REDUCING OFFICIAL BILATERAL DEBT: A ROLE FOR THE MARKET

With the commercial bank debt problem now largely under control, attention has shifted to reducing official bilateral debt and to the potential role of market mechanisms in that process. The conversion of such debt received a boost in 1990 with the adoption by Paris Club creditor countries of the "Houston" terms. These allowed creditors to convert, on a voluntary basis, up to 100 percent of a debtor's concessional debts, and up to 10 per cent of non-concessional debts or US$ 10 million, whichever is higher. In addition, the United States' "Enterprise for the Americas Initiative", also launched in 1990, provided for the sale, reduction, cancellation or conversion of debts owed to Eximbank and the Commodity Credit Corporation through transactions with private investors in debt-for-equity and debt-for-environment swaps.

While both initiatives were innovative and potentially significant as debt reduction tools, they have not proved easy to implement. For a start, an appropriate market infrastructure for such transactions is lacking. As a result, although about 15 Paris Club agreements include a debt conversion clause and the United States initiative is into its third year, few official debt conversions (ODCs) have occurred. Meanwhile, the stock of official bilateral debt has risen to new peaks in all severely indebted developing countries, largely as a result of interest capitalization through repeated reschedulings.

Against this background the UNCTAD secretariat commissioned a study earlier this year on mechanisms for converting official bilateral debt.[1] This was followed by a meeting during which 30 experts from debtor and creditor countries examined the issues involved. On that occasion a number of debtor countries requested UNCTAD's help in preparing the groundwork for setting up official debt conversion schemes. This article summarizes the conclusions reached in the study referred to above.

The Background

After a detailed evaluation of the measures taken by official creditors to reduce the debt and debt-service burden of developing countries since the early 1980s, the authors conclude that the internal dynamic of continuing bilateral debt accumulation through the compounding effects of interest capitalization has become unsustainable. In particular, they point out that the 1988 "Toronto" terms agreed by Paris Club creditors have failed to provide needed relief for severely indebted low-income countries; neither are the 1991 enhanced "Toronto" terms expected to deal adequately with the problem. They go on to suggest that ODCs based on the optional 10 per cent conversion clause introduced in 1990 will therefore need to be resorted to on a larger scale than envisaged.

Experience with Commercial Debt Conversions

The study next reviews recent experience with commercial debt conversions. This shows that debt-equity swaps (DESs), totalling some $38 billion since 1985, have yielded valuable benefits when the policy framework and programme design were appropriate. They have resulted in major reductions in the stock of debt, encouraged the repatriation of flight capital, contributed to a sustained recovery in foreign direct and portfolio investment, helped to promote exports and efficient import substitution, and bolstered the process of privatization and the strengthening of private sector finance.

Debt-for-development swaps (DDSs), on the other hand, have only amounted to $350 million, but they have highlighted areas of priority concern in social and environmental spending and have helped to direct other expenditures to those areas. As for debt-for-bonds swaps, these now exceed even DESs in volume terms but they mainly substitute one form of debt for another, albeit with some degree of debt and debt-service reduction.

The experience with commercial debt indicates that the greatest scope for effective debt conversion in severely indebted developing countries exists when it can be closely associated with programmes for large-scale privatization and domestic capital market development. These two aspects help to avoid the monetary expansion effects of large-scale swap programmes and can result in greater productive and allocative efficiency in the economy. The scope for DESs is therefore greater in countries with large public sectors which they wish to shrink, such as Argentina, Brazil, Jamaica and Zambia, than in countries where the state sector is small, such as Ecuador. In the latter, however, DESs can still be deployed to achieve debt and debt-service reduction by attracting foreign investment and redirecting domestic capital into more efficient activities. Debt-for-development swaps, though having a smaller potential, can play an important complementary role.

[1] *Forthcoming, "Conversion of Official Bilateral Debt," by Percy Mistry and Stephany Griffith-Jones (UNCTAD/GID/DF/1), December 1992.*

The Scope for Official Debt Conversions

The study's examination of concepts and technical issues relating to the interests of both bilateral creditors and debtors leads to a number of conclusions concerning the scope for ODCs. Some of these are summarized here.

On the basis of the analysis, which includes four country case-studies, the authors conclude that there is considerable scope for ODCs across a wide range of severely indebted developing countries. They add that in low-income countries, ODCs should be additional to the maximum possible levels of cancellation of bilateral debt under the enhanced "Toronto" terms. In the middle-and lower middle-income countries, debt cancellation is less likely, however, so that debt conversion could play an important role. In some cases, moreover, ODCs are likely to engender wider efficiency returns than cancellations and may therefore be preferable on that score alone.

A second important finding relates to the mechanics of ODCs. The authors point out, for example, that transparency in the pricing of transactions is essential for their success and credibility. Debt sales through auctions in debtor countries do not necessarily assure transparency or competitiveness. The setting of prices needs to be undertaken with special care in countries with seriously distorted exchange rates; failure to do so can result in debt conversions fuelling exchange rate volatility.

The study identifies five prices connected with official DESs which determine the net gains and losses to debtors and creditors of such transactions. These are the secondary market discounted price of the debt being converted; the redemption price, *i.e.* the proportion of face value that the debtor agrees to convert into local currency; the transaction or conversion fees and taxes which are levied by the debtor government or the central bank to capture part of the market discount benefit; the price in local currency of the asset to be acquired; and the incentives that are offered by debtor governments to encourage foreign or domestic investment through DESs. The latter are often accompanied by offsetting restrictions on repatriation in the medium-term, designed to avert premature pressures on the balance-of-payments.

All five prices influence the net present value calculations on which the cost/benefit outcome of conversions is judged. It is essential, especially where ODCs are concerned, that all five prices be transparent and equitably applied across the board to avoid perceptions of unfair treatment among creditors and so as not provide excessive subsidies to foreign investors.

Another conclusion concerns the inflationary potential of DESs and DDSs. The authors suggest that ODC programmes need to have built-in features which satisfy creditors, debtors and multilateral interlocutors that inflationary pressures will not arise. They point out that there is sufficient experience with the design and management of such programmes for such concerns to be properly accommodated. For a start, an up-front disbursement of cash at face value can be highly inflationary. Local currency redemption of converted debt should, to the extent possible, therefore be made in the form of debt instruments with medium-term maturities and bearing interest at rates which do not pose immediate or long-term threats to budgetary control. DESs, moreover, are less likely to be inflationary than DDSs because the former contribute to increasing productive capacity and output. A third lesson of experience is that direct swaps of foreign debt into real assets, such as equity in privatized enterprises, land, buildings or equipment, without requiring an intermediate swap into local currency may involve no increase in the money supply. Finally, DESs restricted to privatization programmes can have either a neutral impact on inflation or even a beneficial impact when revenues accruing to the government help to reduce the public deficit.

The study further concludes that ODC operations need not conflict or compete with private DES programmes. There are large segments of potential market demand for the former which have not yet been fully tapped by private operations. Rather than displace commercial paper, the entry of official debt in secondary markets would help to widen and deepen these markets and to stimulate new innovations.

The authors also identify a number of key factors inhibiting faster progress with ODCs. These include the lack of financial sophistication on the part of export credit agencies and decision makers in governments; disagreement among different agencies of creditor governments on the opportunities and constraints involved; legislative limitations and inadequate reserves which act as powerful constraints on conversions involving sales of official debt at discounted prices; the reluctance of creditor governments to hold equity in developing country enterprises; the immense heterogeneity of official claims, which makes it difficult to tackle the problem through innovation; and the absence of any debtor initiative, other than those by Poland and Egypt, in exercising their conversion option clauses, suggesting to creditors that this avenue is not of interest to debtors. The authors conclude that progress with official debt conversions will depend on tackling all of these shortcomings simultaneously.