involved. There are views which argue that the indebted countries cannot gain anything from the conversion technique. A paper on this technique¹⁵ argues that the favourable evaluation of DES is not well-founded as DES can only be expected to improve the debtor country and benefit the investor and the bank if this technique resulted in a generally better outcome comparing to conventional methods of investment financing. The negative externalities are not, however, distributed equally. The investors and the indebted countries cannot reap such appreciable gains which they cannot obtain by the conventional financing of investment. Its main reason is that in an efficient capital market the dollar denominated loans are priced such that their prices are not below the present value of the expected payments of interest and principal.

4. Debt-Equity Swaps Programs

Several countries have established DES programs, among them Chile, Costa Rica, Ecuador, Mexico, the Philippines, Brazil, Argentina, the Dominican Republic, Uruguay, Venezuela, Peru, and Colombia. Some countries such as Chile, Mexico, the Philippines, Ecuador, and Argentina already have formal swap regulations. The other countries' swap practices are managed on a case by case basis. Among the countries that allow swaps, there are considerable differences in the relevant regulations and procedures. Most heavily indebted countries, especially those in Latin America, have already or will probably be obliged to offer some form of debt conversion — though not necessarily a formal program — as a competitive necessity.

Chile was the first country with standardised regulations, enacted in May 1985. DESs

14. The main determining criteria to be assessed by firms at DES are:

- net benefit (depends, inter-alia, on the local currency discount, and the given exchange rate of multiple-tier system for the purpose of DESs)
- restrictions on foreign investment (rules governing foreign business in general and specifically those governing business employing DESs, e.g. limited access to certain sectors, or other financial source etc.)
- lock-in provision (limits on transfer of equity and transfer of profit and capital repatriation, etc.)

15. See: G. Franke (1987)

are governed by Chapter 18 and 19 of Banco Central's foreign exchange regulations¹⁶, which are designed to deal with two different types of transactions. Chapter 18 regulates conversion to domestic debt instruments by residents or non-residents for any purpose. It explicitly encourages Chilean citizens to take part in swaps. Chapter 19 governs conversions of external debt for investment in Chile. Chapter 18 does not provide any right of access to foreign exchange for eventual repatriation. Since no Banco Central approval is required, as in the case of Chapter 19, transactions are controlled by twice monthly quota systems, which are auctioned. The quotas are used as a means of controlling money creation, with the result that the quotas have tended to fluctuate substantially. Under Chapter 19, the right to repatriate eventual earnings may be obtained under certain conditions, which makes it attractive to foreign investors.

Mexico has pioneered an important variation on the discount system¹⁷. The program graduates the percentage of face value to be redeemed on the converted debt according to the national interest in the intended use of the funds. General criteria used in evaluating proposals for discount assignment include the investment's potential to increase exports, introduce new technology, provide infrastructure, rationalise industry, increase employment, and develop targeted zones. Weight is also given to anticipated profitability and the contribution to sector development. Instead of establishing formal quotas, money supply and inflation are controlled via the pace of approvals or by issuing notes rather than cash to spread out the payment schedule. Both of them can function as rationing the impact of the injection of funds into the market. Moreover, the economy is considered large enough to be able to absorb the converted amounts without any major impact on the monetary and fiscal side. The regulation extended participation to Mexican nationals in 1987.

The Philippine government introduced its DES program in 1986¹⁸. This program imposes relatively heavy government fees and restrictions on new capital investment. The converted capital can be used for equity investment only in already existing firms in almost all sectors. The program sets priority and non-priority investments and levies facilitation fees, and new money requirements, etc. accordingly. The privatization program generally sets limit on foreign capital participation at 40% of equity. The program

16. See: Debt-Equity Swaps - How to Tap... p. 29-49, and Euromoney January 1988 p. 64-80, and F. Garcés (1987).

17. See: Debt-Equity Swaps - How to Tap... p. 51-77, and Euromoney January 1988 p. 44-53

18. See: Debt-Equity Swaps - How to Tap ... p. 79-94, and Euromoney January 1988 p. 94-102

retains a certain flexibility since it sets guidelines rather than rules. There are no specific quotas, but the approval process is used to regulate the rate of conversion. In order to dissipate monetary impacts, some payouts are made by issuing treasury bills rather than currency. The Philippine Investment Note (PIN) was one of the allied concepts to come out of DESs. The PIN was designed to encourage fresh money flows and contribute to the debt-equity program. Because this instrument is a non-interest-bearing foreign currency obligation of the Central Bank, investors have a strong incentive to redeem the notes promptly to make equity investment.

Newly introduced formal and case-by-case debt-equity programs are designed by using the experience of other countries. They usually contain announced target quotas with bids (e.g. Argentina¹⁹, Venezuela²⁰), auctions (e.g. Brazil²¹), or the use of zero-coupon bonds (Bolivia²²) which are similar to the Philippine Investment Note in marketability and end use. Along with other requirements, there are limits on participation and the eligibility of projects. Governments usually try to target investments by offering incentives via the discount levels which depend on the sector, and regions in question, as well as new employment, enhanced exports, etc.

While, most heavily indebted countries have shown some interest in DES programs, all of the formal programs, with the exception of the Philippine, are to be found Latin American. More are expected to be announced there in future. In fact, because of its widespread use in Latin America, it may have become a competitive necessity to institute such program in order to attract foreign investment. The development of similar programs in the rest of the world is less likely.

Except for the Philippines, no Asian country has expressed interest in a DES program. This technique is unnecessary either because of the economic success and foreign investment structure of Asian countries or because these nations possess economies that are not developed enough to make DESs useful.

Some African countries may be considered likely candidates for DES programs, but only Nigeria has expressed interest. The explanation for this lack of interest lies in the structure of debt in African countries, most of which borrowed from governments and

19. See: Paz, M. - D.J. Tecson (1988), and Borchil, M. - M.E. Bombau (1988) and Debt-Equity Swaps - How to Tap... (1987) p. 95-106

20. See: Debt-Equity Swaps - How to tap... (1987) p. 117-120

21. See: Mendes, A. (1988), and Debt-Equity Swaps - How to Tap... (1987) p. 107-116

22. See: Debt-Equity Swaps - How to Tap... p. 137-139

multilateral agencies rather than from commercial banks. Thus there is a lack of eligible debt to fuel conversion programs.

Although many Eastern European nations have large foreign debts, most of them are not likely to operate DES programs because most of them prohibit or limit the sort of equity investment usually involved in these programs. The expressed interest has been moderate and any future change in this position is considered to be remote.

5. Conclusion

The initial period of DES programs was dominated by euphoric expectations. DESs were viewed by their advocates as the compromise market solution to the debt crisis. However, the evaluation of these programs has become more moderate, as evidenced by the realism apparent in the literature²³. DESs offer some hope of alleviating the debt difficulties of LDCs. However, it is easy to overstate the benefits which all parties can gain out of it. It is already obvious that these are likely to remain small relative to the size of the debt problem. Moreover, there are various problems associated with DESs.

In evaluating DESs, one has to keep in mind that this mechanism does not provide a quick fix. The international debt scene is highly politicised, largely as a result of past reschedulings and negotiations. If the DES method heightens this politicisation by promoting liberalisation and privatisation, the result could taint any positive effects.

These DES programs require careful management of exchange rates and capital inflow levels since in the absence of these controls there are likely to be disruptive impacts, as well. There must also be coordination with other economic policies and objectives.

It seems that for sovereign borrowers the current debt management technique of renegotiation operates quite well to restructure principal maturities over long periods. DESs, however, are immediate. With restructured credits, the claim on resources, as represented by the principal amount of the credit, is deferred until at least the next century; in debt-equity conversion this must be met immediately. The borrower gains by reducing debt service payments by the level of the accrued interest foregone. This rather small debt service relief has to be balanced against the immediate delivery of the full

23. See: e.g. Bird, G. (1987), Dezseri-Marcelle (1988).

face value of the credit in local currency. Of course, any disadvantage here may be offset by other factors such as urgent economic necessity, and the positive impact of foreign investment.

Experience shows that DES programs cannot encourage investment in countries which, for other reasons, are not considered as creditworthy by foreign investors. They may facilitate and encourage additional capital inflows, but can not transform a country's debt position. If they are undertaken after a careful assessment of the prevailing economic realities, and if their implementation is coordinated with other policies aimed at political and economic objectives, DESs can provide a welcome addition to the debt management tool kit. They certainly cannot offer a substitute for, but rather a complement to other measures to promote cross border lending and foreign direct investment.

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Abstract

The study describes and analyses the distribution of costs and benefits of participation in debt-equity swaps. It focuses on the mechanisms involved in debt-equity financing and examines the conditions under which particular distributions of costs and benefits accrue to the interested parties. The central focus is on the impact for the national economies of debtor countries. The study gives brief descriptions of national debt-equity programs. As a summary, the study evaluates the importance of debt-equity swap programs in managing the indebtedness.

CONVERSION DE LA DETTE EN CAPITAL: SOLUTION OU ILLUSION?

RESUME

Cette étude décrit et analyse la répartition des coûts et des bénéfices de la participation au financement par conversion de créances. L'étude centre sur les mécanismes impliqués par la conversion de créances et elle examine les conditions dans lesquelles une répartition particulière des coûts/bénéfices échoit aux parties contractantes. L'attention est concentrée sur l'incidence du système sur les économies nationales des pays débiteurs. L'étude décrit les programmes nationaux de conversion de créances. En résumé l'étude évalue l'importance des programmes de conversion de créances dans la gestion d'endettement.