Debt / Equity Swaps

A number of developing countries have reduced their debt by allowing banks or other holders of claims to exchange them for local currency, at a discount, provided that the proceeds are used to purchase shares in local companies. In this way, not only can debt and debt service be eased, but foreign investment can be encouraged, especially in state-run enterprises slated for privatization.

Debt Reduction and Foreign Investment

Debt/equity swaps began in Chile in 1985. Through 1990, 15 highly indebted countries, mainly in Latin America, used debt/equity swaps to reduce about $43 billion worth of debt to foreign commercial banks. The key to the attractiveness of this scheme is the low price of much debt on the secondary market where existing bank debt is bought and sold. Since the difficult economic circumstances of many indebted countries reduce the likelihood that they will be able to pay back their debt on schedule, the value of their debt is correspondingly lower on the secondary market. The discount reflects the risk associated with holding such debt. But the lower the selling price of outstanding debt, the cheaper it is for an investor to convert it into equity.

When considering a debt/equity swap, governments need to decide whether their primary goal is to increase foreign investment or to reduce debt. If encouraging foreign capital flows is foremost, the government may wish to give an incentive to investors, such as a more favorable local currency rate. While this raises the cost to the government of the debt swap, it is likely to lead to higher levels of investment. If debt reduction is the focus, a government will wish to offer a lower payment in local currency to investors in order to maximize its own benefits from the swap.

Government and Market Approaches

A country must also determine the right vehicle for allocating resources in a debt/equity swap: government fiat or a market mechanism. In the first case, the government receives a pool of applications and evaluates each proposal against a set of general criteria. Under a market approach, such as an auction, applicants bid against each other for access to a fixed pool of conversion funds. Most countries have opted for the latter approach, including Argentina, Brazil, Chile (for conversions by residents), Mexico, Nigeria, Peru and Venezuela. The auction method is easier to administer and, because of the competitive bidding element, results in greater benefits for the government.

Inflationary Impact

One concern raised by debt/equity swaps regards their potential inflationary impact. During 1989 and 1990, Brazil and the Philippines scaled back their swap programs for this reason. Debt/equity swaps usually involve trading dollar-denominated debt for local currency. For instance, if debt is to be swapped for shares in private companies, the central bank must issue local currency with which investors can then purchase such shares. This adds to the amount of money in circulation, and leads to higher inflation.

However, this obstacle can be overcome when debt is exchanged for shares in state-owned enterprises due to be privatized. The government no longer needs to go through the intermediate step of providing currency; instead shares in state firms can be directly swapped for debt. Argentina is using debt/equity swaps to privatize its phone company, airline and other public enterprises. Debt/equity swaps to facilitate privatization are also part of the Brady debt-reduction initiative. Mexico, the first country to engage in Brady-style operations, has already used such swaps to reduce its external debt by $4 billion, and is planning further debt reductions through privatization of state-owned enterprises.

Other Swaps

Private investors have been the most active players in debt/equity swap operations, but other types of debt swaps-- among them debt-for-nature, debt-for-education, and debt-for-health swaps--have attracted other participants. Harvard University has concluded debt-for-education agreements with the governments of Ecuador and Mexico. The local currency earned in these conversions will finance local research and student exchanges. Ecuador has also negotiated with the World Mercy Fund to finance the control of cerebral cistercircosis there. Conservation International, a private U.S. group, was the first to work out a debt-for-nature deal with Bolivia in 1987. It bought $650,000 worth of Bolivian debt owed to a U.S. bank, at a discount, and is using the local currency it earned to protect the Beni biosphere reserve (a tropical forest). (Apr.1993)

Debt/Equity Swaps, 1985-90 (US$ millions)

Country	1985	1986	1987	1988	1989	1990
Argentina	467	-	-	1,354	514	5,796
Brazil	530	206	300	5,115	4,724	483
Chile	332	981	1,950	2,762	2,778	1,103
Costa Rica	-	-	145	189	46	21
Ecuador	-	-	127	259	32	45
Guatemala	-	-	-	152	20	-
Honduras	-	-	-	10	74	41
Jamaica	-	-	-	9	25	24
Mexico	-	363	1,786	2,919	2,546	652
Nigeria	-	-	-	40	257	205
Philippines	-	11	353	808	493	418
Uruguay	-	-	36	144	50	-
Sierra Leone	-	-	-	-	9	-
Venezuela	-	-	-	47	656	405
Zambia	-	-	-	-	6	26
Total	1,329	1,561	4,697	13,805	12,215	9,220

Source: World Bank

The World Bank • 1818 H Street, N.W. • Washington, D.C. 20433 • (202) 473-1793 • Fax (202) 676-0578