DEFINING THE ROLE OF DEBT SWAPS IN USAID DEVELOPMENT OPERATIONS

A
Study
prepared for the

Office of Operation and New Initiatives
Bureau for Africa
United States Agency for International Development

by

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EXECUTIVE SUMMARY

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IN USAID DEVELOPMENT OPERATIONS

February 28, 1992

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PURPOSE

The purpose of this study is to review and analyze the use of debt swaps by developing countries and consider the relevance of the different debt conversion techniques to USAID development operations. The goal of the study, which was contracted by the Office of Operation and New Initiatives, Bureau for Africa, is to define those areas of debt swap activity that complement USAID's development operations and recommend a set of policy guidelines for USAID involvement.

BACKGROUND

Debt swaps have become an integral part of the process of working out the developing country debt crisis, and they are likely to continue to be a part of this process as long as there are external creditors who perceive that the real present value of the developing country debt they hold is lower than the nominal present value. The market introduced debt swaps early in the debt crisis in the form of Debt for Equity swaps, a swap involving the cancellation of external debt in exchange for pre-payment at a discount in local currency. The local currency proceeds initially could be used only for domestic investment; however, the permissible end uses of the local payment were later expanded to include, for example, conservation programs (Debt for Nature), education projects (Debt for Education) and other development activities. All of these swaps may be broadly categorized as Debt for Local Currency swaps, as all involve a local currency payment.

A debate within the international community on the potentially adverse macro-economic effects of these swaps began immediately following their introduction and intensified as the volume of debt swaps expanded. Eventually, a *de facto* consensus was reached among the indebted countries, commercial and official creditors and the governments of the industrialized countries that essentially entailed acceptance of the use of debt swaps to gain certain defined benefits as long as the macro-economic costs, which came to be better understood than at first, were properly managed. A decisive element in reaching this consensus was the recognition that the re-establishment of normalized debtor/creditor relations with commercial banks was essential and that debt swaps contributed substantively toward achieving this goal.

In the course of events, a new category of debt swap appeared--the Debt for Assets swap, involving the exchange of public sector external debt for public sector assets--and begin to be used in privatization transactions and the restructuring of troubled domestic financial institutions. Since these swaps normally do not involve monetary creation, their macro-economic impact was seen to be more easily managed than in the case of Debt for Local Currency swaps. In the most recent major development, the "Brady Initiative" introduced large-scale, officially-sponsored Debt for Foreign Exchange swaps--the exchange of existing external debt for a new foreign currency-denominated instrument on improved terms--as a component in debt and debt service reduction exercises, as well as limited options for prepayment of external debt in foreign exchange (i.e. a buy back) at a discounted price.

TRENDS IN DEBT SWAPS

Total debt conversion by developing countries climbed to a level of over $8 billion annually by 1988, nearly all of which were Debt for Equity swaps, but also including occasional Debt for Development swaps. By 1990, several of the larger indebted countries had begun to emphasize Privatization swaps (a Debt for Assets swap which does not involve a local currency payment) and to de-emphasize Debt for Equity swaps, a trend which is expected to become more widespread. Privatization swaps exceeded $7 billion in 1990, while total Debt for Equity swaps declined to under $5 billion. Finally, the year 1990 was also the first year of implementation of the "Brady Initiative." Agreements were reached in five countries, including larger debtors such as Mexico and Venezuela, which involved the exchange of close to $60 billion of old debt for new foreign currency-denominated "Brady Bonds" issued with more favorable terms (a Debt for Foreign Exchange swap). Additional "Brady Initiative" agreements are under negotiation.

Although all of the debt swap activities discussed above have involved only external debt with commercial banks, various proposals have surfaced from time to time for utilizing official external debt in debt swaps to promote private sector and development activities. Undoubtedly, any move in this direction that may materialize would be focused on the severely indebted low-income developing countries whose external debt is largely comprised of official debt, such as the Sub-Saharan African counties.

USAID INVOLVEMENT IN DEBT SWAPS

USAID has taken the lead among bilateral and multilateral institutions in assisting countries that are experiencing debt problems in the design and management of debt swap activities. Although the Guidelines issued by the Agency focus on Debt for Development swaps, USAID has undertaken projects that have involved all of the major types of debt swaps.

The Bureau for Africa co-sponsored a senior level debt conversion workshop in Abidjan in 1989, and later approved grant assistance to the World Wildlife Fund for a Debt for Nature swap involving $1.6 million of face value in debt. Overall, about $9.6 million in USAID funds have been utilized in Debt for Development swaps arranged by fifteen grantees to acquire and cancel as much as $30 million in the foreign currency obligations of 13 countries in exchange for the equivalent of about $17 million in local currency to be used in various development programs. Further the Agency provides core funding for the Debt for Development Coalition, Inc., a specialized institution created to provide technical assistance to governments and sponsors of debt swaps.

The Dominican Republic Debt Conversion Project is the first to be designed specifically to help a government establish a formal Debt for Equity swap program. Although the political decision to introduce a formal program, designed by a USAID-financed resident technical assistance team, has not yet been taken, the project has already proven to be a valuable complement to the Mission's macro-economic dialogue with the government.

In Honduras, the Mission and a USAID-financed resident technical assistance team played a substantive role in introducing Privatization swaps into an existing USAID Privatization Project. These Privatization swaps eventually proved to be a key factor contributing to the success of the Project.

The R&D Office of Population recently introduced a global sector project in which debt swaps figure prominently. The project is designed to increase developing country resources for family planning and to encourage greater private sector involvement, and it includes up to $20 million to finance debt conversions which will be arranged and managed by a specialized contractor.

The Agency also assisted Bolivia with its 1988 Debt Buy-Back (a Debt for Foreign Exchange swap) and has participated in "Brady Initiative" negotiations in countries where an assistance program is in place.

CONCLUSIONS

Experience has demonstrated that those indebted countries who have managed their debt swap activities as an integrated component in their overall strategies for working out of the financial crisis have enjoyed the most benefits. Those countries who have approached debt swaps as a piecemeal, isolated activity have gained the least. Debt swaps are neither inherently "good" nor "bad," but costs and benefits have to be managed. Further, debt swaps can have important implications, positive or negative, for the government's macro-economic policies, management of its domestic and foreign indebtedness and its relationships with sources of external capital. Therefore, the quality of the government's management of the debt swap process is the key issue to be addressed.

Despite the overriding importance of this issue, only a handful of countries can be judged to have mastered the process of managing debt swap activities, and out of about 60 countries classified either as "severely indebted" or "moderately indebted," perhaps less than 20 can be said to have had any meaningful experience with the debt swap process. Nevertheless, debt swaps will continue to represent a possible option for developing countries who cannot meet the terms of their existing external debt and whose loans are traded in the secondary markets at a discount. Those who choose to take advantage of this option can benefit greatly from the practical experience of other countries through technical assistance.

USAID is well positioned to serve as a channel for such technical assistance in those countries where assistance programs are in place. It is the only official aid institution to have promulgated a policy that encourages direct support and funding of debt swap activities and it has gained "hands-on" practical experience with all of the three basic types of debt swaps. The involvement of other official bilateral aid agencies has been sporadic at best, and while the multilateral development institutions have been generally supportive, their direct involvement has mostly been limited to "Brady Initiative" swaps.

The Agency's decentralized approach to the design and implementation of projects involving debt swaps offers many advantages, among them the encouragement of innovation and prudent experimentation, responsiveness to changing economic and political circumstances, and the opportunity to link debt swaps into the macro-economic dialogue. The use of swaps in the developing country debt crisis is, however, a complex area of activity that is constantly evolving and subject to changing perceptions as practical experience is gained. What seems to be lacking within the Agency is a systematic mechanism for tracking market developments involving debt swap activities, evaluating country experiences with this option, exchanging views with other aid agencies, analyzing this information, putting it together in a manner that is relevant to the Missions and their client governments, and providing effective information dissemination.

RECOMMENDATIONS

1. Restate Policy Guidelines: USAID should amplify its policy directives on debt swaps to emphasize that the primary goal of debt swaps is to support economic adjustment and reform and to help re-establish normal relations between the indebted country and its creditors. Within this broad policy goal, secondary objectives, such as investment promotion, funding of development programs, promotion of exports, support for privatization efforts, or debt and debt service reduction, should be matched with the type of debt swap that most efficiently meets these objectives. USAID support should always be accompanied with technical assistance to help manage the corresponding costs.

2. Clarify Operational Guidelines: Operational guidelines on the use of USAID funds to support debt swap activities are articulated in "A.I.D. Debt for Development Guidelines." Many grantees, contractors and other involved organizations have found that there are important policy and procedural questions that the Guidelines do not adequately address or do not address at all. The Debt for Development Coalition, Inc. prepared a draft paper which provides many useful suggestions for improving the Guidelines. R&D/EID has subsequently prepared another paper, "Supplement to the A.I.D. Guidelines on Debt for Development." These efforts should be pursued and expanded to include guidelines for USAID involvement in all types of debt swaps.

3. Designate a Unit Responsible for Policy Guidance: The Office of the General Counsel took the lead in the preparation of the Guidelines and their distribution to USAID offices in Washington and overseas Missions. No office or individual, however, was assigned continuing responsibility for overseeing and promoting the debt swap initiative or providing guidance and assistance as might be required. A unit or office within the Agency should be assigned these responsibilities, which could be characterized as "staff" functions as opposed to "line" functions. This unit could look to a specialized entity, for example, the Debt for Development Coalition, Inc., for the required technical expertise, which should be more cost effective than building up in-house staff skills.

4. Expand the Use of Centralized Expertise: As noted earlier, the Agency's decentralized approach to the operational implementation of projects offers many advantages, and these should be fully preserved. However, it is not realistic to expect the staff in the Regional Bureaus and Missions to develop their own

expertise in this specialized area and keep up to date with the latest developments. A central point is needed for pulling together a core of specialized staff who can gather information, perform the required analysis, evaluate experience, and provide operations assistance and advice to Agency staff, governments and other participants in debt swaps. The Debt for Development Coalition, Inc. already provides these services with respect to Debt for Development swaps, and it would probably a relatively easy task to broaden their involvement to incorporate all types of debt swaps and all of the technical assistance services that might be required by the Agency's staff or its clients.

5. Enhance the Delivery Systems for Technical Assistance: USAID has utilized three different technical assistance delivery systems: (i) resident technical assistance teams, (ii) the Debt for Development Coalition, Inc., and (iii) an independent contractor specializing in a specific sector.

The use of a resident technical assistance team is very effective for assisting in the introduction of country debt swap program, providing training, and creating necessary institutions. This approach, however, should be confined to situations where there is a prospect of longer-term continued use of the debt swap mechanism and where the political will to sustain a program exists.

Most often, however, ad hoc rather than long-term assistance is required in the form of general advice related to the subject, the exploration of possible options, the formulation of a strategy for the use of debt swaps, and operational assistance in the negotiation and completion of individual transactions. For purposes of consistency, quality and timeliness in the delivery of "on-demand" technical assistance, a specialized central unit would be best suited. Again, the Debt for Development Coalition, Inc. could fill this role most expeditiously.

Finally, the global sector approach using a specialized contractor appears to hold much promise for efficient utilization of the scarce combination of required sector and debt swap skills and it also provides an opportunity for cross-fertilization of experiences within the sector but across national borders. The PROFIT project sponsored by the R&D Office of Population should be followed closely to evaluate the effectiveness of this approach.

6. Anticipate Future Developments: USAID should constantly be looking ahead to future developments in the use of debt swaps. At the moment, the next important development would seem to be the introduction of the use of official debt to promote private sector activities. Research and consideration of potential issues should be undertaken now in order to be fully prepared to respond when it is appropriate. The lessons learned from the use of commercial debt in developing country swaps should have an important influence on the techniques that might be considered for use in swapping official debt.

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I. INTRODUCTION

A. Purpose of the study

The purpose of this study is to review and analyze the debt conversion activities of developing countries, known more familiarly as debt swaps, and consider the relevance of the different debt conversion techniques to USAID development operations. The study looks at all types of debt conversions that have taken place since the onset of the developing country debt crisis and describes the basic features of each broad type of debt swap. While the study attempts to provide sufficient detail to convey the nature of each type of swap, it is not intended to be a manual for practitioners.

The goal of the study is to identify those areas of debt swap activity that complement USAID's development operations and those that do not, and in the case of debt conversion that holds promise of supporting development operations, to recommend a set of policy guidelines for USAID involvement.

B. Perspective of the study

The types of debt swaps considered in this study are limited to those that involve the cancellation of public sector debt in exchange for an alternative asset in a developing country that is experiencing sustained difficulty in servicing its foreign debt and whose creditors are willing to accept repayment at a significant discount. The exchange of debt for an alternative asset is not a new phenomenon. Indeed, the history of debt swaps may go back as far as the history of lending. There are few antecedents, however, for the current decade-long financial crisis of a large block of the countries of the developing world and the widespread use of debt swaps as one of several responses to the crisis. The focus of this study is on the use of debt swaps within this context.

The study looks at debt swaps from the perspective of the indebted developing country, taking account of what the country has to give in exchange for cancellation of external debt and what it gains in the process. From this perspective, three distinct categories of debt swaps may be extracted:

1. DEBT FOR LOCAL CURRENCY: Debt exchanged for an immediate or deferred payment in local currency,

2. DEBT FOR ASSETS: Debt exchanged for ownership of a public sector asset, and

3. DEBT FOR FOREIGN CURRENCY: Debt exchanged for an immediate or deferred payment in foreign currency.

The historical record of debt swap activity is reviewed and trends are identified. One of the first findings of the study was that no systematic collection of information has been undertaken on the volume and type of developing country debt swaps that have taken place. The International Monetary Fund (IMF) annually updates a partial survey of debt swaps, but the results appear to understate grossly the actual volume. For example, Federal Reserve Bank of New York staff completed a one-time survey in 1987 of a selected sample of countries that shows a level of debt swap activity that is about twice that shown in the IMF survey for that year. The World Bank is considering a survey of commercial institutions to determine the volume to debt swap activity, but this work will not be completed for some time. Other institutions who are likely candidates for the role of tracking and analyzing debt swaps, such as the Institute of International Finance (an institution created by commercial banks to address debt issues) and the regional multilateral development banks, have not addressed the subject in any appreciable depth.

In view of this situation, a comprehensive survey was undertaken in the course of this study. A package of survey materials (Annex 1) was designed and sent to 36 developing countries that were determined to have participated at one time or another in debt swap activities. The results of the survey, however, will not be available perhaps until mid-1992. In the interim, data has been drawn from several sources and combined for use in this study. Although the numbers may be understated, the basic trends identified for each type of debt swap are believed to be reasonably correct. These trends are analyzed in the context of the role of debt swaps in the debt management strategies of the countries involved. The costs and benefits of each type of swap are discussed and an illustrative example of each drawn from an actual or sample transaction is provided. The relevance of each of the types of debt swaps to USAID development operations is discussed, and past experience in USAID projects and programs that involved the swapping of debt is used to illustrate the points made, whenever possible.

The macro-economic effects of debt swaps have been intensely debated throughout the debt crisis. This debate on the costs and benefits of debt swaps, largely centered on their role in the work-out process, is reviewed and conclusions are drawn with respect to USAID involvement in debt swap activities. Finally, the analysis of actual trends, costs and benefits, and the role of debt swaps in country debt strategy is pulled together in the context of the implications for USAID development operations. Conclusions and recommendations are drawn from this analysis with respect to broad policy guidelines for USAID.

II. BRIEF HISTORY OF DEBT SWAPS

The debt swap is not a new financial technique. In appropriate circumstances, creditors have traditionally considered debt swaps as one of the ways of restructuring the finances of a borrower who cannot meet his initially scheduled debt service commitments. The exchange of debt for equity, for example, has long been a staple of corporate debt work-out strategies. However, the use of sovereign debt in debt for equity and other varieties of swaps in response to a country financial crisis is a new development. Some observers believe that the first formal recognition of the role that debt conversion can play in the management of developing country debt came at the time of the restructuring of Turkish indebtedness in the 1970s; however, the Turkish experience appears to have had little influence on the subsequent evolution of debt conversion. The origins of the various debt conversion activities that are seen today are found in the response of the international financial community to the massive and unprecedented developing country debt crisis of the 1980s, which commenced with the announcement by the Mexican government in August 1982 that it could not continue to service its foreign debt and spread to engulf a total of 62 developing countries, mostly in the Latin America and Africa regions. The total external debt of these countries in 1990 was about one trillion dollars.

<u>The first stage -- Trading of debt among creditor banks</u>:

Initially, commercial banks found that their ability to deal with the problem of deteriorating loan portfolios was severely restricted because of the long-held banking tradition that loans were not to be traded or sold, but held to maturity.[1] However, as the magnitude of the debt crisis became apparent, banks began to develop strategies aimed a providing partial and limited relief. One of the first steps was to begin to restructure the composition of loan portfolios. Banks with large exposure in developing countries reduced their exposure in certain countries and increased it in others by trading loans with other banks whose long-term risk perceptions or market strategies differed. From 1982 through 1985, transactions were mostly limited to the trading of loans between banks, but even this limited trading led to the creation of an incipient secondary market with pricing differentials. The estimated volume of such trading was small relative to debt outstanding, but grew from \$1.0 billion in 1983 to over \$4.0 billion in 1985.[2]

By 1985, a new dimension was added to this secondary market with the entrance on a limited scale of buyers of debt for cash at a discount from face value, which injected some degree of liquidity into the previously trade-dominated market. Many US regional banks and

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[1]The trading or selling of loans among commercial banks that had occurred previously was usually linked to temporary liquidity problems or balance sheet reporting requirements.

[2]All estimates of the volume of debt traded in the secondary market are at best indicators of trends and the general order of magnitude, even today, since this is an informal and unregulated market. The most up-to-date and reliable estimates appear to be those provided by the financial press, such as Euromoney and Latin Finance magazines, from which the figures used in this study are drawn.

non-US banks with small developing country debt exposure relative to total assets then began to sell their loans in the secondary market to avoid having to participate in country debt rescheduling exercises and confront demands for new loans needed to keep interest payments current.

The second stage -- The Introduction of Debt for Equity Programs:

Brazil's 1982 debt restructuring agreement prohibited private sector borrowers from remitting foreign exchange to meet debt service payments on their external debt and required them to deposit the local currency equivalent with the Central Bank for account of the corresponding creditor. Some creditors decided to relend this local currency and some decided to use it for the purchase of equity. Several creditors chose to sell their Brazilian private sector loans to multinational corporations, who in turn invested the corresponding local currency deposits in their Brazilian affiliates. Thus, the first de facto debt for equity swaps after the onset of the debt crisis were introduced. Argentina followed in late 1984 with a proposal to allow the case-by-case conversion into equity of special promissory notes issued in connection with their debt rescheduling agreement of that year. Both the Brazilian and Argentine experiments were short-lived and cancelled or rendered ineffective through restrictions, but the idea of swapping debt for equity took hold.

A number of independent traders, who initially assisted banks with the legal and pricing complexities in trading loans, began to share their newly acquired expertise to multinational companies by helping them to purchase debt from banks and negotiate its exchange for a local currency payment from the indebted government. The Chilean government saw these developments in the marketplace as an opportunity to eliminate uncooperative banks from their debt rescheduling negotiations by offering them an "exit" at a price. They reasoned that by offering a formal debt for equity program, a market would be created into which these banks could sell their loans at a discount.

The large major international money-center banks, with correspondingly large developing country loan exposures, initially opposed the concept of debt swap programs and strongly discouraged governments from moving in this direction. These banks dominated the ad-hoc commercial bank "Steering Committees" that were set up to negotiate debt restructuring agreements and their views on debt swaps were often reflected in various clauses in the restructuring agreements that tended to restrict, if not preclude, such activity. Further, most of these banks seemed to believe that the affected developing countries were experiencing a short-term liquidity problem and that it was, therefore, important that all banks act in concert until the liquidity problem dissipated. Many regional and non-money center banks disagreed with this perspective of the debt crisis, and they often opposed, and sometimes ignored, restrictions on the trading, selling and swapping of developing country debt.

In 1987, however, Brazil suspended interest payments to commercial banks and the prices quoted in the secondary market for developing country debt began to drop precipitously. Citicorp followed with an announcement that it would set aside $3.0 billion in loss reserves (equivalent to about 25% of their developing country loan portfolio), thus acknowledging the severity of the debt crisis. Other US money-center banks followed suit[3], and the perception of the debt crisis held by these influential banks was profoundly altered. The major commercial banks, including Citicorp, not only abandoned their initial opposition but came to endorse enthusiastically, and even demand, the establishment of debt swap programs, and they began to modify debt rescheduling agreements to remove legal obstacles. Smaller US banks and many non-US banks, who had favored debt swaps all along, generally welcomed this change.

By this time, Chile had already introduced a well-conceived program that began strongly and ultimately proved to be a lasting success. Although the Chilean program was not without its critics, it became a major factor in convincing other countries to devise their own schemes. By 1988, Mexico, the Philippines, Ecuador, Jamaica, Venezuela and Nigeria had introduced new programs, and Argentina and Brazil restructured and re-launched their own. A number of other countries began to engage in informal ad hoc debt swaps.

With the expansion of cash buyers of debt in the secondary market, motivated by the increased opportunities for debt swaps, the volume of trading in the secondary market increased markedly to an estimated level of about $20 billion in 1988.

The Third Stage -- Endorsement of the Official Community:

The response of the official community during the first years of the debt crisis was to emphasize concerted action. The essence of the concerted strategy, embodied in the "Baker Plan," was to use a combination of official lending and involuntary lending from commercial creditors to supply debtor nations with enough foreign exchange to service their debts. In effect, concerted lending represented a strategy of playing for time and for more favorable circumstances. However, if the more favorable circumstances were not to materialize, concerted lending would simply put heavily indebted countries more deeply into debt. Further, the difficulties of enforcing involuntary lending by commercial lenders, who were becoming increasing reluctant over time, tended to increase the burden of new lending required from official lenders.

Critics of this concerted strategy favored voluntary debt reduction mechanisms, while proponents of the concerted approach pointed out that a purely voluntary approach would favor some creditors over others (and perhaps raise the costs to the country) if all creditors did not participate. While this debate was underway, concerted debt rescheduling exercises became progressively more difficult to implement and it became clear that differences among creditors meant that no single mechanism would have universal appeal. In fact, the market itself had been introducing a wide variety of debt reducing mechanisms, building upon the debt for equity model. Most of these were commercial transactions based on variations of the exchange of debt for local currency cash, assets or other debt instruments. Further, non-profit organizations had begun to use debt swaps for non-commercial programs, while USAID introduced the "Debt for Development" concept,.

[3] European banks, though not the Japanese banks, had already set aside substantial loss reserves.

The announcement of the "Brady Initiative" in early 1989, signalled the arrival of a consensus within the official community on a new approach to the debt crisis that fell somewhere in between the concerted and voluntary approaches. Its centerpiece was official support for debt reduction schemes and implementation was to be achieved with a mixture of concerted and voluntary actions. Commercial lenders were to be offered a "Menu of Options," with financial incentives for participating in the concerted actions. Voluntary actions all involved different forms of debt swaps, and concerted action itself included the exchange of existing debt at a discount for new obligations with implied seniority. Thus, debt swaps, which were introduced early on by several borrowing countries and later embraced by the commercial lenders, were eventually endorsed by the official community. This change in the views of the official community is discussed further in Chapter III.

By 1990, the volume of developing country debt traded in the secondary market had exploded to an estimated level of about $106 billion and was projected to expand further to as much as $125 billion in 1992. The volume of debt swaps related to domestic investment now surpasses $10 billion annually, while the volume of debt exchanged at a discount for new foreign currency instruments under the "Brady Initiative" reached nearly $60 billion in 1990.

<u>The fourth stage -- Major "Debt for Privatization" Transactions</u>:

At various times during the debt crisis, there have been instances of the use of debt swaps in the privatization of public sector holdings. While there are trade-offs between costs and benefits in all debt swaps, privatization swaps can more easily be structured to minimize, if not eliminate, potential inflationary effects compared to debt for equity swaps, which are often criticized for their expansionary impact on the monetary base. In 1990, Argentina introduced such privatization swaps on a scale not previously seen. In only two privatization transactions, Argentine commercial bank debt was reduced by over $7.0 billion in face value, representing about 20% of the total commercial bank debt outstanding.

Increased use of privatization swaps seems likely as developing countries around the world shift their economic development strategies to a market orientation with increased emphasis on the role of the private sector. Sectors are being opened up to private investment that were previously dominated by if not exclusively reserved for the public sector, and existing institutions in these sectors are becoming candidates for privatization. As the implementation of privatization programs accelerates, it seems reasonable to expect that the Argentine model may be adopted by other countries.

<u>Speculation on the next stage</u>:

Developing country debt held by official institutions has so far been entirely excluded from debt trading in the marketplace and debt conversion activities conducted by market participants. Official multilateral institutions have insisted as a condition of continued lending on full compliance with the original repayment terms of their loans and this position has been strongly and effectively supported by their major industrial country shareholders, in particular the US. Official bilateral debt, on other hand, often has been rescheduled, the terms softened or outstanding loans forgiven. The US Government, for example, allowed certain Sub-Saharan debt to be forgiven or paid in local currency, which in turn could be used for development purposes. These arrangements, however appropriate and beneficial they may be, do not constitute debt swaps as they are considered in this report.

Several official bilateral aid agencies have indicated informally that they are exploring the possibility of utilizing some of their outstanding loans to help achieve development objectives, perhaps through investment promotion, encouragement of privatization and the funding of social and environmental programs sponsored by non-governmental organizations. One of the many issues raised is whether to allow third parties to benefit from the cancellation of official bilateral debt. A second is how to place a value on official debt to be used in a debt swap--presumably no bilateral agency would want its debt to be traded in the secondary market. Nevertheless, market-based pricing of the internal local currency redemption value could still be introduced. One possible technique is discussed later in the paper. A general issue for bilateral agencies will be determining the appropriate mix of rescheduling, debt forgiveness, the repayment of loans in local currency and the exchange of bilateral debt for local assets through debt conversion.

Undoubtedly, any move in this direction that may materialize would be focused on the poorest developing countries whose external debt is largely comprised of official debt, such as the Sub-Saharan African countries.

III. THE DEBATE ON THE MACRO-ECONOMIC EFFECTS OF DEBT SWAPS

Throughout the debt crisis, an intense debate has continued on the desirability of debt swaps. Opponents have argued that the cost in terms of monetary expansion, foreign exchange position and fiscal impact were too high. Advocates have argued that these effects could be managed and the costs contained, while still enjoying the advantages of investment promotion and debt reduction. Describing the debate in these terms, however, is misleading. The real underlying debate was actually about the overall strategy to be followed in dealing with the highly-indebted countries. Essentially, two fundamentally different approaches were proposed.

One side favored a concerted strategy managed by the official community, as noted earlier. This position was portrayed as analogous to a corporate Chapter 11 reorganization under the US bankruptcy laws in which all creditors would agree to a restructuring of their respective loans under a process managed by the courts. The corporation would then be able to attract new financing, make new investments and increase its cash flow sufficiently to service both new and restructured debts. They further argued that in order to "force" the commercial banks to participate in an officially-designed scheme, no other options, in particular voluntary debt conversion, should be permitted.

The other side argued that basic differences between a creditor's relationship with a corporate debtor and with a foreign sovereign debtor rendered the corporate bankruptcy analogy meaningless. First, all creditors would not participate fully in the concerted restructuring; the major block of official lenders, the multilateral institutions, would retain a senior claim over both old and new creditors on the debtor's foreign exchange resources through their "preferred creditor status" which is enforced by the industrial country governments. Second, if the official community were to force a reduction and restructuring of commercial debt, the official community would also implicitly be undertaking an unacceptable financial obligation both to support the newly restructured commercial debt and provide the new resources that would not likely be forthcoming from commercial lenders. They argued for a purely voluntary approach with the primary emphasis on debt reduction through voluntary debt conversion schemes.

Experience during the first seven years of the debt crisis demonstrated that the "single solution" concerted approach would not work well in practice not only because of major differences between the two principal groups of creditors, official and commercial, but also the many differences among the institutions within each group. Furthermore, highly-indebted developing countries increasingly came to recognize the harm done by maintaining a confrontational stance with their commercial bank creditors. Eventually, the debate led to the introduction of the "Brady Initiative" in 1989 which, in effect, represented a compromise within the official community on an approach that fell somewhere in between to two extremes, offering a mixture of concerted lending and debt reduction schemes along with voluntary lending and debt reduction schemes. Various types of debt swaps therefore became officially acceptable options in the "menu" offered through "Brady Initiative" negotiations. The issue today for developing countries is less focused on whether to offer voluntary debt conversion schemes and more on selecting which ones to offer and how to manage the costs and benefits.

A developing country whose external debt is traded on the secondary market at a discount can structure a debt swap in a way that enables it to capture all or some portion of that discount. This prospect lies behind the willingness of indebted countries to consider any of the debt conversion techniques. In capturing the discount, the government will attempt to achieve one or more of several objectives, among them, the reduction of its external debt, promotion of foreign and domestic investment, influencing the sector allocation of investment, promotion of exports, repatriation of "flight capital", or the funding of development programs. There may be conflicts among these objectives in that achieving one may affect the capacity to achieve others, and the different types of debt swaps may achieve different objectives.

There are trade-offs to be considered between the benefits of debt swaps and the potential macro-economic costs. All debt conversion techniques will entail one or more of several costs, among them, sharing of the market discount with third parties in order to influence their behavior, the use of local currency resources in a way that adds to inflationary pressures, the possible displacement of anticipated foreign exchange inflows, the use of existing foreign exchange resources to repurchase outstanding debt which could otherwise be invested in the economy, and the risk of subsidizing "capital flight" through "round-tripping." As is the case with the potential benefits of debt conversion, the costs will vary depending on the type of debt swap and how the swap is structured. The important point in all debt conversion is that only the indebted country government can choose which types of debt swaps can be done and decide how they are to be structured, and in making these choices the government can exercise control over the objectives to be achieved and the costs incurred.

IV. TYPES OF DEBT SWAPS AND THE RELATED BENEFITS AND COSTS

A bewildering array of debt conversion techniques have been publicized and given names chosen more for their marketing impact than for their descriptive value, such as "debt for equity," "debt for assets," "debt for nature," "debt for development," "debt for exports," and so on. In order to consider how debt conversion may be utilized to promote development, it is useful first to categorize the relevant debt conversion techniques according to the effects each has on the parties involved. As mentioned earlier, it appears that so far three basic debt conversion techniques have emerged in the marketplace that might be considered as a means of supporting development operations:

1) Debt for Local Currency
2) Debt for Public Sector Assets
3) Debt for Foreign Exchange

The principal characteristics of each of these three techniques is described below.

A. DEBT FOR LOCAL CURRENCY

Debt for Local Currency swaps take a variety of forms, as described below. The basic feature of all Debt for Local Currency swaps is that external sovereign hard currency denominated debt is used by non-government investors, directly or indirectly, to acquire local currency. This local currency in turn is used to invest in equity, fixed assets and working capital, retire domestic debt, pay local currency expenditures, or purchase foreign exchange. In economic terms, Debt for Local Currency swaps allow a developing country government to utilize its external debt, whenever it is traded at a discount, to provide a subsidy to either domestic or foreign investors. Because of this subsidy, a common characteristic of Debt for Local Currency transactions is that they are subject to significant restrictions by the government on the application of the local currency proceeds.

There are a number of factors to be taken into account if debt swaps involving a local currency payment are to be an efficient tool for an indebted developing country, and the government's decision on each of these factors, or elements of the debt swap process, will vary depending on the objectives the government wishes to achieve and on which type of debt swap is being considered. The principal factors are:

a. Eligible debt
b. Eligible investors
c. Use of local currency proceeds
d. Amount of local currency payment
e. Source of local currency payment
f. Volume of debt swaps

Precisely how these factors are taken into account is entirely the decision of the government and in each case there could be important implications for the government's macro-economic policies, management of its domestic and foreign indebtedness, or its relationships with sources of external capital. Therefore, the quality of the government's management of the debt swap process is the key issue. The other players--creditors and investors--essentially respond to pricing once a framework for debt swaps is established. For instance, the creditor bank must decide whether to accept the price an investor is willing to pay for its loan, and the investor must decide whether the end cost of his proposed investment meets his pricing criteria.

The various types of debt swaps that fall within the "Debt for Local Currency" category are usually classified in the marketplace according to the use of the local currency proceeds. Each of the major types is discussed below:

1. Debt for Equity Swaps: Conceptually, Debt for Equity swaps are straight forward and easy to understand. In a Debt for Equity swap, an investor buys sovereign debt in the secondary market and agrees to allow the indebted government to redeem the loan in local currency. In practice, the implementation of a Debt for Equity swap is technically complex and its impact in economic terms is difficult to measure.

In the case of Debt for Equity swaps, the key considerations with respect to the factors noted above that the government has to evaluate are as follows:

a. Eligible debt: The government will have to select the debt that is eligible for conversion through a Debt for Equity swap. Since debt swaps usually involve prepayment of debt to certain creditors, legal restrictions such as those that require mandatory prepayment to all creditors in a proportionate amount will have to be taken into account. However, debt restructuring agreements now typically exempt certain classes of debt from these restrictions as long as the debt is used in a swap.

In some cases, governments have created special classes of debt instruments in the renegotiation process to be used in debt conversion schemes.

b. Eligible investors: The first choice for governments is whether to restrict Debt for Equity swaps to foreign investors or also allow domestic investors to participate. If repatriation of flight capital is a primary objective, the program may also have to be structured to provide a de facto amnesty to nationals who may have sent funds abroad in violation of then existing regulations.

Investors, whether domestic or foreign, may also be screened to determine whether they have the technical, marketing and financial capacity to manage the proposed investment. The investor's future marketing strategy may also be a factor, for example, the prospect of production for export. Finally, the government may exercise some judgement on the investor's intentions with respect to whether the debt swap will motivate the investor to make an incremental investment or simply reduce the cost of one that would likely take place in any event. Some governments have reserved certain existing investment incentives to those investments made without a debt swap in order to strike a balance between the incentives offered to normal investment and the bonus produced by a debt swap.

Additionally, the government will chose among the various types of investors, for example, individuals, corporations, creditor banks, non-governmental organizations, in the context of its objectives.

c. Use of local currency proceeds: Governments always retain the right to approve or disapprove a proposed domestic investment to be financed through a debt swap. How this right is exercised is largely a function of the government's objectives, and in screening investment proposals, the government can follow its own priorities. The type of incentive the government can offer though debt swaps is highly effective as investors tend to respond favorably to pre-investment advantages, such as the bonus generated by a debt for equity swap, as long as the expected rate of return is acceptable and the designated priority sector is of interest.

The expenditures to be financed through a debt swap are another factor. Many governments restrict the use of local currency proceeds to cover local currency expenditures in order to avoid an outflow of foreign exchange and, in effect, force the investor to bring in fresh foreign exchange to meet foreign currency expenditures.

The specific type of expenditure may also be a consideration for the government in meeting its objectives, for example, whether the local funds are to be used to acquire equity shares, add to fixed investment, replenish working capital, or repay domestic loans.

Lastly, to ensure that the local currency proceeds are used for the approved purpose, the government generally controls, monitors and audits the disbursement of the local currency proceeds of a debt swap. One goal of such monitoring is to prevent "round-tripping," that is, the use of the local currency proceeds to purchase foreign exchange to be sent abroad.

d. Amount of local currency payment: The government determines the local currency redemption price, and in this way determines the portion of the discount that it will retain and the portion that will accrue to the investor as an investment incentive. This sharing of the discount can be determined through negotiation, an auction, or a fixed formula.

If the primary objective of the government is additionality in investment, then highly selective criteria should be applied in choosing eligible projects and a large share of the discount may need to be left to the investor. If, on the other hand, the primary objective of the government is debt reduction, then a more flexible criteria may govern the eligibility of projects and a low share of the discount granted to the investor, to achieve the maximum amount of reduction of liabilities for a given expenditure.

e. Source of local currency payment: Resources to prepay external debt in local currency can come from increased revenues, monetary expansion or public sector borrowing. Assuming additional revenues cannot be raised in the short run, that leaves monetary expansion or borrowing as the likely alternatives. The central bank has the option of sterilizing any monetary creation resulting from a debt for equity swap by issuing a like amount of local currency debt instruments. In the short term, this postpones the impact of the new money issued, but in the longer term the central bank will still have to raise the resources to retire the domestic debt. In the interim, the additional borrowing by the government may put upward pressure on domestic interest rates, depending on supply and demand conditions in the domestic capital market, and decrease the amount of credit resources available to the private sector.

A World Bank staff paper[4], however, argues that the government should take a dynamic view of the net impact on monetary expansion over time. They note that debt service payments are saved over time after debt is retired through a debt swap and that net demand on monetary expansion declines, eventually leading to a reduction in the demand for monetary expansion compared to the case with no debt swap. Using the Philippines debt swap program as an example, the paper demonstrates that under reasonable assumptions, net demand for monetary creation shifts from an increase to a decrease in the fifth year following a debt swap, and the cumulative impact on reserve money is negative in the seventh year. The issue, therefore, is to what extent the economy can absorb the impact of generating the resources now (for retiring debt at a discount) or must postpone that until later (to repay at full value). Most often, governments have elected to control the impact of debt for equity swaps by limiting the absolute annual volume of swaps, as discussed below.

f. <u>Volume of Debt for Equity swaps</u>: However the government chooses to raise the local currency resources, it will be faced with limitations. All governments have elected to place absolute limits on the volume of Debt for Equity swaps to avoid incurring excessive short term costs. In determining the permissible volume of debt for equity swaps, an analysis of the potential impact must take place in the context of the macro-economic planning that sets growth and inflation targets within a consistent framework. The authorities must consider the amount of money creation, debt expansion and reflow of rescheduled debt to the central bank that can be allocated to debt for equity swaps, consistent with the expected rate of return on swaps and other macro-economic targets, particularly inflation.

The impact of debt for equity swaps on the country's balance of payments also has to be considered. Debt for equity swaps give rise to direct foreign investment[5] without an actual inflow of additional foreign exchange. Prepayment of external

[4] World Bank Discussion Paper #76, <u>Debt Equity Conversion Analysis</u>, March 1990.

[5] In the case of a debt for equity swap by a domestic investor, foreign exchange is used to purchase debt in the secondary market as is the case with a foreign investor. Although the ownership of the new investment will be domestic, the balance of payments effect is the same as direct foreign investment.

debt in local currency saves future foreign exchange payments by the central bank and has a high rate of return; however, the availability of free foreign exchange is reduced in the short term. Again, the World Bank study cited above demonstrates that the negative impact on foreign exchange reserves declines and becomes positive in the fifth year after the debt swap, taking account of dividend remittances, and the cumulative impact on the balance of payments becomes positive after the sixth year. Some countries have placed restrictions on dividend remittances and capital repatriation to improve the net balance of payments impact. Further, to the extent the investment made through a debt swap is incremental, the foregone foreign exchange inflow is lower. Thus, the balance of payments impact is another consideration in setting a prudent absolute volume of debt for equity swaps.

The Debt for Equity swap technique is illustrated in Annex 2, Chrysler: A Model Debt Swap, which describes one of the early and well publicized transactions in Mexico, and in Annex 3, Illustration of Transactions Under Chile's Debt Conversion Scheme, Debt Capitalization (Chapter XIX), which describes the process of structuring a "typical" Debt for Equity swap in Chile.

2. Debt for Development Swaps: Environmental conservation groups pioneered the use of debt conversion by not-for-profit organizations in 1987 by conducting Debt for Nature swaps. The concept was later expanded to include debt swaps employed to provide local currency funding for other generally non-commercial projects in education, health and social welfare, usually sponsored by non-governmental organizations. This broader range of end uses of debt conversion became known as Debt for Development swaps, and now cover a variety of sub-types of debt swaps, for example, Debt for Nature, Debt for Conservation, Debt for Education, Debt for Health, and others classified by the nature of the development program.

The economic rationale for Debt for Development swaps, as in the case of Debt for Equity swaps, is based on the ability to purchase developing country sovereign debt in the secondary market at a discount and exchange it for local currency at a premium. Therefore, the same considerations that govern the country's management of Debt for Equity swaps are largely valid for Debt for Development swaps. There are, however, important differences in some instances in how these considerations are applied:

a. Eligible debt: Generally the same debt eligible for Debt for Equity swaps will be eligible for Debt for Development swaps.

b. Eligible investors: Eligible "investors" are likely to be limited to non-governmental, non-profit organizations with special expertise in the corresponding development program.

c. Use of local currency proceeds: The use of local currency funds usually will not create private ownership of assets, but will generally be restricted to the funding of planned expenditures under a development program, usually designed by the sponsor of the debt swap and agreed with the government. Further, the program is likely to fall within the administrative jurisdiction of a ministry or government department, which facilitates the exercise of control over the use of the local currency proceeds.

d. Amount of local currency payment: Since the local currency proceeds of a Debt for Development swap are used exclusively for an agreed development program, governments have tended in practice to be much more generous in fixing the local currency payment amount (100% local currency equivalent of face value in some cases) than in the case of Debt for Equity swaps. Although the entity sponsoring the debt swap gains additional local currency resources to use in implementing the agreed program for the same amount of foreign currency, the benefits ultimately accrue to the country rather than the sponsor.

e. Volume of debt swaps: Debt for Development swaps tend to be relatively small, certainly compared to the many large scale Debt for Equity swaps that have taken place, which makes it easier for the government to offset any monetary expansion impact. In some cases, these swaps may involve only the reallocation of budgetary resources from one purpose to another deemed to be of a higher priority. Although most governments still set annual limitations on Debt for Development Swaps, actual transactions seem to fall well within these limits.

The nature of Debt for Development swaps is perhaps best illustrated in a background paper prepared by the Debt for Development Coalition, Inc., What is Debt for Development?, from which relevant material has been extracted and presented in Annex 4.

3. Debt for Cash Swaps: Many debt swaps may involve the repatriation of "flight capital", as long as domestic investors are permitted to use them. Even when they are not, there have been instances of "flight capital" repatriation by domestic investors acting through foreign corporations as a front. Debt for Cash swaps, however, are the only examples of swaps specifically designed to encourage the return of foreign currency holdings by nationals. Only Chile has established a formal program for this purpose, known as the Chapter XVIII program. Chapter XVIII (a provision in Chile's foreign exchange regulations) permits individuals or entities to purchase foreign currency-denominated debt of any Chilean debtor (state, public or private sector) for conversion into a central bank local currency debt instrument. The local currency debt instrument can then be discounted (sold) in the domestic capital markets for cash. The principal difference of this type of Debt for Cash swap from a Debt for Equity swap is that the use of the local currency proceeds is unrestricted and need not be used for investment and no governmental approval of the swap is required.

a. Eligible debt: Same as for Debt for Equity

b. Eligible investors: Local investors

c. Use of local currency proceeds: Unrestricted

d. Amount of local currency payment: Determined by auction (Chile)

e. Source of local currency payment: Same as for Debt for Equity

f. Volume of debt swaps: Control over the potential monetary impact and possible abuse of the system through "round-tripping" is exercised by varying the amount of "rights" to conduct Debt for Cash swaps that are periodically auctioned to the public, the precise amount largely determined by taking into account the impact on exchange rates of prior operations. Chile's Chapter XVIII program illustrates how a government can manage a debt swap program through careful observation of economic indicators such as movements in the differential between the official and free market exchange rates, rather than through cumbersome direct supervision measures.

A typical Debt for Cash swap transaction is described in Annex 5, Illustration of Transactions under Chile's Debt Conversion Scheme, Debt Conversion (Chapter XVIII).

4. Debt for Exports Swaps: Debt conversion has been used to promote exports as well as investment. In a Debt for Export swap, sovereign debt in effect is exchanged for exportable goods; however, the conversion process requires a local currency payment from the government. The reason is that most highly-indebted countries usually require exporters to deliver the foreign exchange earned from exports to the central bank in exchange for the local currency equivalent. When a debt swap is introduced, the central bank agrees to accept cancelled sovereign debt in lieu of foreign exchange. Most of the known transactions were conducted with little publicity, although one of the earliest transactions, arranged by First Interstate Bank in Peru, was widely reported in the press. Peru for a time had a formal Debt for Export swap program.

All of the considerations noted above for Debt for Equity swaps also apply to Debt for Export swaps, except that the buyer of the exported product would take the place of an investor. There are, however, significant differences in the macro-economic impact compared to a Debt for Equity swap. First, Debt for Export swaps imply a subsidized international price rather than a subsidy in the form of an investment incentive. The international importer "pays" for some portion of the price of the goods with an equivalent amount at face value of sovereign debt acquired in the secondary market at a discount, thus receiving a discounted price for the goods. The exporter on the other hand, receives the full local currency equivalent from the central bank (otherwise, he would not participate in the transaction). Since the discounted export price may depress effective prices in the international market, the exporting country risks retaliatory measures. Second, unless the exports paid for through a Debt for Export swap are truly incremental, the country would experience a negative effect on its balance of payments. Finally, exports of goods in short supply in local markets may add a stimulant to the existing inflationary pressures in the exporting country, in addition to whatever inflationary impact is caused by the local currency payment.

The indebted country benefits from the promotion of non-traditional exports (assuming they are incremental) and may gain access to new markets, since sales in the new market could possibly be continued without Debt for Export swaps, once the exporter has established a presence. Debt for Export swaps could also help preserve existing access to international markets. One other factor makes Debt for Export swaps particularly appealing to countries that have not been able to negotiate successfully with their creditors. Since Debt for Export swaps typically have been arranged by creditor banks as a means of recovering some value for their loans, the mechanics of the transaction are such that the bank also provides Letter of Credit trade financing, which may not otherwise be available.

An example of a Debt for Export swap completed by Chase Investment Bank, Ltd. in Peru is provided in Annex 6, USAID/African Development Bank Conference, Debt for Export Swaps.

B. "DEBT FOR PUBLIC SECTOR ASSETS"

The Debt for Public Sector Assets swap appears to be the least controversial of swaps. In its most basic form, this swap entails the simple exchange of public sector external debt for ownership of a previously public sector-owned asset, for which there are no inflationary consequences as even the severest critics of debt swaps acknowledge. There are, however, other consequences. If, for example, the government could have sold the asset (the asset could be a physical asset, a government loan or receivable, or equity shares in an entity) for a cash payment in foreign exchange, it would be foregoing an inflow of foreign exchange by selling through a swap. Further, if the transaction is structured to involve a local currency cash payment from the central bank which is then paid to, say, a semi-autonomous state holding company to acquire the asset, the monetary base could be affected depending on how the funds are ultimately used.

Most exchanges of public sector external debt for public sector assets are usually linked to privatization programs as Privatization swaps. They have, however, also been used for the financial restructuring of government financial intermediaries, in which case a private sector borrower repays a loan (often in arrears) by purchasing and cancelling a certain amount of the external debt of the government financial intermediary, which in turn shrinks its balance sheet by writing down its assets (the loan to a domestic private sector borrower) and its liabilities (its external debt), thus improving its capital ratio.

In a privatization swap, the private investor, if a foreigner, will service the equity liability through repatriation of dividends and eventually his capital, so there remains a future claim on foreign exchange, but not on the government budget. If the investor is a national, there is no further specific right or expectation to expatriate earnings or capital, and the foreign exchange obligation is also cancelled.

The factors noted earlier which the government must take into account in managing a Debt for Equity swap program are further modified in Privatization swaps:

a. Eligible Debt; and

b. Eligible Investors: Considerations governing the eligibility of debt and eligibility of investors remain the same.

c. Use of local Currency: The use of local currency is not an issue nor is the priority of the targeted investment (the government's priorities will already have been taken into account in selecting the asset to be privatized).

d. Amount of local currency payment; and

e. Source of local currency payment: The question of the amount and source of the local currency payment in a Debt for Equity swap translates into the question in a Privatization Swap of the internal redemption value of the debt, that is, at what value will the external debt be recognized toward the purchase of the asset. Two of the approaches that have been used appear to produce the best results. Argentina utilized a tendering process in which the winning bid was based on the highest amount of face value of foreign currency-denominated sovereign debt. Honduras also conducted a tendering process, but asked for bids denominated in local currency with a provision that allowed the winning bidder to pay in cancelled foreign currency-denominated sovereign debt valued at a pre-announced redemption rate. Both approaches encourage bidders to offer the highest price in terms of the amount of external debt to be cancelled.

f. Volume of debt swaps: The volume of Privatization swaps that the government can prudently authorize can be less restrictive than in the case of Debt for Equity swaps, although the amount of possible foregone foreign exchange inflows will have to be considered.

Annex 7, Argentina: Debt Swaps for Debt Reduction and Privatization, presents a brief description of two Argentine privatization swaps.

Annex 8, The Honduras Privatization Project, describes USAID's role in introducing Debt for Public Sector Assets swaps into the Privatization Project and reviews their contribution to the success of the Project.

C. "DEBT FOR FOREIGN CURRENCY"

In Debt for Foreign Currency swaps, external debt is cancelled in exchange for an immediate or deferred payment in foreign exchange. The two principal types of such swaps are Debt Buy-backs and "Brady Initiative" Bonds. The Bolivia debt relief scheme and, later, the "Brady Initiative" contributed to the introduction of formal creditor approval of the buying back of public sector debt at a discount, as well as the exchange of existing external debt for new external debt instruments issued at a discount or on improved terms. Previously, little publicity was given to any swaps of this type, although there had been unconfirmed reports of clandestine use of international reserves by governments to buy back external debt at a discount, in violation of existing creditor agreements.

The factors governing the use of Debt for Foreign Exchange swaps, such as eligible debt, eligibility of creditor institutions, the amounts involved and the terms and volume of such swaps, are subject to formal agreement with the country's creditors, usually negotiated in the context of debt restructuring exercises taking account of their impact on the agreed economic adjustment program. Agreement is also reached on waiving any restrictions that would preclude these swaps.

1. Debt Buy-backs -- External debt is repurchased (and thus cancelled) at a discount with foreign exchange provided by external donors or with international reserves authorized by the country's creditors.

Bolivia managed to put together one of the first significant debt buy-back operations, with assistance from Bank of America as Chairman of the Steering Committee, the World Bank and the IMF. In 1988, Bolivia completed a large debt buy-back operation in which $335 million of its $670 million in commercial bank loans (plus interest arrears) were cancelled. In order for a debtor to engage openly in a debt buy-back operation, it needs the consent of all its creditors. Bolivia obtained such consent during 1987 from its 131 creditor banks subject to the following conditions:

a) Only contributions from other countries, and not Bolivia's own international reserves could be used in the buy-back.
b) Contributions would be deposited in a Trust Fund managed by the IMF.
c) Offers would be made to all creditor banks on identical terms.
d) If available funds were insufficient to redeem all of the debt tendered, the repurchase was to be made on a pro-rata basis.
e) Banks that elected to participate in the operation would be given a choice of receiving a discounted cash payment for loans tendered or a local currency denominated, 25 year, collateralized and indexed bonds which could be utilized for Debt for Equity swaps at a 50% premium (i.e., the bank using these bonds for a swap would receive 50% in local currency over the face value of the bond).

Of Bolivia's original 131 creditor banks, 53 tendered all or some portion of their outstanding loans to Bolivia,[6] for which $270 million was exchanged for a cash payment of $0.11 for each dollar of principal (interest arrears were forgiven) and $65 million was exchanged for local currency investment bonds. The transaction required $28 million from the IMF Trust Account, and extinguished more than 40% of Bolivia's commercial indebtedness. Bolivia reportedly is considering a second operation.

Options for Debt Buy-Backs have been negotiated or are in the process of

[6]Regional and non-money center banks tended to offer to exchange most or all of their portfolios, while the larger banks tended to offer only a small share. In the latter case, these banks presumably judged that they would be better off holding on to their loans in the long term since the secondary market value would likely increase as Bolivia reduced its overall indebtedness.

negotiation in nine other countries.[7]

2. "Brady Initiative" Bonds -- Existing debt is exchanged at a discount for new debt in the form of long-term bonds, often at a low interest rate, which are partially secured or guaranteed.

Mexico's debt and debt service reduction agreement of 1990, the first negotiated under the auspices of the "Brady Initiative," covered almost all ($48.9 billion) of Mexico's public and publicly guaranteed commercial bank debt eligible for restructuring. The agreement's primary goal was to reduce payments to banks and provide financing over the medium term. This was accomplished by offering creditors a choice among (i) exchanging loans for a dollar-denominated bond bearing a market interest rate at a 35% discount, (ii) exchanging loans for a dollar-denominated bond at par bearing a fixed interest rate of 6.25%, or (iii) providing new money equal to 25% of their exposure at a market interest rate. The principal of the bonds was collateralized with US government 30 year zero-coupon bonds. Interest payments also were enhanced through the use of an escrow account from which the bonds would be serviced for up to 18 months if Mexico fell short of contractual payments. The bonds were also explicitly excluded from any future new money agreements.

Mexico's creditor banks exchanged $19.7 billion of debt for discount bonds and $22.8 billion for par value, reduced interest rate bonds, while creditors holding $6.5 billion of debt opted to provide new money. Further, only banks participating in the debt relief package would be eligible to participate in Mexico's new debt for equity swap program.

During 1990, similar agreements were reached for the Philippines, Costa Rica, Venezuela and Morocco under the guidelines set by the "Brady Initiative." As a result of these operations, the participating countries have effectively reduced their eligible commercial bank debt by a quarter or about $20.3 billion.[8]

V. VOLUME AND TRENDS FOR EACH TYPE OF DEBT SWAP

A. TOTAL DEBT CONVERSION

Total debt conversions by developing countries climbed to a level of close to $10 billion annually by 1988, nearly all of which were Debt for Local Currency swaps. As illustrated in Table I below, two significant developments in the volume and trends of debt conversions occurred in 1990. First, Debt for Foreign Exchange swaps under the auspices of

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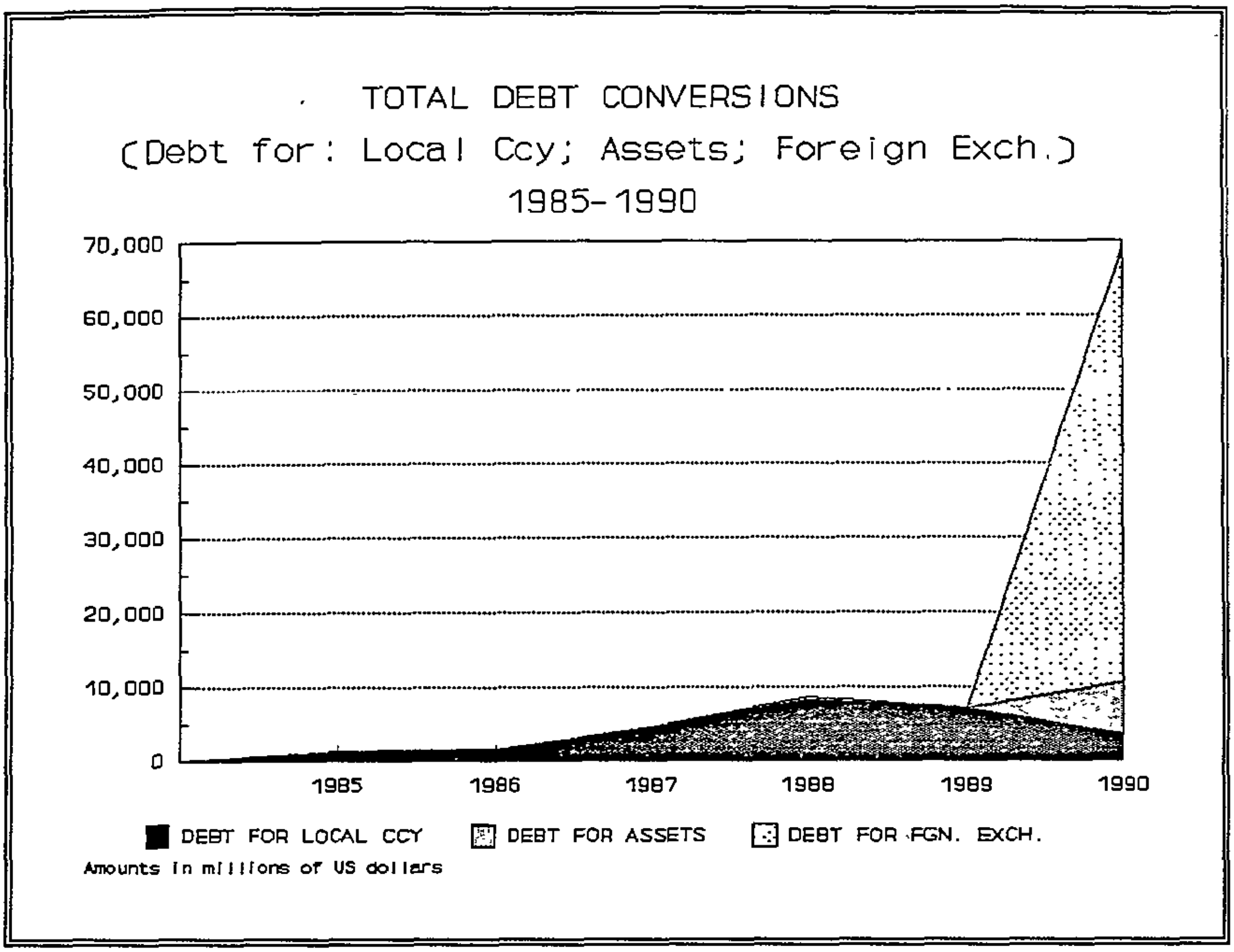
[7] Chile, Mexico, Morocco, Mozambique, Niger, Nigeria, Philippines, Uruguay and Venezuela.

[8] World Bank, World Debt Tables, 1991-1992.

the "Brady Initiative" began to be implemented, resulting in massive amounts of debt being converted to new foreign exchange instruments on terms more favorable to the borrowing countries than the previous debt. Second, Debt for Assets swaps became a significant factor

Table I



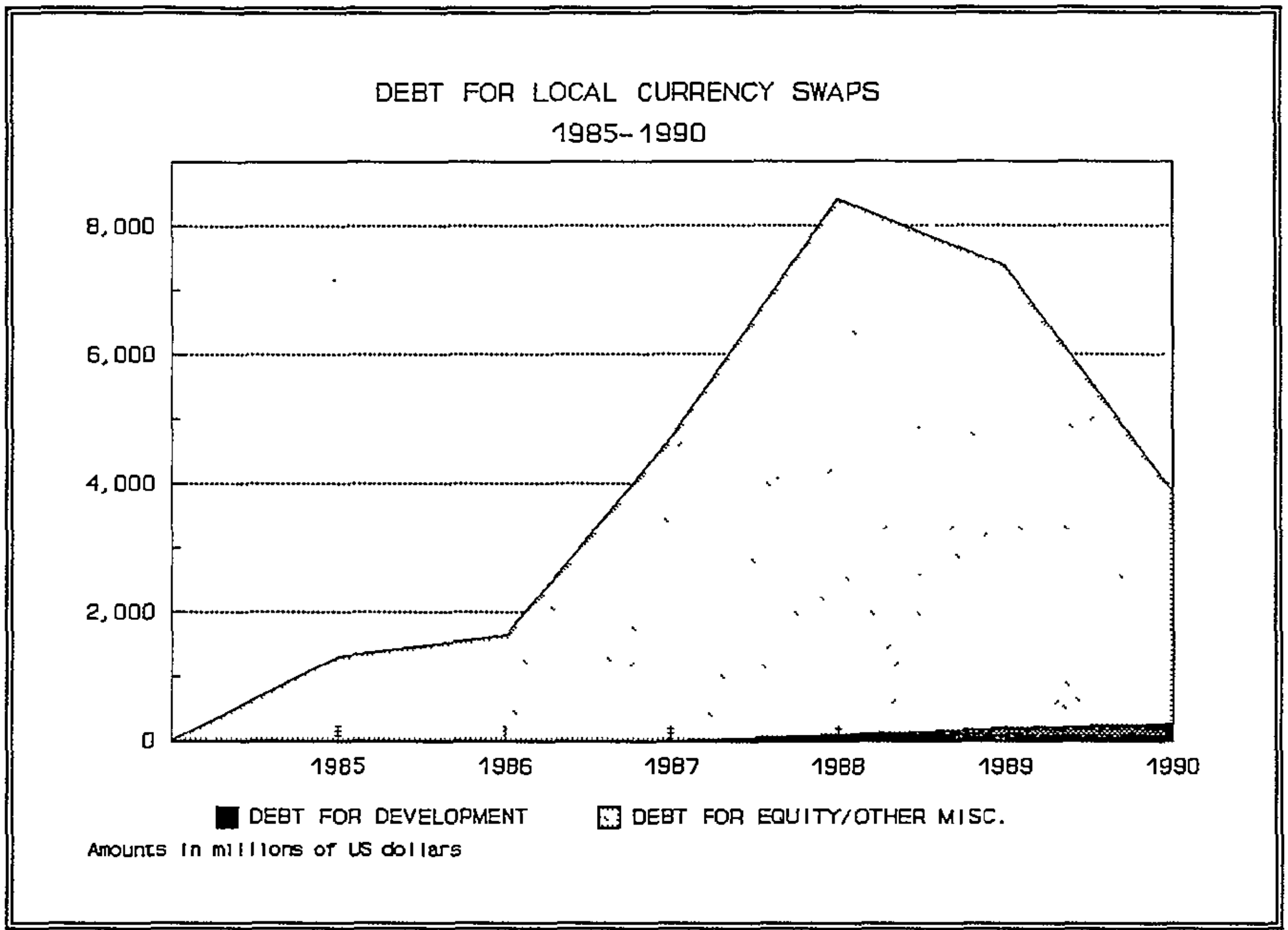
in overall debt conversion with the introduction of large-scale privatization swaps in Argentina, while the share of Debt for Local Currency swaps in total conversions, previously the nearly exclusive form of swapping debt, declined dramatically.[9]

[9]Information on the volume and type of debt swaps has been gathered from various sources, such as the IMF, the World Bank, the Federal Reserve Bank of New York and several commercial and investment banks. As much of the available information is incomplete and sometimes inconsistent, a survey of debt swaps is being conducted through the embassies and central banks of appropriate LDCs. This information is expected to be available by mid-year 1992.

B. DEBT FOR LOCAL CURRENCY SWAPS

1. Debt for Equity Swaps: The history of Debt for Local Currency swaps, which were comprised nearly exclusively of Debt for Equity swaps through 1988, has been characterized by "Stop and Go" policies. The annual total of these swaps grew steadily to over $8 billion by 1988 and then began a decline to roughly half this amount in 1990 as shown in Table II below.

Table II



Within these annual totals, however, are large fluctuations as different countries at different times introduced swap programs, then suspended them and, in some cases, repeated the cycle. There are many examples. Brazil's first program in the early 1980s was cancelled after about a year. The government cited its inflationary impact as a reason, although there were many far more significant factors driving Brazilian inflation. In retrospect, nevertheless, one can see that the government failed to take adequate account of potential costs in both its structuring and management of the program. A second program was introduced in 1987 and cancelled in 1988 as the economy and Brazil's relations with its creditors deteriorated. The current government has announced plans to reintroduce a program. Mexico's formal program, introduced in the mid-1980s was cancelled in 1987; however, ad hoc transactions continued.

A new program has been established which gives priority to privatization and infrastructure investments and is slated to redeem \$3.5 billion in debt over the next three years.

Only Chile has maintained a formal program over an extended period of time, opting for gradual modifications and refinements based on experience. Chile's steady approach has given investors the confidence to undertake proper feasibility studies and take their projects through the normal gestation period, a major factor in the program's success. The determinants of a successful and effective Debt for Equity swap program, best illustrated in the Chilean example, appear to be (i) good management of the macro-economic impact, (ii) clear and consistent rules, and (iii) linkage to progress on economic adjustment program.

Despite the mixed record of Debt for Equity swap programs, most highly-indebted countries continue to express intentions of maintaining a Debt for Equity option. A trend that appears to be underway and gaining momentum is the offering of this "option" through ad hoc, case-by-case negotiations rather than through a formal structured program. This development is discussed further in the context of the Dominican Republic's swapping activities in Chapter VI, Linkages Between Debt Swaps and USAID Development Objectives.

2. Debt for Development Swaps: Debt for Development transactions enjoy substantial political support, but they are just beginning to become a factor in debt conversion activities. Since the first operation in 1987, 19 operations involving about \$150 million of debt in 10 countries have been concluded.[10] The U.S. General Accounting Office (GAO) prepared a report on Debt for Development swaps[11] which emphasizes the small contribution of Debt for Development swaps to the reduction of total developing country debt, a somewhat puzzling conclusion since debt reduction is not generally considered as the primary objective of these swaps. Most proponents of Debt for Development swaps point to the potential for increased funding of not-for-profit development and social programs which benefit the society at large as the primary objective and, indeed, in this respect they appear to be quite successful.

On the average, these Debt for Development swaps have enabled the donor organizations to quadruple the local currency value of their development funding, compared to the straight transfer of foreign funds to the target country. Indebted countries redeemed the debt at local currency values ranging from \$0.30 to \$1.00 equivalent for each dollar of face value, for an average of \$0.61 equivalent in local currency for each dollar of donor funds.[12]

No clear framework has yet emerged for Debt for Development activities, yet strong support from international and domestic constituencies will probably ensure further growth. Most Debt for Development swaps appear to have been arranged on an ad hoc basis,

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[10] Source: Debt for Development Coalition, Inc., Washington DC.

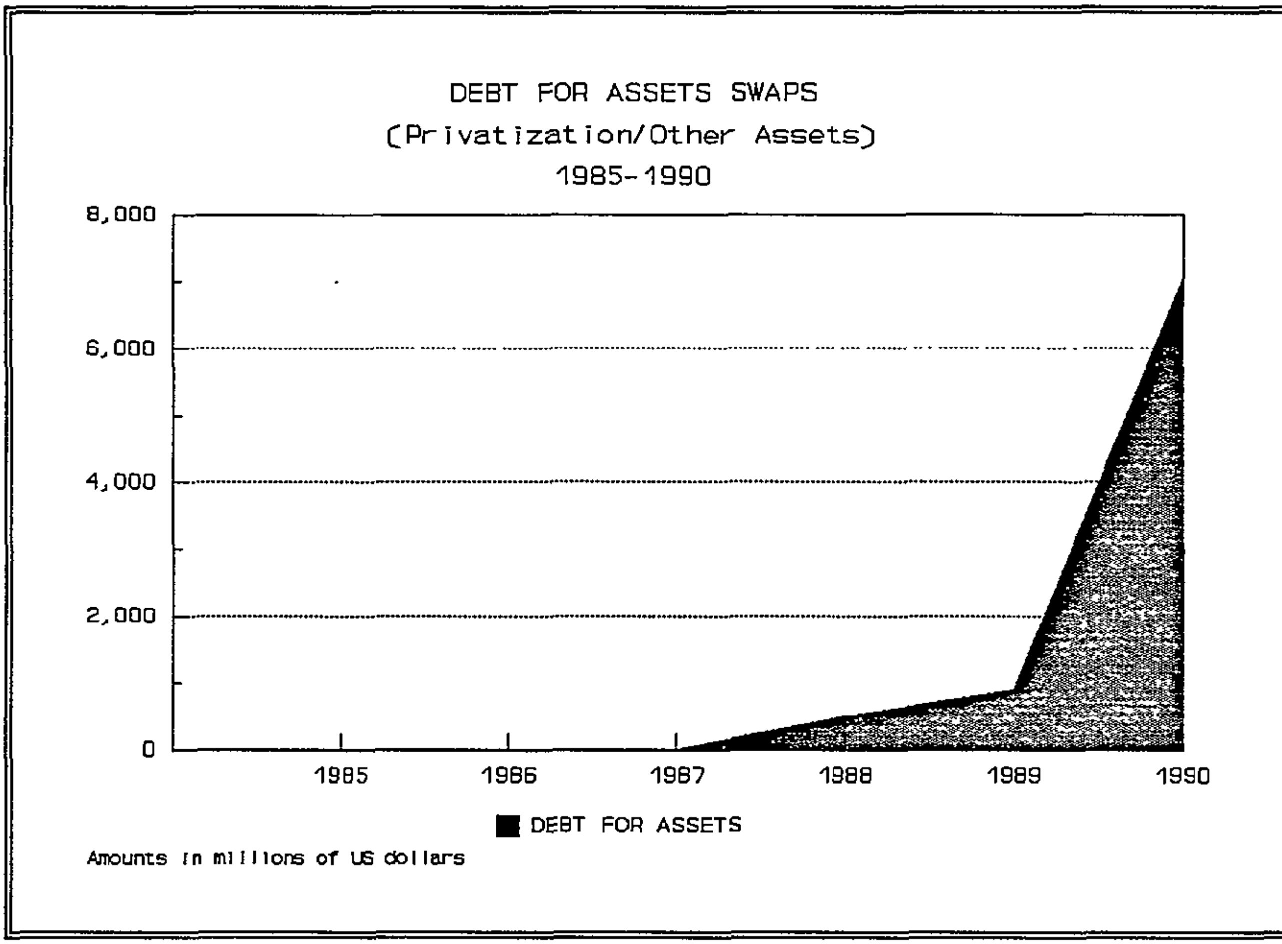
[11] GAO/NSIAD-92-14 Debt Swaps for Development and Nature, Report to Congressional Requesters, December 1991.

[12] Source: Debt for Development Coalition, Inc., Washington DC.

and to have been subject to prolonged negotiation. One possible explanation is that neither of the two principal parties involved, NGO donors and the specialized ministries (interior or natural resources, education, health, etc.) have much experience in structuring complex commercial financial transactions.

C. DEBT FOR ASSETS SWAPS

Table III



1. <u>Privatization Swaps</u>: Table III above illustrates the sharp increase in Debt for Assets swaps in 1990, mostly due to large-scale Privatization swaps completed by Argentina. The amount of Privatization swaps is believed to be considerably higher than that shown in the table, since many countries still include these swaps in their Debt for Equity figures. If so, the upward trend of Privatization swaps and the downward trend of debt for equity swaps is likely to be more pronounced than shown in the accompanying tables. As the pace of introduction and implementation of privatization programs accelerates, and there are many indications that it will accelerate, Privatization swaps are expected to become increasingly significant. An important factor in this trend is that the macro-economic impact of Privatization swaps is more easily managed than it is for Debt for Equity swaps. The monetary

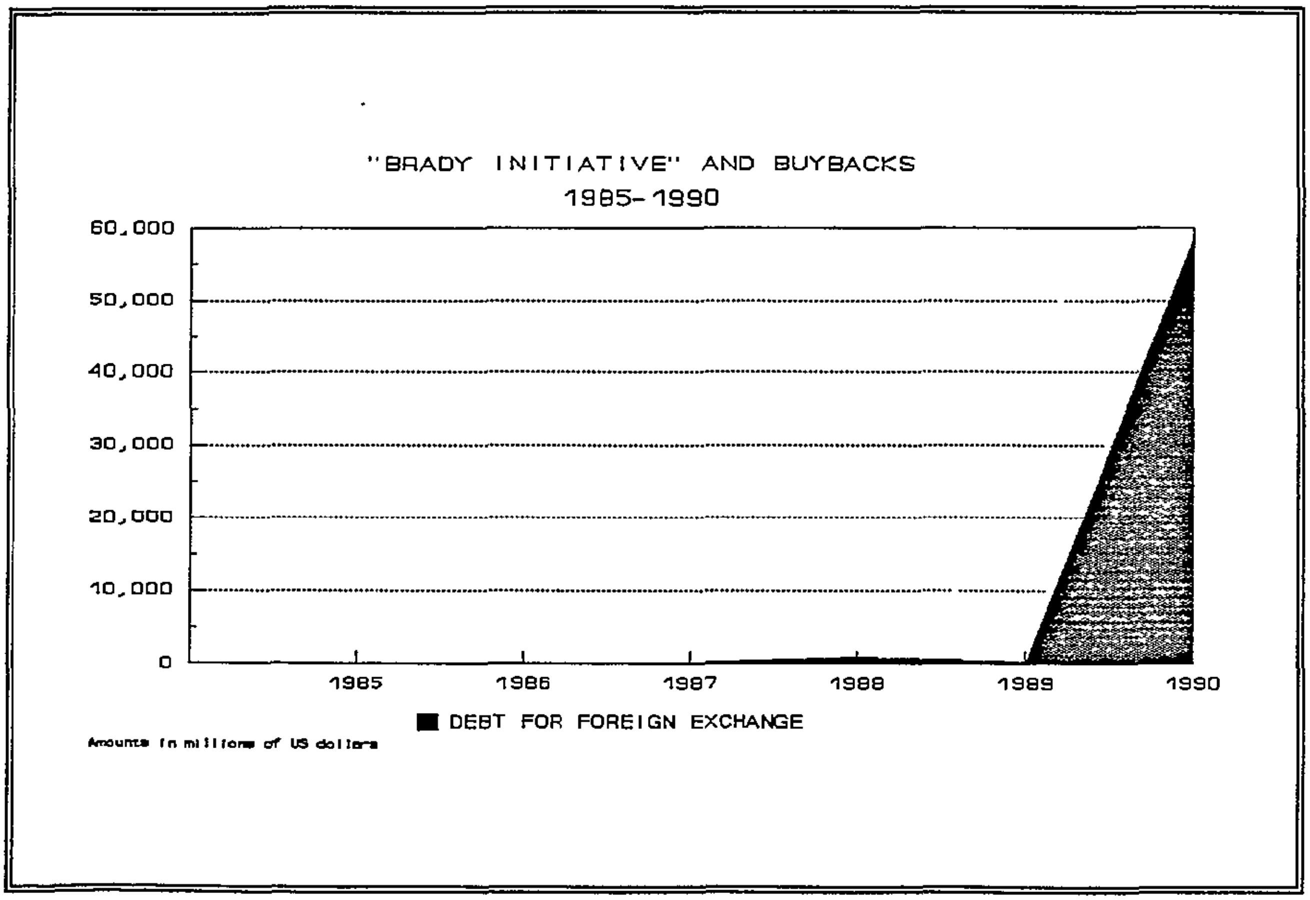
impact is usually negligible and additionality and the balance of payments impact can be evaluated more readily and convincingly.

2. Financial institution restructuring swaps: Debt swaps have been utilized to help strengthen and restructure domestic financial institutions in several countries, such as Chile, the Dominican Republic and the Philippines. However, these swaps are generally reported as debt for equity swaps and figures on their volume is not available.

D. DEBT FOR FOREIGN EXCHANGE SWAPS

1. "Brady Initiative" swaps: The dramatic increase in Debt for Foreign Exchange swaps, mostly due to exchanges negotiated under the guidelines set by the "Brady Initiative", is shown in Table IV. Additional countries with acceptable adjustment programs underway are likely to negotiate "Brady Initiative" exchanges of existing debt for new external debt instruments and buy-back arrangements, and the volume of debt exchanged in this way will probably continue at high levels, particularly in years when major debtors such as Brazil and Argentina become involved.

Table IV



VI. LINKAGES TO USAID DEVELOPMENT OBJECTIVES

USAID has taken the lead among bilateral and multilateral institutions in assisting countries experiencing debt problems in the design and management of debt swap programs, with the strong encouragement of both the Executive and Legislative branches of the US Government. Further, USAID is the only major donor to have formulated an explicit policy enabling debt conversions with its own funds. The policies followed by USAID on the use of its own funds in debt conversions is articulated in the "A.I.D. Debt for Development Guidelines." The first version of the Guidelines were included in an Agency paper entitled "A.I.D. Announces Debt for Development Initiative", first issued on February 15, 1989. These Guidelines were subsequently revised and reissued on April 11, 1990. In early 1989, the Bureau for Africa co-sponsored a workshop on debt swaps for senior African government officials, together with the African Development Bank and the Overseas Private Investment Corporation.

The direct involvement of USAID in debt swaps has taken a number of forms, as might be expected since decision-making on debt conversion is decentralized, just as it is on projects. Although the lack of centralized responsibility for operations involving debt swaps makes it difficult to take a complete inventory of these operations, the wide-ranging role USAID has played in debt conversion can be adequately illustrated with the specific examples discussed below.

A. Debt for Equity swaps

An example of the approach followed by USAID in providing support for Debt for Equity swaps is the Dominican Republic Debt Conversion Project. Annex 9 provides an extract from the project document which describes the project's goals and work program. The primary objectives of the project were the creation of $500 million in new investment and the reduction of foreign debt by $350 million. The core of the $3.5 million, three-year project is a resident technical assistance team (TA Team) that was established to work with the Central Bank's Office of Debt Conversion. This TA Team was to be responsible for assisting the government in designing a debt for equity swap program that would be designed within the framework of the government's overall macro-economic program. The TA Team would then continue to provide day-to-day assistance with asset valuation and assessment, program accounting and financial services, management information system development, banking liaison and institutional coordinating, and program promotion. It is precisely this type of "hands-on," in-country technical assistance that seems to be most needed, particularly in the smaller countries.

Although the Project Agreement was signed in August 1988, the TA Team was not put in place until August 1990. A mid-term evaluation was completed in July 1991[13], which provides an opportunity to examine the progress of the project. At first glance, the project

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[13] Mid-Term Evaluation of Debt Conversion Project (517-0237), prepared for USAID/Dominican Republic by Louis Berger International, Inc., July 1991.

appears not to be meeting its objectives. The TA Team helped the government design and draft a Debt for Equity program, which the evaluation team judges to be a well structured, sound and useful debt conversion system. A deteriorating economic situation and changes in personnel, however, led the government to delay making the political decision to put the system in place, and the project has been temporarily suspended. Nevertheless, the accomplishments of the project at mid-term still appear to be substantial.

First, the Mission early on demonstrated a high degree of responsiveness to changing circumstances by recognizing that the project had to take a much broader look at the debt conversion process (than just debt for equity swaps to promote investment) and began to focus on debt conversion as a component in the country's overall strategy for managing its external debt. With assistance from the TA Team, who by this time had established an effective working relationship with the Central Bank, the project proved to be a valuable complement to the Missions's macro-economic dialogue with the government. Eventually, a radical change of economic policy was effected which led to the signing of a Letter of Intent with the International Monetary Fund in July 1991, following upon a protracted period of conflicting positions. The government is now moving toward improving its relations with other official and private lenders.

Second, even though the government might not want to implement the proposed debt swap program before it reaches a restructuring agreement with its commercial bankers, it has a fully prepared program ready to go and has gained familiarity and sound advice on managing its costs and benefits. Finally, the TA Team has had an opportunity to train the staff of the implementing agency.

During the course of the project, the government also had to confront the danger of a crash in the domestic commercial banking system due to mounting loan arrearages and under-capitalization. To ease the situation, the government turned to debt swaps as a means of reducing commercial bank liabilities to the Central Bank (in effect, Debt for Asset swaps) and, reportedly, over $300 million of such swaps were concluded. These swaps were negotiated individually (as opposed to a formal program) and outside the scope of the USAID project. The evaluation team believes that the technical assistance provided by the TA Team in their work on a Debt for Equity program contributed positively to the government's ability to manage these swaps, but they also felt that additional benefits would have been achieved had the TA Team been directly involved. The issue that is raised is not whether a formal program has been instituted, but rather whether the technical assistance provided by USAID is available for any type of debt swapping activity.

The Dominican Republican experience demonstrates the importance of understanding that individual types of debt swaps (in this case, Debt for Equity swaps) should not be considered in isolation, but rather as a component in the overall process of dealing with the immediate problem of debt restructuring and of implementation of structural economic reform in the longer term. In this perspective, a debt swap project might provide for assistance in various types of swaps depending on the objectives to be met, for example, Debt for Equity to promote investment, Debt for Assets to assist in financial restructuring or privatization, and Debt for Foreign Exchange to help reduce the external debt service burden.

B. Debt for Development

USAID's support for Debt for Development swaps is sanctioned by policy directives and governed by operational guidelines. In 1988, USAID announced its intention to establish a Debt for Development program. The Guidelines which were subsequently drafted allowed USAID to issue grants to intermediary institutions to purchase debt for conversion into local currency. The local currency proceeds could be used to fund development programs of the type that USAID might typically finance directly, such as conservation of natural resources, environmental protection, health, education, social welfare and development of local entrepreneurship.

The Agency has channelled its support for Debt for Development swaps through various mechanisms. First, it provides core funding to the Debt for Development Coalition, Inc., a Washington-based specialized institution. Several of the larger umbrella groups of NGOs agreed in 1988 to establish the Debt for Development Coalition, Inc. to serve as a central point of information gathering and dissemination on all matters related to Debt for Development swaps. Later, an associated Debt for Development Foundation was created and staffed with experts to provide technical assistance to donors in conducting swap transactions and to developing country governments in setting up and managing Debt for Development programs. The Foundation was then merged into the Debt for Development Coalition, Inc. in late 1991. USAID's financial support for these efforts is intended to lead to efficiency gains for both the donors and the indebted countries by creating a centralized body of knowledge and expertise which can be accessed both by indebted country governments and sponsors of debt swaps.

A second form of USAID support is providing direct financing of the purchase of debt in individual transactions, either in foreign or local currency. One example is the Bureau for Africa's grant assistance to the World Wildlife Foundation (WWF) for a Debt for Nature swap in Madagascar in 1989. WWF used part of the grant combined with its own funds to acquire $2.1 million in debt at a 55% discount and received the full local currency equivalent for a nature conservation project. According to a recent internal EID review,[14] fifteen grantees utilized $9.6 million of USAID funds through the end of 1991 to acquire $12.1 million in commercial bank loans plus a comparable amount of corporate accounts receivable and "blocked currency" funds.[15] Although the precise face value of the accounts receivable and "blocked currency" is not available, it appears that at least $30 million of foreign claims on 13

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[14]Wein, Gerald R.; <u>Stretching A.I.D. Dollars Through Debt Conversions and Other Financial Transactions: Lessons Learned</u>; R&D/EID; January 23, 1992.

[15]The corporate accounts receivable usually arise from goods and services sold to a government entity on normal trade terms for which payment has not been received on the due date. "Blocked currency" funds usually originate from corporate local currency revenues that cannot be converted into hard currency and remitted due to government restrictions or its inability to provide the corresponding amount of foreign exchange. Both represent a foreign claim on the country, as is the case with commercial bank loans.

developing countries[16] was extinguished. The sponsors of these Debt for Development swaps received the equivalent in local currency of about $16.6 million for various development programs, a gain of about 73% compared to normal channels of converting foreign exchange into local currency. The principal constraints on USAID-financed swaps are the paucity of eligible countries with a Debt for Development program in place, on the one hand, and the difficulty and uncertainty of negotiating ad hoc transactions, on the other. In many instances, the Debt for Development Coalition, Inc. provides technical assistance to help overcome these constraints.

Finally, USAID recently introduced a large sector project in which debt swaps figure prominently, which represents a third approach. The project is sponsored by the R&D Office of Population and is entitled, "Promoting Financial Investments and Transfers" (PROFIT). The project is designed to increase developing country resources for family planning and to encourage greater private sector involvement. The PROFIT project, which is described in more detail in Annex 10, includes up to $20 million to support debt conversions and blocked currency transactions to increase the level of local currency resources available to family planning organizations in developing countries. The contract for the project was awarded only in late 1991, and it is too early to review its progress. Nevertheless, the project's design appears to be well thought out and seems to offer a realistic blend of official development assistance with market mechanisms.

C. Privatization Swaps

USAID has already gained experience in providing effective support for the move toward market-oriented economies in many countries through a number of privatization projects. The use of debt swaps as a tool for completing privatization transactions may or may not be a component in the initial design of these projects, although the prospect of their use is likely to arise in most cases. In these cases, there may be a role for USAID in providing technical assistance to the government for the management of these swaps.

Two models for conducting Privatization swaps have emerged: a) formal programs to deal with numerous smaller transactions (e.g., Honduras), and b) individual negotiation of large transactions (e.g., Argentina). In the first instance, formal Privatization Swap programs in smaller countries, USAID's support in the Honduras Privatization project, cited earlier (Annex 8), is a useful model for future privatization projects. The Honduras project is one where Privatization swaps had not been contemplated in the initial design. However, once a resident technical team (the Technical Working Group--TWG) was in place and project implementation underway, successive tenderings of companies offered for divestiture failed to elicit acceptable bids. This seemed due mostly to the large gap between the minimum price that the government was willing to accept and the price that potential investors were willing

[16] Dominican Republic, Ecuador, Guinea, Haiti, Honduras, Jamaica, Kenya, Madagascar, Niger, Nigeria, Philippines, Uganda and Zambia

to pay.[17] The government perceived potential political obstacles to lowering the asking price to a realistic market value and, after discussing the issue with the Mission and the TWG, agreed to introduce debt swaps with a predictable local currency redemption value as a means of payment. Investors would then be able to submit tenders in local currency at a price close to the local currency asking price, knowing that payment could be effected with Honduran external debt acquired in the secondary market at a substantial discount (no actual local currency payment would be involved, only an accounting transaction). Thus, the pricing gap would in effect be covered by the loss realized by the banks who sold their loans. This payment mechanism proved to be highly successful, and eventually these Debt for Assets swaps accounted for 80% of the total recovered value of assets sold.

In the second instance, individual negotiation of large privatization transactions, most of these swaps have been effected by countries that are not beneficiaries of USAID assistance, such as Argentina, Chile and Mexico. However, the Philippines privatization program, where USAID has a privatization project in place, is moving towards the divestiture of large state-owned entities. Again, the initial design of the project did not contemplate the use of Privatization swaps, although USAID funds could be used to finance technical assistance to the government or its disposition entities for the purpose of evaluating the use of a privatization swap related to the pending large divestitures. A mid-term process evaluation of the project recommended that the prospect of utilizing Privatization swaps be addressed explicitly with the government.[18]

Generally, the link between USAID privatization projects and Privatization swaps needs to be strengthened. Further, information on the experience gained by countries who have utilized Debt for Assets swaps in their privatization programs needs to be accumulated, analyzed and made available to the Missions in appropriate countries.

D. "Brady Initiative" and Buy-backs

The Multilateral Financial Institutions, usually the World Bank and the IMF, have been designated to assume the lead role in debt and debt service reduction negotiations carried out under the "Brady Initiative" and, accordingly, USAID's role in these exercises in countries where the Agency has an assistance program in place would be worked out in the context of overall donor coordination. Most likely, the overall debt and debt service reduction exercise will include options that incorporate all of the types of debt swaps discussed in this paper, and all of the experience with the different types of debt swaps gained by USAID could conceivably be brought to the table. As mentioned earlier, no other bilateral official aid institution has comparable experience.

Debt Buy-Backs have been conducted both within and outside the context of the

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[17] Case Study, The Honduras Privatization Program, Center for Privatization, January 1990.

[18] An Evaluation of the USAID/Philippines Privatization Project, Center for Privatization, August 1990.

"Brady Initiative." Bolivia's 1988 debt buy-back, for example, was negotiated separately with the commercial banks, though the multilateral institutions and USAID assisted in the process. Reportedly, USAID has indicated a willingness to provide the U.S. funds involved (to purchase loans held by U.S. banks) if Bolivia can manage a second buy-back.

E. Official Debt Reduction and Potential Links to Debt Swaps

Debt swaps have been limited to the cancellation of public sector indebtedness to commercial lenders. Official debt reduction, so far, has been implemented through the traditional techniques of forgiveness or the easing of terms. From time to time, proposals are advanced to use official debt in some form of debt swap. For example, the U.S.-sponsored "Enterprise for the Americas Initiative" (EIA) contemplates supporting the reduction of debt linked to environmental protection. A further EIA proposal would allow the sale of Commodity Credit Corporation or Export-Import Bank loans to eligible investors for the purpose of engaging in Debt for Equity or Debt for Nature swaps. Similar proposals have surfaced from European bilateral aid agencies as well.

Although no such operations have been effected, some observers believe that the use of official debt in debt swaps is a logical next step, particularly in the low-income countries that generally have little commercial debt. Should official debt become available for debt swaps, two of the likely areas of activities are Debt for Development operations and Privatization swaps.

One of the obstacles to using official debt is finding a way to determine its real market value. One proposal involves the exchange of official debt for special "Certificates" valued at 100% in local currency. These "Certificates" could be used only for a specified purpose, for example, as payment for public sector assets being privatized, in which case the "Certificates" could be auctioned to investors for payment in foreign exchange. All or some portion of the foreign exchange payment could accrue to the debtor country, if the official institution wishes to provide further benefits. The end effect would be the same as in current Privatization swaps, except that official debt would be cancelled and the country could still benefit from a foreign exchange inflow.

The mechanism describe above could also be used for Debt for Development operations, in which case donor organizations could bid in foreign exchange for local currency "Certificates" that could only be used to pay for the costs of an agreed development program.

VII. CONCLUSIONS AND RECOMMENDATIONS

A. SUMMARY AND CONCLUSIONS

Debt swaps have become an integral part of the process of working out of the developing country debt crisis, and they are likely to continue to be a part of this process as long as there are external creditors who perceive that the real present value of the developing country debt they hold is lower than the nominal present value. The market introduced debt swaps early in the debt crisis in the form of Debt for Equity swaps, a swap involving the cancellation of external debt in exchange for pre-payment at a discount in local currency which can only be used for domestic investment. The permissible end use of the local payment was later expanded to include, for example, conservation programs (Debt for Nature), education projects (Debt for Education) and other development activities. All of these swaps may be broadly categorized as "Debt for Local Currency" swaps, as all involve a local currency payment.

A debate within the international community on the potential adverse macro-economic effects of these swaps began immediately and intensified as the volume of debt swaps expanded. Eventually, a <u>de facto</u> consensus was reached among the indebted countries, commercial and official creditors and the governments of the industrialized countries that essentially entailed acceptance of the use of debt swaps to gain certain defined benefits as long as the macro-economic costs, which came to be better understood than at first, were properly managed. A decisive element in the reaching of this consensus was the recognition that the eventual re-establishment of normalized debtor/creditor relations was essential and that debt swaps contributed substantively to this goal.

In the course of events, a new category of debt swap appeared--the Debt for Assets swap, involving the exchange of public sector external debt for public sector assets--to be used principally in privatization transactions and the restructuring of troubled domestic financial institutions. As these swaps normally do not involve monetary creation, their macro-economic impact is more easily managed than in the case of Debt for Local Currency swaps. Finally, the "Brady Initiative" introduced large-scale Debt for Foreign Exchange swaps--the exchange of existing external debt for a new foreign currency-denominated instrument on improved terms--as a component in officially-sponsored debt and debt service reduction exercises, as well as limited options to prepay in foreign exchange (i.e. buy back) external debt at a discounted price.

Experience has demonstrated that those indebted countries who have managed their debt swap activities as an integrated component in their overall strategies for working out of the financial crisis have enjoyed the most benefits. Those countries who have approached debt swaps as a piecemeal, isolated activity have gained the least. Debt swaps are neither inherently "good" nor "bad," but costs and benefits have to be managed. Further, debt swaps can have important implications, positive or negative, for the government's macro-economic policies, management of its domestic and foreign indebtedness and its relationships with sources of external capital. Therefore, the quality of the government's management of the debt swap process is the key issue to be addressed.

Despite the overriding importance of this issue, only a handful of countries can be judged to have mastered the process of managing debt swap activities, and out of about 60 countries classified either as "severely indebted" or "moderately indebted,"[19] perhaps less than 20 can be said to have had any meaningful experience with the debt swap process. Nevertheless, debt swaps will continue to represent a possible option for developing countries who cannot meet the terms of existing external debt and whose loans are traded in the secondary markets at a discount. Those who chose to take advantage of this option can benefit greatly from the practical experience of other countries through technical assistance.

USAID is well positioned to serve as a channel for such technical assistance in those countries where assistance programs are in place. It is the only official aid institution to have promulgated a policy that encourages direct support and funding of debt swap activities, and it has gained "hands-on" practical experience with all three of the basic types of debt swaps. The involvement of other bilateral aid agencies has been sporadic, and while the multilateral development institutions have been generally supportive, their direct involvement has mostly been limited to "Brady Initiative" swaps.

The Agency's decentralized approach to the design and implementation of projects involving debt swaps offers many advantages, among them the encouragement of innovation and prudent experimentation, responsiveness to changing economic and political circumstances, and the opportunity to link debt swaps into the macro-economic dialogue. As can be seen from the section on the history of debt swaps, this is an area of activity that is constantly evolving and subject to changing perceptions as practical experience is gained. What seems to be lacking within the Agency is a systematic mechanism for tracking market developments involving debt swap activities, evaluating country experiences with this option, exchanging views with other official aid agencies, analyzing this information, putting it together in a manner that is relevant to the Missions and their client governments, and proper dissemination.

B. RECOMMENDATIONS

1. Restate Policy Guidelines: USAID should amplify its policy directives on debt swaps to emphasize that the primary goal of debt swaps is to support economic adjustment and reform and to help re-establish normal relations between the indebted country and its creditors. Within this broad policy goal, secondary objectives, such as investment promotion, funding of development programs, promotion of exports, support for privatization efforts, or debt and debt service reduction, should be matched with the type of debt swap that most efficiently meets these objectives. USAID support should always be accompanied with technical assistance to help manage the corresponding costs.

2. Clarify Operational Guidelines: Operational guidelines on the use of USAID funds to support debt swap activities are articulated in "A.I.D. Debt for Development Guidelines." However, many grantees, contractors and other involved organizations have found that there are important policy and procedural questions that are not adequately addressed or

[19] World Bank classifications, World Debt Tables, 1991-1992.

not addressed at all. The Debt for Development Coalition, Inc. prepared a draft paper[20] which provides many useful suggestions. R&D/EID subsequently prepared another paper, "Supplement to the A.I.D. Guidelines on Debt for Development." These efforts should be pursued and expanded to include guidelines for USAID involvement in all types of debt swaps.

3. Designate a Unit Responsible for Policy Guidance: The Office of the General Counsel took the lead in the preparation of the Guidelines and their distribution to USAID offices in Washington and overseas Missions. No office or individual, however, was assigned continuing responsibility for overseeing and promoting the debt swap initiative or providing guidance and assistance as might be required. A unit or office within the Agency should be assigned these responsibilities, which could be characterized as "staff" functions as opposed to "line" functions. The unit could look to a specialized entity, for example, the Debt for Development Coalition, Inc., for the required technical expertise, which should be more cost effective than building up in-house staff skills. Recommendations on which unit or office might best be able to handle these responsibilities are beyond the scope of this paper.

4. Expand the Use of Centralized Expertise: As noted earlier, the Agency's decentralized approach to the operational implementation of projects offers many advantages, and these should be fully preserved. However, it is not realistic to expect the staff in the Regional Bureaus and Missions to develop their own expertise in this specialized area and keep up to date with the latest developments. A central point is needed for pulling together a core of specialized staff who can gather information, perform the required analysis, evaluate experience, and provide operations assistance and advice to Agency staff, governments and other participants in debt swaps. The Debt for Development Coalition, Inc. already provides these services with respect to Debt for Development swaps, and it would probably be a relatively easy task to broaden their involvement to incorporate all types of debt swaps and all of the technical assistance services that might be required by the Agency's staff or its clients.

5. Enhance the Delivery Systems for Technical Assistance: USAID has utilized three different technical assistance delivery systems: (i) resident technical assistance teams, (ii) the Debt for Development Coalition, Inc., and (iii) an independent contractor specializing in a specific sector.

The use of a resident technical assistance team is very effective for assisting in the introduction of a country debt swap program, providing training, and creating necessary institutions. This approach, however, should be confined to situations where there is a prospect of longer-term continued use of the debt swap mechanism and where the political will to sustain the program exists.

Most often, however, ad hoc rather than long-term assistance is required in the form of general advice related to the subject, the exploration of possible options, the formulation of a strategy for the use of debt swaps, and operational assistance in the

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[20] Draft Discussion Paper; Debt Conversions with AID Resources: Clarifying the Rules, Debt for Development Coalition, Inc., December 11, 1991.

negotiation and completion of individual transactions. For purposes of consistency, quality and timeliness in the delivery of "on-demand" technical assistance, a specialized central unit would be best suited. Again, the Debt for Development Coalition, Inc. could fill this role most expeditiously.

Finally, the global sector approach using a specialized contractor appears to hold much promise for efficient utilization of the scarce combination of sector and debt swap skills that are required. This approach also provides an opportunity for cross-fertilization of experiences within the sector but across national borders. The PROFIT project sponsored by the R&D Office of Population has adopted this approach and its progress should be followed closely to evaluate its effectiveness.

6. Anticipate Future Developments: USAID should constantly be looking ahead to future developments in the use of debt swaps. At the moment, the next important development would seem to be the introduction of the use of official debt to promote private sector activities. Research and consideration of potential issues should be undertaken now in order to be fully prepared to respond when it is appropriate. The lessons learned from the use of commercial debt in developing country swaps should have an important influence on the techniques that might be considered for use in swapping official debt.

ANNEXES

^D

^F1^

Mr. Ambassador ^F2^:

The US Agency for International Development (USAID) is conducting a survey of debt swap activity in a number of countries. The information gathered through this survey will be used in an internal review and analysis of debt swap activities during the past decade, in order to identify those areas of debt swap activity that complement USAID's development operations.

It would be helpful if you could arrange to obtain the summary information indicated on the attached forms. Also included is an explanatory note which is intended to serve as a guide in providing the information requested. We believe the summary information requested is organized in a manner that best reflects the perspective of the host country in terms of the costs and benefits of debt swap activities.

We appreciate any assistance you can provide in this survey of debt swap activities. Since we plan to consult with all countries that may have utilized debt swaps as part of their debt management strategies, we expect to be able to compile summary results which promise to be of value in the continuing discussion of debt swap activities. We will be pleased to share this information with you upon completion of this survey.

Thank you for your cooperation.

Very truly yours,

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USAID Form DS-8191

CONVERSION OF PUBLIC SECTOR FOREIGN DEBT

COUNTRY ______________________________

Debt Swaps during the Year of: ________

[Millions of US dollars]

FOREIGN DEBT CANCELLED IN EXCHANGE FOR:	Debt swaps completed by foreign investors (Total face value of debt) (1)	Debt swaps completed by domestic investors (Total face value of debt) (2)	Total -- Face value of foreign debt swapped (1+2)=(3)	Total -- Internal redemption value (local currency or foreign exchange) (4)
1. LOCAL CURRENCY PAYMENT: (Cash or deferred payment)				
A. DEBT FOR EQUITY SWAPS (Private Investors)				
B. DEBT FOR DEVELOPMENT SWAPS (Nature, Health, Education, Conservation, etc.)				
C. OTHER DEBT SWAPS				
Remarks: ______________________				
2. PUBLIC SECTOR ASSETS:				
A. PRIVATIZATION SWAPS				
B. LOANS FROM GOVERNMENT FINANCIAL INSTITUTIONS (Debt swaps to repay domestic loans)				
3. FOREIGN EXCHANGE:				
A. DIRECT BUY BACKS				
B. EXIT BONDS				
C. "BRADY" BONDS				
4. "INFORMAL" DEBT SWAPS BY PUBLIC SECTOR ENTITIES:				
A. DEBT FOR EQUITY SWAPS (Direct negotiations with creditors)				
B. NEW FOREIGN EXCHANGE NOTE (Restructuring of foreign debt of public sector entities at a discount)				
TOTALS:				

Prepared by: ______________________
(Name/Org.)

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ANNEX 1: DEBT SWAP SURVEY MATERIALS

GUIDELINES ON INFORMATION REQUESTED FOR A SURVEY ON THE CONVERSION OF PUBLIC SECTOR FOREIGN DEBT

I. PERSPECTIVE OF THE SURVEY

A. The survey looks at debt swaps from the perspective of the indebted developing country, taking account of what the country has to give in exchange for cancellation of external debt and what it gains in the process. From this perspective, there are three distinct categories of officially-approved debt swaps, plus a category for other debt swaps that do not require official approval:

1. DEBT FOR LOCAL CURRENCY: Debt Exchanged for an immediate or deferred payment in local currency,

2. DEBT FOR ASSETS: Debt exchanged for ownership of a public sector asset, and

3. DEBT FOR FOREIGN CURRENCY: Debt exchanged for an immediate or deferred payment in foreign currency.

4. "INFORMAL" SWAPS: Debt swaps that do not require official approval.

II. DESCRIPTION OF THE FOUR TYPES OF DEBT SWAPS

A. Various types of debt swaps fall within the "Debt for Local Currency" category, in which external public sector debt is canceled in exchange for an immediate payment in local currency or through a deferred payment in the form of domestic bonds, other financial instruments or special accounts.

1. "DEBT FOR LOCAL CURRENCY"

a. Debt-for-Equity Swaps -- Proceeds of the debt swap are invested in equity shares, fixed assets or working capital of a private company.

b. Debt-for-Development Swaps[1] -- The government makes available local

[1]For this survey, debt-for-development is defined as a debt swap to benefit a not-for-profit organization in carrying out education, health, environment, or other development activities. The not-for-profit group may receive a financial or material assets (such as land) in exchange for external debt. For survey purposes, public-supported universities are considered not-for-profit entities.

currency (in cash or some form of deferred payment) in exchange for cancellation of external debt. The local currency proceeds from the Debt for Development swap must be used for agreed programs, for example, to cover the costs of nature, environment, health, education, or other socially-oriented programs.

c. Other Debt Swaps: Any other debt swaps which involve a local currency payment from the Government. Some examples are:

(1) Debt-for-Exports Swaps -- A developing country exporter accepts canceled public sector debt in lieu of foreign exchange as payment for an export and receives local currency from the Central Bank in exchange.

(2) Debt swaps designed to encourage the return of foreign currency holdings by nationals, such as Chile's Chapter 18 program.

2. "DEBT FOR PUBLIC SECTOR ASSETS" -- In these cases, external debt is canceled in exchange for the transfer of ownership of a public sector asset. These debt swaps are usually linked to privatization programs or the financial restructuring of government financial intermediaries.

a. Privatization Swaps -- External debt is used as a medium of payment for a government-owned asset, either equity shares or physical assets.

b. Loans from Government Financial Institutions -- External debt is used as a medium of payment for a loan (usually in arrears) from a government financial intermediary (the loan is a public sector asset).

3. "DEBT FOR FOREIGN EXCHANGE" -- Public sector external debt is canceled in exchange for an immediate or deferred payment in foreign exchange, or it is exchanged for a new external debt instruments issued at a discount and/or on improved terms.

a. Direct Buybacks -- External debt is repurchased (and thus canceled) at a discount with foreign exchange provided by external donors or with international reserves authorized by the country's creditors.

b. Exit Bonds, and Debt for "Brady" Bonds -- Existing debt is exchanged at a discount for new debt in the form of long-term bonds, often at a low interest rate, which may be partially secured or guaranteed.

4. "INFORMAL" SWAPS BY PUBLIC SECTOR ENTITIES -- These swaps generally involve the direct negotiation with creditors of a restructuring of the

foreign debt of state owned enterprises, either through conversion to equity or pre-payment at a discount.[2] Understandably, precise figures are often not readily available; however, estimates of the amounts would be useful.

III. EXPLANATION OF THE COLUMNS

1. DEBT SWAPS COMPLETED BY FOREIGN INVESTORS -- The share of the amount in Column "A. Face Value of Foreign Debt" that was accounted for by either foreign commercial bank creditors or third-party foreign investors who purchased the debt in the market.

2. DEBT SWAPS COMPLETED BY DOMESTIC INVESTORS -- The share of the amount in Column "A. Face Value of Foreign Debt" that was accounted for by domestic investors who purchased the debt in the market.

3. FACE VALUE OF FOREIGN DEBT -- The total amount for the year of public sector foreign debt principal and accrued interest that was canceled through debt swaps in the appropriate category.

4. INTERNAL REDEMPTION VALUE (LOCAL CURRENCY OR FOREIGN EXCHANGE):

a) Local Currency -- The total amount in local currency which the government commits to pay either immediately or through deferred payments (for example, the total face value of bonds issued);

b) Public Sector Assets -- The value in local currency or foreign exchange at which the sale of the asset is recorded, or, in the case of financial assets, the amount of the past due obligation that is canceled; or

c) Foreign Exchange -- The amount of the foreign exchange payment in the case of a "buy back", or the face amount of the new external debt instrument that is issued to replace canceled public sector debt.

[2] Although this survey does not include debt swap transactions that are completed entirely within the private sector, for example, the direct negotiation between a private company and its creditors (Debt for Equity), or special officially-sponsored private sector debt restructuring schemes (New Foreign Exchange Notes), such as the Mexico FICORCA program, any information on such transactions should be included separately.

Source: The Economist Publications, Guide to Debt Equity Swaps, September 1987

CHRYSLER: A MODEL DEBT SWAP

The $110 mn debt purchase arranged last year for Chrysler by Manufacturers Hanover (discussed in Chapter 9) provides a useful example of a representative Mexican debt swap transaction. The funds produced were used to finance further expansion and modernisation of the engine factories and assembly plants that made Chrysler Mexico's largest private export earner in 1986.

Concluded in September 1986 the Chrysler deal was at the time the largest debt equity exchange ever approved in Mexico. (In December, Volkswagen signed a $141 mn debt conversion contract which stands as the largest such transaction in Mexico to date.)

Investment in a wholly owned subsidiary

The Chrysler contract typified the Mexican debt swap programme in several respects. It involved a large foreign multinational with a wholly owned local subsidiary that had been established in Mexico for many years. The parent firm was already planning major new investments in its Mexican operations. But it says it would not have invested as quickly as it did had it not been for the economic incentive offered by a debt swap.

The Chrysler investments were approved, as required, by the National Foreign Investment Commission, because they fit several of the priority categories defined by the Mexican government. The investments involved high technology. They were being made by a 100 per cent foreign owned company in an industrial sector dominated by wholly foreign owned enterprises. Most importantly, the investments were designed to increase Chrysler's – and therefore Mexico's – export earnings.

Also typically, the bank that arranged the transaction was itself among the Mexican government's largest private creditors. At the time the deal was signed, Manufacturers Hanover held $1.9 bn in Mexican public sector debt, putting it third on the creditor list after Citicorp ($2.8 bn) and BankAmerica ($2.5 bn).

Acting on Chrysler's behalf, Manufacturers Hanover purchased $110 mn in Mexican government debt from another foreign bank for approximately 59 cents on the dollar. For arranging the deal, the bank collected a large fee said to have been close to the equivalent of 1 per cent of the transaction. Chrysler, therefore, paid perhaps $70 mn for debts with a face value of $110 mn. These debts would eventually be converted into $99.5 mn in pesos.

As in the majority of the large swap transactions approved in Mexico to date, the client was a major foreign car company. In terms of retired debt, the automotive industry accounted for fully 55 per cent of the debt swap transactions approved by Mexico in 1986, the programme's first year of operation.

The car industry's dominance in the debt swap programme was directly due to a 1983 decree which forced Mexican automakers to reverse their chronic trade deficit and finance future expansion through export earnings. The decree also gave car companies a further incentive to sell abroad: models produced for export were granted partial dispensation from Mexico's tough domestic content rules. Several of the big car companies – most notably Chrysler, Ford and Volkswagen – went far beyond the decree's export requirements, however, and converted their Mexican subsidiaries into major international suppliers of engines, parts and finished vehicles. In providing cut-rate pesos through debt swaps to the auto industry, Mexican authorities were also protected by a political and economic reality: there were no local capital competitors in the industry, and hence no complaints from aggrieved Mexican businessmen.

Funds were destined for technological improvements –

With the exception of a new automatic transmission plant, none of the proposed Chrysler investments represented an expansion in installed capacity. Most of the debt swap funds were destined for a technological overhaul of local assembly lines in an attempt to make Chrysler's Mexican products internationally competitive in price and quality, precisely the sort of modernisation that the government was urging for Mexico's manufacturing industry in general.

After securing authorisation from the National Foreign Investment Commission, Chrysler began negotiating with the Finance Ministry over the discount rates that would be applied to the debt conversion. The project was divided into several separate transactions. Most were authorised in Category 2, under which debts were exchanged at 92 per cent of face value. Authorities insisted, however, that funds destined for local suppliers would have to be exchanged at a lower rate because the payment commitment pre-dated the new investment project. The average rate of exchange for the $110 mn debt trade was 90.5 per cent, Chrysler finance officials said. For a capital expenditure of about $70 mn, Chrysler was able to undertake $99.5 mn in new investments.

– and directed through suppliers

As required by Finance Ministry regulations, these $99.5 mn in pesos were supplied not to Chrysler itself, but to the automaker's local suppliers, contractors and creditors. The purpose of this payment rule is to ensure that the funds are spent as promised on approved investments and not diverted into working capital or into speculative currency transactions. In practice, however, Mexican officials lacked the staff or budget to monitor this spending, and in effect had to accept the corporation's word that the funds were being spent in the manner authorised. A Chrysler finance executive commented: 'We were dealing with more than 200 suppliers and literally thousands of invoices. The volume of work was so great that they recognised that they simply didn't have the human resources to police an operation that size.'

In mid-1987, Chrysler was anticipating final approval of its second debt capitalisation operation, an approximately $10 mn transaction that will finance an in-bond auto interiors plant in Ciudad Juarez. Chrysler executives said the company will also try to use debt swap facilities to finance any future large investment projects in Mexico.

ANNEX 3: ILLUSTRATION OF A DEBT FOR EQUITY TRANSACTION (CHILE)

Source: World Bank, Debt Conversion - Chile, Memorandum to the Board, September 1986

ILLUSTRATION OF A DEBT FOR EQUITY TRANSACTION:

Debt Capitalization (Chapter XIX)

Parties Involved 1/

1) Foreign investor who has an investment opportunity in Chile and requires local currency at least equal to the amount of the debt transformation transaction.

2) Foreign broker who deals in LDC debt and has or can find a creditor who is willing to sell the debt at a discount.

3) Foreign creditor bank who either holds Chilean debt in portfolio or swaps other LDC debt for Chilean debt, and is willing to sell such debt at discount.

4) Chilean debtor who must be, as direct obligor, the Treasury, the Central Bank, a public sector entity, a bank or financial institution authorized to operate in Chile, or a private sector debtor whose debt was guaranteed by the government, a bank or financial institution prior to July 1, 1985, and is willing to accept redenomination of the foreign debt in local currency.

5) Chilean bank who is given an irrevocable mandate by the foreign investor to carry out the redenomination of the foreign debt, obtain local currency payment or a new local currency debt instrument, and carry out the investment.

1/ In the two examples given in this Annex, different and unrelated entities are assumed to play the role of each party to the transaction. Often, in practice, the same entity (including its affiliates) can perform more than one of the distinct functions and thereby increase its share of the gains from the transaction. For example, a foreign commercial bank that owns a bank in Chile which is active in the domestic financial market can fulfill the roles of the foreign agent, the foreign creditor bank, the Chilean bank and the Chilean agent. Or, in another example, a Chilean bank that is guarantor of the foreign debt of a corporate client in financial difficulty can take advantage of either Chapter XIX or Chapter XVIII to help with the financial restructuring of its client.

6) Chilean broker who acts as advisor to the investor and may handle the placement of the newly created local currency debt instrument.

7) Central Bank who authorizes each investment through debt conversion on a case-by-case basis. In practice, the principal criterion that determines the eligibility of a proposed investment is whether it represents new money that would not otherwise have been invested under the normal foreign investment code (DL-600).

Transaction Steps for Debt Capitalization (Chapter XIX)

Step 1: Foreign investor contacts the foreign broker to find an eligible Chilean foreign debt instrument available for prepayment at a discount. The foreign investor must use his own external funds to acquire the debt instrument. The foreign broker collects a fee of 1% (usually) for completed transactions.

Step 2: Once the foreign broker has located an appropriate debt instrument, the foreign investor obtains the agreement of the Chilean debtor to redenomination at face value of the external debt into local currency at the official exchange rate.

Step 3: Foreign investor applies to the Central Bank and obtains an authorization to make an investment in Chile with the local currency proceeds of the debt capitalization transaction. The application must identify all parties and describe the transaction in detail, and provide appropriate information on the proposed new investment. The foreign investor must also accept restrictions on the repatriation of profit (4 years) and capital (10 years), and, if deemed appropriate by the Central Bank, agree to waive the free repatriation provisions of DL-600 that govern other previous investments made by the investor. Furthermore, the Central Bank may require that some part of the investment be made in freely convertable foreign exchange.

Step 4: The foreign investor purchases a foreign debt obligation of (e.g.) US$100.00 from a foreign creditor bank through his foreign agent for (e.g.) US$70.00 and pays a commission of (e.g.) US$.70 (1%). The purchased note is delivered to the Chilean bank.

Step 5: The foreign investor gives an irrevocable mandate to the Chilean bank to (i) collect in cash the face value of the redenominated note or (ii) exchange it for a new debt instrument payable in local currency, UF (indexed units of exchange), or foreign currency payable in local currency at terms and conditions negotiated with the debtor. If the Central bank is the debtor on the local currency debt instrument, the terms are fixed by regulation, otherwise, domestic financial market conditions prevail. "Bearer" instruments may be used. The purchased note is delivered to the Chilean bank.

Step 6: The Chilean bank, with the prior agreement of the foreign creditor bank and the Chilean debtor, redenominates the debt in local currency equal to the face value of the foreign obligation converted at the official exchange rate (now Ps. 192) or for Ps. 19,200.00, leaving all other terms and conditions standing; thus, the foreign exchange obligation is transformed.

Step 7: The Chilean bank creates a new local currency debt instrument with the Chilean debtor as direct obligor payable to bearer and denominated (e.g.) in UF and payable, for example, over 15 years. The foreign debt instrument (now denominated in local currency) is cancelled and the new UF debt instrument is delivered to the Chilean broker.

Step 8: The Chilean broker places the UF debt instrument in the domestic financial market at (e.g.) 93 or Ps. 17,856 which is delivered to the Chilean bank with a mandate to disburse the funds directly for the acquisition of equity shares (or other approved form of investment). A commission of about 1% on the face value or Ps. 201.00 is deducted for transaction costs, leaving net proceeds of Ps. 17,655 for investment.

Step 9: The equity shares or other evidence of the investment are delivered to the foreign investor.

Financial Summary of the Debt Capitalization Transaction
(Valued in local currency at the parallel exchange rate)

Foreign creditor bank

-Holds debt obligation of US$100.00 which would have been paid at the official exchange rate. Local currency value:	Ps. 19,200
-Receives payment of US$70.00 which has a value at the parallel exchange rate of:	Ps. 14,070
-Discount valued in local currency:	Ps. 5,130
-Less Commission to foreign broker	201
-Value of the discount	Ps. 4,929

Distribution of Value of the Discount

Foreign Investor		
Paid to purchase debt:	Ps. 14,070	
Commission:	201	Ps. 14,271
Received for investment 1/		Ps. 17,655
Investor's net gain		Ps. 3,384
Domestic Broker commission		201
Domestic financial market discount		1,344
		Ps. 4,929

Foreign investor's effective exchange rate

Invests foreign exchange of US$70.70 which otherwise would have yielded:	Ps. 13,574.40
Official exchange rate:	192
Through debt capitalization actually received in local currency:	Ps. 17,655.00
Effective exchange rate	250

1/ See Step 8.

Source: Debt for Development Coalition, Inc.; April 1991

The Debt-for-Development Coalition, Inc.

What is Debt-for-Development?

Background

During the 1970s, many commercial banks lent heavily to Third World countries to finance a variety of projects. Developing countries have been forced to sacrifice internal economic growth and social programs to maintain these debt payments. In 1982, Mexico became the first major developing country unable to service its foreign debts. Subsequently, a number of other countries also became unable to meet their debt repayment requirements. Poor economic conditions have discouraged new foreign investment and development programs.

Over the past decade, numerous techniques have been proposed for reducing the debt burden of Third World countries. Among these techniques is the debt-for-equity conversion program. Initially, these programs were designed to reduce the external debt and encourage foreign direct investment on the part of international corporations and banks. The corporations would purchase the external debt of a country from a bank at less than its face value and "swap" the debt for ownership in a local company or other form of equity. Environmental conservation groups pioneered the use of debt conversions by not-for-profit organizations in 1987 by conducting "debt-for-nature swaps". Other "debt-for-development" transactions have since been employed to provide local currency funding for local educational, health, and social welfare projects.

The Financial Appeal of Debt-For-Development Swaps

The economic rationale for debt-equity or debt-for-development conversions is based on the ability to purchase the financial obligations of a developing country from a commercial bank at a discount. A not-for-profit or non-governmental organization (NGO) can purchase the debt and, by a prearranged agreement with the debtor government, agree to cancel the debt in exchange for receiving local currency. These proceeds are used to fund the NGO's development project. Depending on the country, swaps can generate between 5% and 200% in additional local currency for an NGO's project in comparison with a conventional foreign exchange transaction.

Debt-for-development transactions are appealing because all parties involved in the transaction can benefit, as follows:

- <u>The NGO</u> obtains local currency at a favorable rate because the debt was purchased at a significant discount in the secondary market and sold to the Central Bank or other obligor at a value higher than its purchase price. This financial gain will permit the NGO to leverage the resources it has available for development assistance.

- The debtor country has reduced its external debt servicing requirements and overall hard currency payments. The country's debt levels are reduced, enhancing their ability to service their remaining debt. The debt conversion program may also attract new development initiatives, particularly to countries that receive little foreign assistance.

- The commercial bank has received immediate partial repayment on its outstanding loans at a price it believes is equal to its market value. The reduction in the country's external debt may improve its ability to service any remaining debt held by commercial banks.

Necessary Preconditions

To execute a debt-for-development swap, several preconditions should exist:

- The country's external debt must be priced at a discount on the secondary market, and the debt must be available for purchase.

- Under the prevailing credit agreements and country laws and regulations, the debt must be eligible for conversion.

- The debtor government must be willing to convert the debt. Some countries only approve debt conversions on a case-by-case basis; others have formalized programs that indicate the government's requirements for conversion.

- An NGO must propose a development project that meets the country's criteria for debt conversion projects.

Steps in Conducting a Debt-For-Development Transaction

Step #1: Design of The Development Project Including Local Partners The NGO decides to conduct a new or expand an existing development project in a developing country. The NGO plans and designs this activity, perhaps in conjunction with a local NGO or affiliate. Some countries require that a local counterpart either be the beneficiary of the swap proceeds or actually undertake the swap transaction. Accordingly, an agreement covering programmatic and financial concerns should be reached between the NGO and its local partner prior to applying for the debt conversion. Several considerations are important:

- A cost-benefit analysis of the proposed transaction should be completed by the NGO. As debt swaps may be time-consuming, the NGO should undertake a thorough assessment of the benefits, costs and potential risks.

- The NGO should obtain the support of its board and staff for use of this financing mechanism. Debt conversions are new financing tools for most NGOs, so the board and senior staff should be educated about the technique and approve of its use.

- The NGO should evaluate in-country sensitivities and project partners. Debt conversions often involve a local NGO counterpart and require close cooperation. Areas of responsibility and capabilities should be determined.

- Adequate funding must be available to finance the project. Prospective donors may require education regarding the costs and benefits of debt conversions.

Step #2: Designing the Financial Structure of the Transaction: A budget should be developed along with potential funding sources. The cost and benefits of completing a debt-for-development swap should be assessed including such issues as the type of proceeds to be received from the Central Bank (cash, bonds, land, etc.), the exchange rate applied to the debt conversion, the percent of face value to be redeemed by the government, any taxes or commissions applicable to the transaction, and inflation-protection measures. Associated fund-raising activities should be conducted. AID debt-for-development policy permits eligible NGOs with prior approval to use AID funds to purchase debt to finance AID-approved development projects and programs.

Step #3: Obtaining Government Approval The debtor government generally requires that the NGO and its local counterpart submit for review or approval an application outlining the project to be funded. The application review process is usually managed by the Central Bank and appropriate sector agencies. While the terms of the debt conversion are outlined in formal guidelines in most cases, some governments prefer to negotiate the terms ad hoc during the application process.

Step #4: Executing The Debt-For-Development Conversion Once the NGO has received written approval from the government, the transaction can be "closed". The NGO will normally purchase the debt from a secondary market participant (commercial bank, investment bank, or debt trading "boutique"). Once the NGO has title to the debt (which must be considered eligible for conversion by the government and its creditors), it can present the financial instrument to the government. In exchange for canceling the debt, the government will provide the NGO with local currency proceeds, usually in the form of cash or a bond.

Step #5: Managing the Swap Proceeds Typically, the NGO or its local counterpart will need to prepare reports for the government on the use of the proceeds. If the NGO was the recipient of local currency bonds, the NGO may be permitted to sell these instruments in the local secondary market to obtain funds for the project. In other cases, the NGO may be involved in creating trust funds to finance ongoing activities. At this stage, it is important that the NGO undertake measures to protect the funds against the effects of inflation.

Costs and Risks of Debt Conversions

Debt-for-development swaps are not without costs and risks. Among the costs are the price of the debt, the fees paid for legal and technical assistance, and fees paid to financial advisors. In addition, the transaction may require considerable staff time, costs involved in negotiating program agreements, auditing and reporting fees, and costs for implementing and managing the funds.

The risks could include delays in application approval or execution of the transaction, changes in government or applicable laws and regulations, rising secondary debt prices, decline in local currency proceeds received due to changes in exchange rates or percentages of face value received, and inability of the government to deliver local currency. Once the proceeds are received, the NGO may experience a loss in value due to high inflation, currency devaluations or local taxation.

A Sample Transaction

A U.S. NGO decides to commence a new development project in Country X. The NGO estimates that under a traditional currency exchange, the project would require an investment of US $ 1 million. The current price of Country X's debt on the secondary market is $0.40 per $1.00 of face value. The NGO spends $600,000 to purchase debt eligible for conversion with a face value of US $1.5 million. The NGO presents the eligible debt to the Central Bank which discounts the face value of the bond by 33 %. The Central Bank issues local currency bonds which are equivalent to US $ 1,000,000 (using the current free market exchange rate).

In addition, the NGO is required to spend $45,000 on transaction costs and taxes. Accordingly, the NGO has spent $645,000 to obtain the local currency equivalent of US $1.0 million. The NGO has been able to leverage its funds and generate a 55 % financial gain from using a debt-for-development swap rather than utilizing a conventional foreign exchange transaction.

The Debt-for-Development Coalition (DDC) is a not-for-profit organization that provides general informational services regarding debt-for-development opportunities free of charge. DDC will provide technical assistance to NGOs in conducting debt conversions for a fee. For additional information, contact:

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The Debt-for-Development Coalition, Inc.
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Phone (202)467-0881 FAX (202)467-4093

April 18, 1991

Source: World Bank, Debt Conversion - Chile, Memorandum to the Board, September 1986

ILLUSTRATION OF A DEBT FOR CASH TRANSACTION:

Debt Conversion (Chapter XVIII)

Parties Involved

1. Chilean investor who wishes to take an internal profit on the discount available in the international market for Chilean foreign debt obligations (or to convert his own debt at a discounted value). The Central bank, state-owned entities, and Chilean banks are prohibited from doing these transactions for their own account, as are individuals with a significant financial interest in Chilean banks unless they receive prior Central bank approval.

2. Foreign broker who deals in LDC debt and has or can find a creditor willing to sell the debt at a discount.

3. Foreign creditor bank who either holds Chilean debt in portfolio or swaps other LDC debt for Chilean debt, and is willing to sell such debt at discount.

4. Chilean debtor who is the direct obligor, either as a private sector or a public sector borrower, on a foreign debt instrument payable abroad for an original or extended term of over 365 days, and registered as required by appropriate regulations.

5. Chilean bank who is willing to accept an irrevocable mandate from the Chilean investor to carry out the redenomination of the foreign debt and obtain local currency payment or a new local currency debt instrument.

6. Chilean broker who acts as advisor to the investor and handles the placement of the newly created local currency debt instrument.

7. The Central Bank who auctions to banks the right to intermediate the conversion of a foreign debt obligation to a local currency obligation. Currently the Central Bank holds bimonthly auctions and limits the total amount of rights granted to a total of US$60 million per month of the discounted value of foreign debt obligations.

Transaction Steps for Debt Conversion

Step 1: The Chilean investor contacts the foreign broker to find an eligible Chilean foreign debt investment available for prepayment at a discount.

Step 2: Once the foreign broker has located an appropriate debt investment, the Chilean investor obtains the agreement of the Chilean debtor to redenomination at face value of the external debt into local currency at the official exchange rate.

Step 3: The Chilean investor gives an irrevocable mandate to the Chilean bank to (i) collect in cash the face value of the redenominated note or (ii) to exchange it for a new debt investment payable in local currency, UF (indexed units of exchange), or indexed foreign currency payable in local currency at terms and conditions negotiated with the debtor. If the Central Bank is the debtor on the new local currency debt instrument, the terms are fixed by regulation, otherwise, domestic financial market conditions prevail. "Bearer" instruments may be used.

Step 4: The Chilean bank submits a sealed bid to the Central Bank which sets forth the total face value in foreign currency to be paid to acquire the foreign debt instrument for the Chilean investor (e.g) US$70.00 and the price (i.e. commission as a percent of the acquisition cost) that he is willing to pay to the Central Bank for authorization to convert the debt to local currency, (e.g.) 15%.

Step 5: The Central bank selects sufficient bids beginning with the highest offered price (commission) and taking the next lowest bids until the total amount preallocated to the auctions is fully utilized, and then notifies the corresponding Chilean banks. These rights may be transferred to other banks. The Central bank debits the account of the Chilean bank for the commission of Ps. 2,110.50 (15% of the authorized amount) and a value added tax on the commission of Ps. 422.10 (20%).

Step 6: The Chilean investor purchases the foreign debt obligation of (e.g.) US$100.00 from a foreign creditor bank through his foreign broker for (e.g.) US$70.00 and pays a commission of (e.g.) US$0.70 (1%). The purchased note must be delivered to the Chilean bank.

Step 7: The Chilean bank, with the prior agreement of the foreign creditor bank and the Chilean debtor, redenominates the debt in local currency equal to the face value of the foreign obligation converted at the official exchange rate (now Ps. 192) or for Ps. 19,200.00, leaving all other terms and conditions standing; thus, the foreign exchange obligation is transformed.

Step 8: The Chilean bank creates a new local currency debt instrument with the Chilean debtor as direct obligor payable to bearer and denominated (e.g.) in UF and payable, for example, over 15 years. The foreign debt instrument (now denominated in local currency) is cancelled and the new UF debt instrument is delivered to the Chilean broker.

Step 9: The Chilean broker places the UF debt instrument in the domestic financial market at (e.g.) 93 or Ps. 17,856 which is delivered to the Chilean bank for disbursement to the Chilean investor. A commission of about 1% on the face value or Ps. 201.00 is deducted for transaction costs, leaving net proceeds of Ps. 17,655.

Step 10: The Chilean bank reimburses itself for the commission paid to the Central Bank (Ps. 2,110.50) and the value added tax (Ps. 422.10) and pays the Chilean investor the balance of Ps. 15,122.40.

Financial Summary of the Debt Conversion Transaction
(Valued in local currency at the parallel exchange rate)

Foreign Creditor bank

-Holds debt obligation of US$100.00 which would have been paid at the official exchange rate. Local currency value:		Ps. 19,200
-Receives payment of US$70.00 which has a value at the parallel exchange rate of:		Ps. 14,070
-Discount valued in local currency:		Ps. 5,130
-Less Commission to foreign broker		201
-Value of discount		Ps. 4,929

Distribution of Value of Discount

Chilean investor		
Paid to purchase debt	Ps. 14,070	
Plus commission	Ps. 201	Ps. 14,271.00
Net local currency received 1/		Ps. 15.122.40
Net gain for Chilean investor		851.40
Central bank commission		Ps. 2,110.50
Domestic broker commission		201.00
Government value added tax		422.10
Domestic financial market discount		1,344.00
		Ps. 4,929.00

1/ See Steps 9 and 10.

Source: Presentation by Ann Rennie; Vice President, Chase Investment Bank, Ltd.

DEBT FOR EXPORT SWAPS

I. Conceptual Basis

- Debt-for-export swaps enable foreign purchasers of a country's exports to pay all or a portion of the purchase price in external debt.

Advantages

To the debtor country:

1) Reduction in external debt and associated debt service.

2) Promotion and diversification of exports.

3) Provided that:

   a) The portion of the export price payable in cash exceeds the import content of the product, and

   b) Exports are indeed incremental,
   The Central Bank increases its foreign exchange receipts.

4) Immediate pay-off to country and creditor versus longer-term benefits of debt/equity conversions.

II. The Peruvian debt-for-export program and Chase's experience in Peru

Background:

Strained relations between Peru and creditors:

- Unilateral 10% ceiling on debt service announced by President Garcia (actually under 10%).

- Savings to be utilized to stimulate domestic economy, resulting in sharp increase in demand for imports, decline in exports, depletion of FX reserves, suspension of trade lines, etc. Inflation of 1780% in 1988.

Types of Peruvian commercial bank debt:

1) <u>Medium-term syndicated</u>

- several restructuring agreements,
- no payments since 1985

2) <u>Working Capital loans</u>

- Originally short-term loans to commercial banks for on-lending to customers for trade and working capital financing.
- Unilaterally rescheduled by Peru in 1983. Principal amounts frozen, but interest kept current until recently, when interest payments suspended <u>except</u> to banks who have signed debt-for-export agreements.
- Since 1983, commercial banks in Peru have been able to either:

  a) keep local currency deposits at Central Bank, with Central Bank assuming external obligation and FX risk.

  b) Re-lend foreign currency denominated loans for working capital to Peruvian customers. Bank (and their customers) responsible for FX risk and interest payments.

- Generally single non-syndicated bank agreements.

3) Trade debt granted since 1983.

These lines have generally been kept current.

Peru had borrowed extensively in the past from the Soviet Union and Eastern European countries, which have historically been active in countertrade. In 1983, Peru entered into several multi-million dollar debt-for-export agreements with the Soviet Union, Czechoslovakia, East Germany and Hungary. These involved one-for-one swaps, utilizing Peru's traditional exports. Such agreements did nothing to help Peru's foreign exchange position.

- The first debt-for-export agreements with commercial bank creditors were signed in 1987 with First Interstate, Midland and Chase Manhattan, covering amounts of $42 million, $22 million and $90 million respectively. These agreements were on terms considerably more favorable to the government of Peru than earlier agreements with Eastern block creditors. These three agreements, along with a much smaller one for the Banco de Bogota, are to my knowledge the only such agreements signed to date, though others are under negotiation. All three carry similar terms, though I will restrict my remarks to Chase's agreement, the broad lines of which are as follows:

  1) Only working capital loans are eligible, as these are single creditor agreements not covered by a formal restructuring. Debt-for-export would not be allowed under the terms of restructuring agreements covering the medium-term syndicated bank debt, as they would violate various terms of the agreements (sharing, negative pledge, pari-passu). The working capital loans total approximately $800 million of a total $15 Billion in external debt.

     The $90 million agreement signed between Chase and the Peruvian government covers the bank's total working capital exposure. This agreement has been formalized into law in Peru.

  2) The agreement of understanding includes a list of products and amounts of product eligible for export under the agreement. Chase Trade, the trading arm of the bank, proposed the goods, and the list was subsequently negotiated and agreed to by the Instituto de Comercio Exterior, or Ministry of Foreign Trade.

     The list of products includes primarily non-traditional exports such as automotive parts, textiles, metal alloys, gold and silver jewelry, frozen fish, and chemicals.

     The agreement requires Chase to pay $2 in cash for every $3 of goods. It also calls for Chase to provide fresh trade credit to Peru in an amount equal to one-third of the debt effectively retired.

3) Following the signing of the agreement of understanding, Chase is to sign yearly technical banking agreements.

Our agreement for 1989 covers $45 million in exports ($15 million in debt retirement and $30 million in cash). This agreement sets out the mechanics of the transactions, which are fairly straightforward i.e.

a) The importer's bank opens a sight L/C in favor of the Peruvian exporter for, i.e., $900,000 covering the FOB price of a scheduled shipment. Chase is always the advising and paying bank under the L/C, or presenting bank under documentary collections. Chase will not issue an L/C until we have evidence that the local currency equivalent of the $300,000 redeemable in debt is available on deposit at the Reserve Bank of Peru.

b) The advising/confirming bank in Peru is the original obligor under Chase's working capital loans.

c) Reimbursement to the Peruvian Bank is as follows: Chase remits an amortization notice for one-third of the FOB value, or $300,000, and pays the remainder, $600,000, in cash.

d) The Peruvian bank presents the amortization notice to the Central Reserve Bank. The bank draws on the special account of the Peruvian debtor bank maintained to cover working capital debt, and delivers the funds corresponding to the amortization notice to the Peruvian bank.

e) The Peruvian Bank combines funds received from the Central Bank with the balance paid in dollars by Chase to pay the exporter.

f) The working capital debt of the Peruvian bank is retired in the amount of the amortization notice.

III. Benefits and Drawbacks of debt-for-export programs from the point of view of debtor and creditor.

1. From the point of view of the creditor banks, the major attraction is that it provides a means to recover loans in a relatively short period of time. In the case of Peru, the recovery is substantially higher than could be obtained through a cash sale of the asset.

   On the other hand, there is a significant amount of work involved in executing these transactions, and only a handful of banks have both the expertise and inclination to undertake the task.

   Chase Trade, for example, called on 187 exporters in Peru, and subsequently contacted many importers, end-users, and distributors. Eighteen months elapsed between our initial approach to the Peruvian government and the first shipment of goods. For First Interstate, I understand the period exceeded 2 1/2 years. First Interstate and Midland have signed contracts with Peruvian trading companies who identify markets and provide assistance, whereas Chase works through its own trading company.

2. Do debt-for-export swaps promote incremental exports (which is indeed what is desired), or do they merely represent a subsidy for trading companies and reduce foreign exchange inflows?

   Our experience to date indicates that they do, in fact, increase exports. For example, in Peru, Chase identified a company which had previously manufactured ceramic tiles entirely for the domestic market. Due to a decline in domestic demand, the company now has excess capacity. Chase Trade put together a marketing strategy for the company, which included adaptations of color and design, and found two distributors for the company in the U.S. It is estimated that the company will export $1 million in tiles in the first year. Clearly, a major bank like Chase has access to a very large customer base throughout the world representing potential buyers. Market identification is the key element to the success of debt-for-export swaps.

   In order to ensure additionality, there is a temptation for countries to wish to restrict eligible exports to so-called "non-traditional" exports. I believe that "incremental" is a far more useful distinction.

Again in Peru, Chase has been authorized to export cotton under the program, though this is one of Peru's traditional exports. Because of recession in the local market, however, local demand for cotton has decreased sharply, creating an unexpected and temporary excess supply. Chase has identified buyers, and is now arranging for the export of the cotton.

In addition to situations of temporary oversupply, a country may wish to enter new markets or increase market share in a traditional export, and can use these programs to do so. Finally, some products do not fall clearly into the traditional / non-traditional category. An LDC for whom coffee is a traditional export may nonetheless wish to make non-quota coffee eligible. A metal producer might wish to include metal alloys.

Finally, in determining eligible exports, it is important not to be overly restrictive. If faced with a list of products which are exceedingly difficult to sell, banks and / or trading companies will not be willing to spend the time, money and energy required to make a success of such programs. We believe that requiring a combination of non-traditional and more traditional goods maximizes the potential for such programs.

3. Some theorists object that allowing debt-for-export swaps does not make economic sense as it helps inefficient exporters and violates free market principles.

Based strictly on economic theory, there is some validity to this point. However, the same can be said of any number of policies intended to promote exports or investments, e.g. tax holidays, export credit agencies, preferential interest rates or credit allocations for certain sectors, etc. While it is probably safe to say that it does not make economic sense to allow debt-for-export swaps indefinitely, it is also clear that it does make sense - both politically and economically - under certain curcumstances and for finite periods of time.

As in the example of cotton in Peru mentioned previously, there may be a temporary oversupply of goods which a country is unable to sell. On the other hand, the oversupply could be longer-term, but the country may be dependent on revenues of a given product and require time to diversify its export base. Under these circumstances, the debtor could use debt-for-exports both to sell its traditional goods more efficiently and diversify exports without social and political upheaval.

Moreover, many LDC's are operating at a disadvantage vis-a-vis competitor countries. Poor infrastructure, perceived unreliability of delivery and quality, overvalued exchange rates, etc. may make it difficult for exporters to compete, and debt-for-export programs can help exporters overcome some of these disadvantages.

Finally, it should be noted that Peru's agreement with Chase includes an anti-dumping clause, which stipulates that Peruvian goods be sold at would market prices.

4. Relations with Creditor Banks

As many of you are well aware, poor relations with creditor banks and the disappearance of normal channels of credit make it exceedingly difficult to expand economic development and trade.

Debt-for-export possibilities can improve relationships, as they offer creditors an additional option for recovering loans. Furthermore the active involvement of these creditors in export promotion and diversification tends to keep traditional banking relationships alive. Finally, in the case of Peru, the extension of ongoing trade credits and / or investment is a condition of existing debt-for-exports agreements. It is important however, to allow creditors to decrease their exposure over time, as most commercial banks consider such reduction a key objective. In the case of Peru, new investments and / or trade lines are extended only after retirement of existing debt and only for one-third of the amount of debt retired. Finally, in Peru, this commitment exists only for the period covered by existing one-year technical banking agreement, and Peru keeps these new trade lines current.

IV. Applicability of debt-for-exports swaps in Africa

Debt-for-exports is, I believe, particularly well-suited to many African countries for several reasons:

1) Over-reliance on exports of one or two primary commodities for foreign exchange revenues is arguably the greatest weakness of many African economies. Many of these commodities are subject to extreme price volatility. The terms of trade for countries reliant on commodity exports has in many instances declined sharply over the past decade. It is therefore critical for these countries to diversify their export base. Debt-for-exports can assist such efforts, while simultaneously reducing the external debt burden.

2) As mentioned above, in light of the inadaquacy of infrastructure in many African countries, manufacturers and / or exporters must often spend large sums providing the basic infrastructure their competitors in more developed countries take for granted.

The resulting increased production costs, coupled with perceived or real lack of reliability in terms of delivery or quality put the country at a competitive disadvantage which can be offset by debt-for-export swaps.

3) Lack of foreign exchange to import spare parts and raw materials, limited access to credit markets, inability to remit dividends, and political instability have discouraged private direct investment, both foreign and domestic.

By increasing potential returns, these programs can provide financial incentives to invest in export industries.

There can be interesting possibilities for debt/equity swaps in conjunction with debt-for-exports. A coffee-exporting country could, for example allow an investor to utilize a debt/equity swap to finance a coffee roasting plant, and, as an additional incentive, allow the plant to utilize debt-for-export swaps for a specified period to establish markets and increase yields. Spinning mills (for cotton exporters), canning plants (for exporters of fruits and vegetables), and smelters to make metal concentrates are all examples of value-added investments where debt-for-equity and debt-for-exports can be used synergistically.

4) Many African countries have overvalued currencies, and have legally or de-facto a two-tier foreign exchange rate. Because there is often a relatively high import content to exports, the resulting breakeven cost of production may exceed the world market price for an exported good. An economist from the IMF may quite reasonably maintain that the country should devalue its currency. If, however, a political decision has been taken not to do so, or to do so only gradually, debt-for-exports can resolve the problem in the short run. Let's take the following example:

Assume the following conditions prevail in country X:

- Official FX rate: 6 pesos / $.

- Cost of producing a widgit in country X:. 950 pesos.

- Price of widgit in the international market: $150.

- Price of country X's external debt in the secondary market: .35.

  According to the foreign exchange regulations of country X, the exporter must remit the $150 from the sale of the widgit to the Central Bank and receives 900 pesos in local currency, (6 x 150). Obviously, he will not export under these circumstances.

  Now assume that country X adopts a debt-for-export program, allowing creditors to pay for widgits (an incremental export) with a 50/50 combination of cash and debt. Chase Trade agrees to pay the exporter 1050 pesos for his widgits, and to find markets for them. Chase Trade sells the widgits for $150, and pays $75 in cash and $75 in debt to the Central Bank. The Central Bank then remits 900 pesos to the exporter. Chase Trade remits the remaining 150 pesos ($25) to the exporter.

The benefits are as follows:

- The manufacturer, who was not previously exporting, is now exporting widgits and making a profit of 100 pesos per widgit.

- The Central Bank has reduced its external debt by $75, and receives incremental foreign exchange of $100 per widgit sold (75 + 25).

- Chase has reduced its exposure by $75, and recovered $50 (less expenses incurred), or 67% of face value ($75 in cash retained on the sale of the widgit less $25 "subsidy" paid to the exporter).

5) Many companies which produce goods for the local market are operating at low capacity, and have the potential to export. For example, an oil exporting country can sell crude for cash and therefore has no interest in selling oil for debt. However, they may have a refinery operating well below capacity because domestic consumption is below the capacity of the refinery. Because of perceptions of risk in terms of delivery or quality, the refinery may not have been able to develop export markets for its refined products. By enabling creditors to buy these products with a combination of debt and cash, however, they may be able to export refined products, thus accomplishing the following objectives:

- Increasing foreign exchange receipts.
- Adding value to primary commodity exports.
- Increasing capacity utilization, thereby lowering production costs for local refined products.
- Reducing external debt.

I think the above examples illustrate that a strong case can be made, for selectively allowing debt-for-export swaps. It can prove a useful tool both for debt reduction and for promoting export expansion and diversification, and would be a welcome addition to the "menu of options" approach increasingly being adopted by LDC's and their creditors. Indebted countries and banks should bear this in mind in negotioting flexible restructuring agreements which allow such transactions to take place.

Source: Discussions with World Bank Staff

Argentina: Debt Swaps for Debt Reduction and Privatization

Introduction

During the ten year period 1979-88, Argentina had a poor economic performance. In 1980 GDP per capita started a steep decline that resulted in an accumulated fall of 23.5% and the price level increased at an annual compound rate of 349% during the decade. Argentina's external debt was approximately US$62 billion before recent privatizations, about 85% of GDP. In 1990 interest accrued on external debt amounted to over one-fourth of expenditures of the non-financial public sector representing nearly 8% of GDP. Approximately US$38 billion was commercial bank debt, US$6 billion of which was short-term trade lines. Argentina suspended regular payments on term obligations to commercial banks in April 1988, and had accumulated arrears over US$6 billion by June 1990.

The Government's medium-term objective is to regularize relations with foreign commercial banks on the basis of debt reduction. To this end, the authorities in June 1990 resumed partial payments to commercial banks and have had several subsequent meetings with them. In this connection, the process of debt reduction through swaps became central to normalizing relationships with commercial bank creditors and establishing a sustainable non-inflationary fiscal position. The Government has accelerated the timetable for privatization or partial divestiture, with the objective of reducing the budgetary burden for the enterprises on the Treasury, making the firms more competitive, and increasing the volume and efficiency of new investment. The Government has already sold two television stations, Aerolineas Argentinas and 60% of ENTel. It recently announced a restructuring of the nation's railways, and it plans to divest the largest distributor of electricity, ports, maritime transport, reinsurance and the entire power sector.

Privatization of ENTel and Aerolineas Argentinas

Among a number of privatization transactions, ENTel and Aerolineas Argentinas deserve looking into in detail because of the magnitudes and impacts on debt reduction. The former is Argentina's mammoth, antiquated telephone monopoly and the latter the nation's airliner. The telephone company deal was concluded on November 8, 1990 through which the Government obtained US$214 million in cash and reduced commercial bank debt of US$5,028 million in face value. In addition, new investors committed some US$5 billion in capital improvements over the next ten years. The airliner deal was concluded on November 20, 1990 and the Government received US$260 million in capital, half up-front and the remainder over 5-years and debt reduction of US$2,010 million in face value, as well as a commitment of US$700 million in capital improvement over a seven-year period. As a result of these two transactions, over US$7 billion in face value of Argentine commercial bank debt, representing about 20% of the total commercial bank debt outstanding was reduced.

In order to privatize the telephone company, most of its assets were divided into two newly-created regional enterprises Telco North and Telco South. In each of these enterprises, a controlling 60% equity share was offered to an operating company led by an experienced foreign telecommunication firm. Workers were allowed to receive 10% of the new companies through an employee stock ownership plan. Another 5% was offered to local cooperatives linked to the ENTel network. The remaining 25% was earmarked for public offering sales on the local stock market.

A two-stage process was used to select operator groups for the two telephone companies. In the first stage, potential bidders prequalified on the basis of their current operating capacity and efficiency as well as their financial positions. In the second stage, prequalified consortia submitted bids which were evaluated solely on the basis of price. Bids for controlling equity stakes in the two telephone companies were offered in two parts; (i) a common "base price" in cash U.S. dollars, which all bidders were required to pay; (ii) an "additional price" in Argentine external sovereign debt, which differed among the bidders and hence was used to determine the winners. The Government set the amount of the base cash payment and specified the exact types of Argentine external debt eligible for inclusion in the additional payment. Both principal value and accrued interest were considered on an equal basis in determining the size of the payment.

Unlike previous debt swaps in Argentina, it was the amount of debt being offered, as opposed to the discount from face value, which was the basis for comparison in the ENTel privatization. In this case, the discount was implicit (based on whatever total valuation each bidder assigned to the equity share being sold), and the explicit selection criterion was the quantity of debt being offered.

Following the above procedures, ENTel's bigger southern enterprise was taken over by Telephonica de Espana and Citicorp. The control of ENTel's northern half was acquired by the consortium led by J.P. Morgan and a French telephone company. Other major investors include the Banco Rio-managed privatization fund backed by Bank of Tokyo, Midland Bank, and IFC. Under similar procedures, 80% of the share of Aerolineas Argentinas was sold to Iberia and the rest to its own employees. Following the two major transactions, some other enterprises also have been or are slated for divestiture in sales partially financed through debt swaps.

ANNEX 8: PRIVATIZATION SWAPS

Source: Case Study; The Honduras Privatization Program; Center for Privatization; January 1990

PRIVATIZATION SWAPS CAN BE A MAJOR DRIVING FORCE BEHIND A SUCCESSFUL PRIVATIZATION PROGRAM

Early in the Honduras privatization program, the Government considered the introduction of a debt-for-asset swap mechanism as a means of payment for privatized assets. USAID/Tegucigalpa staff and the TWG[1] reviewed the possibility of debt for asset swaps with the government and concluded that the introduction of these swaps linked to the privatization program would be prudent and beneficial. They noted that no monetary creation would be involved as a public sector asset would be exchanged for public sector debt, contrary to a debt-for-equity swap which involves a cash payment (or its equivalent) by the government to pay for the purchase of a private sector asset in exchange for public sector debt. A second unique feature of a debt-for-asset swap linked to privatization is that the priority criteria of the country's economic managers are automatically met when the companies in question are included in the privatization program. Debt-for-equity programs commonly include special reviews of the proposed investment to determine that it meets the country's priority criteria. This would be redundant in the case of a privatization debt-for-asset swap.

Given these considerations, the government agreed with these perceptions and supported the appropriate legislation. In December 1988, the Congress issued Decree No. 149-88 establishing a formal debt-equity program and the following clause was incorporated, exempting debt-for-asset swaps involving privatization:

> All operations involving the exchange of debt for assets of CONADI[2] and other government entities are excluded from this legislation, when such operations are carried out within the privatization process.

The effect of this clause in the debt-equity legislation was to grant CONADI (as well as other state entities) the right to accept cancelled foreign debt of state entities as payment for the sale of its assets without having the buyer go through the uncertain approval process of the formal debt-equity program. To further reduce the uncertainty inherent in debt swaps with regard to the final effective cost to the investor of his bid, CONADI introduced, with the encouragement of the TWG, a fixed schedule of foreign debt values as a function of the quoted market value of the debt, as follows:

[1] A Technical Working Group (TWG) was established and financed by USAID under the Honduras Privatization Project. The TWG was staffed with long-term resident consultants and domestic personnel.

[2] Corporacion Nacional de Inversiones (National Investment Corporation)

Market Value of the Debt[3]	Percentage of face value recognized in local currency
60-100	100
55	96
50	92
45	88
40	83
35	80
30	75
25	71
20	67
15	58
5	54

As an illustration of the use of the above schedule, if Honduras debt is quoted at $0.30 at the time of the transaction, the buyer would be credited for 75% of the face value of the foreign debt converted at the official rate of Lps. 2.00: $1.00. In other words, he would receive Lps.1.50 per $1.00 of face value, regardless of the actual buying price he was able to negotiate with the selling bank or intermediary.

Debt-for-asset swaps have accounted for over 80% of the total recovered value of CONADI assets sold. The first seven operations involving debt-for-asset swaps produced a reduction in foreign debt obligations of US$24 million (US$18 million in principal and US$6 million in interest). Most of the privatization transactions processed in the near future are also expected to be completed through debt-for-asset swaps, with the possible exception of sales of the smallest companies and incidental assets. The next seven privatization operations, which are at an advanced stage of processing, will produce a reduction in foreign debt of an additional $74 million ($54 million in principal and $19 million in interest). In the process, CONADI's legal department and the TWG have learned how to deal with the complex legal issues involved in putting together appropriate packages of debt.

A comparison of the Honduras privatization debt-for-asset swap with the Honduras debt-for-equity swap formal program follows:

Debt-for-Equity Program	Privatization Debt-for-Asset Swap
Application with full documentation.	No special application required.
Recommendation of the Special Commission For Foreign Debt Conversion.	Not required.
Approval of Secretary of Treasury & Public Credit and the Central Bank	Not required.
Each investment subject to case-by-case approval based on priority of economic activity.	No restriction on investment activity as long as it falls within the privatization program.

[3]The market value is determined monthly by taking account of quotations provided by at least three international banking institutions.

The "internal discount" rate (the percentage of the face value of the foreign debt upon which the equivalent local currency payment is calculated) is negotiated in each case.	The "internal discount" rate is based on a published sliding scale.
The investor receives long-term government bonds, which have to be discounted in the market to get the local currency to make the approved investment.	The investor receives a full credit toward the purchase of the privatized asset at the published "internal discount" rate.

The privatization debt-for-asset payment mechanism described above has produced some highly desireable results:

- Investors can anticipate with reasonable certainty the value in real terms of their bid price at the time of closing.

- All investors are treated equally in the exchange of debt for assets and transparency of the privatization process is enhanced.

- Competition among investors for the same assets to be paid for with debt serves to drive up the bid price in real terms without reducing the share of the international market discount accruing to the public sector seller.

- Competition is enhanced as both local and foreign investors are eligible to utilize the debt for asset swap payment mechanism.

- The greatly streamlined approval process avoids unnecessary delay in closing privatization operations.

The Honduras privatization debt-for-asset swap is indeed a well-conceived payment mechanism, in-as-much as it largely eliminates the uncertainties that investors face in debt for equity programs in pricing their investment cost in real terms, while simultaneously preserving the debtor country's ability to take maximum advantage of the discounted market value of their foreign debt. The use of debt-swaps also substantially resolves the issue of differing price perceptions between public sector sellers and private sector buyers. It is not surprising that public sector sellers tend to overvalue assets to be privatized in setting and asking price and that private sector buyers tend to undervalue the assets in formulating a bid price, and Honduras is no exception. The pricing process in the Honduras privatization program is further complicated by the enormous distortion between the official exchange rate and the "free" market exchange rate (Lps.2.00 vs. Lps.3.40:$1.00). The debt for asset swap helps overcome these discrepancies. An illustration follows of how debt-for-asset swaps help overcome the problem of price perceptions, assuming that the market quote of Honduras debt is $0.30 per $1.00 of debt which gives an internal conversion factor of 75%:

-- CONADI's asking price is set at Lps.100.00.

-- An investor (and competing investors) perceive the market value to be about Lps.50.00, which he views as worth $15.00 in real terms (at the "free" exchange rate).

-- Planning to use the debt-for-asset payment mechanism, the investor places a bid of Lps.75.00 ($15.00 buys $50.00 face value of debt which for payment purposes is converted at the official rate of Lps.2.00 for 75% of face value, or Lps.75.00). For purposes of illustration, this is the winning bid.

-- On closing the sale, CONADI writes down its foreign liabilities by Lps.100.00 (foreign debt is carried at the official exchange rate) and writes down the corresponding asset by Lps.100.00, which was its asking price (note that any further difference between the asking price and the book value carried by CONADI has to be absorbed as a loss).

-- The investor is out-of-pocket the amount he perceived to be the market value in real terms (US$15.00).

-- CONADI received its asking price of Lps.100.00 ($50 at the official rate).

-- Honduras' public sector foreign debt is reduced by $50.00, which if the "free" exchange rate is a valid indicator of currency value, is worth Lps.170.00.

-- In contrast, had the investor placed a cash bid, he would likely have bid Lps.50.00 (worth $15.00, his perception of the value in real terms at the "free" exchange rate of Lps.3.40).

-- The foreign commercial bank which sold its loan at a discount would have to record a loss of $35.00, equivalent to Lps.120.00 in real terms or the difference between the real gain to Honduras through the debt-for-asset swap (Lps.170.00) and the probable selling price through a cash payment (Lps.50.00).

It can be seen by this example that the quoted discount on Honduras' foreign debt in the international marketplace is transformed into a real gain for Honduras, while the investor purchases the asset at a realistic value in real terms.

Source: USAID; Project Paper

DOMINICAN REPUBLIC DEBT CONVERSION PROJECT

II. PROPOSED PROJECT DESCRIPTION

A. Goal and Purpose

The Project's goal is to promote economic stabilization in the Dominican Republic. The purpose of the Project is to increase U.S. and domestic private sector equity investment in the Dominican Republic. The project will, as a result, stimulate new employment and encourage the privatization of GODR-owned assets.

At the end of this three year project the following will have occurred:

- Create US$500 million in new investment by foreign and local investors;
- Reduce and manage the external GODR debt burden with foreign commercial banks by US$350 million thereby saving scare foreign exchange and;
- Identify and promote the privatization of GODR owned assets and services, thereby decreasing the cost burden of the GODR; and
- Generate new employment for an estimated 4,500 Dominicans.

B. Project Components

1. Institutional Strengthening

The objective of this component is to provide the Central Bank's Division of External Debt with the capability necessary to support the development and implementation of the debt conversion system and to assure that the transfer of knowledge which is required to implement and maintain the mechanism. The Grant will be used to finance an institutional contract for the provision of technical assistance and training to undertake specific tasks leading to the accomplishment of the Project's objectives. The services will be provided by the contractor on a long and short-term basis. The nature and scope of long-term and short-term technical assistance required for the Project will be examined during the intensive review.

a. Technical Services

In order to establish and support a comprehensive system to convert foreign debt the Division of External Debt, Office of Debt Conversion will require assistance in a variety of tasks. Those tasks include; asset valuations and assessment; program accounting and financial services; management information system development; and banking liaison and institutional coordination.

During the intensive review, the functions which the Central Bank will have to perform to operate the debt/equity conversion program will be specifically defined. At present, in order to establish and support a comprehensive system to convert foreign debt, the Central Bank will require assistance in a variety of functions. They inclue: 1) asset valuations and assessment, 2) program accounting and financial services, 3) management information system development, 4) banking liaison and institutional coordinating, and 5) program promotion.

a.1 Asset Valuation and Assessment

One of the Project's objectives is to encourage the privatization of state-owned assets utilizing the conversion mechanism to encourage investor participation. However, it is frequently a difficult task to fairly appraise assets held by governments for sale to the private sector. Consequently, to encourage the privatization of GODR-owned assets an equitable system of valuation and appraisal must be developed which meets the expectations of the GODR while satisfying the requirements of the investors. Although each project submitted to the Central Bank for conversion will be a unique case, a system of valuation must be established to prevent an arbitrary assignment of value and to act as a basis for the asset conversion. GODR-owned assets, can then be assessed to fair market value. In cases of monetary emissions to investors instead of fixed assets, swap assessments of fiscal impact will be performed and disbursement schedules established to mitigate or eliminate the inflationary effect on the money supply.

An estimated 36 persons months of technical assistance are required to establish and implement an asset valuation system. The advisor(s) will work directly with the Chief of the Office of Debt Conversion, Division of External Debt.

a.2 Program Accounting and Financial Services

The process of approving and disbursing local currency funds and transferring state-owned assets to new investors in exchange for debt must be inventoried, tracked and incorporated in the standardized reporting mechanisms of the Central Bank.

An estimated 36 person months of technical assistance are required to implement this task. The contractor will be a resident full-time advisor and will work directly with the Chief of the office of Debt Conversion, Division of External Debt, the Accounting Division of the Central Bank and the Legal Advisor to the Central Bank.

a.3 Management Information Systems Development

Transaction analysis, asset valuation and accounting records will require the use of an integrated management information system. The system will be designed, installed and maintained by the Office of Debt Conversion with assistance provided through the institutional contractor. A system to generate reports and analyses will be developed to assist management in assessing project value and impact within a macro-economic framework.

An estimated 18 months of technical assistance will be required to analyze, design, developed and implement an integrated management information system for use with the project. Hard-disk personal computers with printers and other necessary accessories will be purchased under the Project.

a.4 Banking Liaison and Institutional Coordination

The success of the conversion activity will depend, to a large extent, on successful negotiations between investors and commercial banks, investors and the Central Bank of the Dominican Republic as well as interbank relationships. In order to assist the successful initiation and completion of transactions, accurate and timely information must be obtained from within the Central Bank as well as disseminated to commercial banks and potential investors. In addition, the liaison relationship between the Central Bank and commercial banks both in the U.S. and locally will assist in the identification of potential investors. This coordination function will extend to other local institutions such as the Joint Agricultural Consultative Committee (JACC), the Investment Promotion Council (IPC), the Consejo Nacional de Hombres de Empresa (CNHE), the American Chamber of Commerce (AMCHAM) and others to access their resources regarding the identification, and attraction of potential investors.

An estimated 36 months of technical assistance are required to perform the liaison function working with the Office of Debt Conversion, Division of External Debt of the Central Bank.

b. Training

Training will be carried out locally, on an informal basis to pass on the technical skills and systems developed by the technical assistance contractors. Specifically, training of the counterparts located in the Office of Debt Conversion and their staff will be undertaken resident TA contractors to develop a level of expertise which will assure program development and continuity. Funding will be reserved to sponsor trips to other Latin American countries where conversion programs are being implemented and to the United States to establish an understanding of relationships with creditor institutions. Additionally, short-term TA will be utilized to provide necessary seminars to officials and staff to develop and augment specific skills.

c. Promotional Program and Awareness Activities

In order to establish a full understanding of the conversion mechanism in the Dominican Republic and in the US, an awareness program will be sponsored explaining the mechanism and highlighting priority opportunities. Targeted campaign activities promoting the conversion program will be undertaken to assist in developing an awareness of the mechanism in the U.S. and in the Dominican Republic and to identify potential investors utilizing creditor banks and others in the effort. Additionally, the promotional activities will assist the potential investors in understanding and applying for the conversion program and provide a degree of investor service by developing relationships between the various parties.

The implementation of the promotional and awareness activity will be undertaken in conjunction with the Investment Promotion Council (IPC). The IPC will design, implement and monitor a targeted campaign for the conversion program, identify specific investors in priority areas, develop literature and brochures and provide the investor service follow-up. The IPC will also use its relationships with other business organizations such the Joint Agricultural Consultative Committee (JACC), for agribusiness investment, and Association of Dominican Exporters (ADOEXPO) for light manufacturing to promote the conversion concept to the various subsectors. A technical assistance contractor will act as a liaison and advisor to the IPC and other groups for activities concerning the promotion of the conversion program.

2. Working Capital Credit and Transaction Financing

a. Working Capital Credit

A constraint to investment in the Dominican Republic is the relatively low level of capital available locally to finance working capital. The supply of working capital is lower than usual due to a high inflation and a squeezing out of private sector credit by public sector expansion. Very little working capital can be financed under term loans. Companies which receive their primary investment capital from a swap transaction will need to finance working capital needs in order to operate. A credit facility utilizing local currency will be established in the Central Bank to finance working capital credit for firms which participate in a Debt Conversion. The funds will be designated for use by participants of the conversion mechanism. The funds will be channeled on a "line of credit" basis to participating financial institutions which will on-lend to the final borrowers. The loans extended to the final borrowers will be only for working capital needs.

b. Transaction Financing

This component is structured to enable the Central Bank to sponsor a larger program without incurring the effects of increasing the money supply with new monetary emissions.

While many of the transactions will involved transfer of fixed-assets to the investors, there will remain a significant portion of swaps which will monetize local currency in exchange for the debt. In order to reduce or minimize the potential inflationary impact, local currency will be provided from new PL 480 or ESF resources and designated as currency to be utilized by the Central Bank for transaction financing. These funds may be redirected for use in projects of special interest to USAID.

C. Inputs and Outputs

1. Inputs

The Project will grant to the Central Bank of the Dominican Republic US$5 million. On a term basis, US$10 million in equivalent local currency for working capital and transaction financing will be lent under local currency programs of the STP. It is currently envisaged that the grant portion of the Project will finance approximately 138 person months of technical assistance over a 3 year period.

Training and seminars will be conducted and US$100,000 will be reserved for those activities. The funding for TA and training will be included in an institutional TA contract. A subgrant to or contract with the

IPC valued at US$500,000 will used by the IPC to 1) undertake a promotion campaign, 2) to market the concept, 3) to identify potential investors, 4) to develop, produce and distribute literature and 5) to provide investor services.

2. Outputs

The outputs of the Project will ultimately result in the establishment and development of an operating conversion mechanism which will lead to the conversion of at least US$250 million of GODR commercial bank debt into equity investments during the life of the Project in the Dominican Republic, generating an estimated 4,500 new jobs and new additional investment worth at least 25% of the converted amounts. At least 25 conversions will be undertaken during the Project's life and a comprehensive system will remain in place at the Project's termination consisting of a qualified staff of analysts and a functioning mechanism.

Specifically, the output of the Project will include a staff of 4 trained and experienced counterparts residing within the Central Bank's Department of External Debt, Office of Debt Conversion who are trained in the conversion system. Another significant output will be the institutionalization of a conversion mechanism as a way of reducing the GODR debt.

D. Implementation and Monitoring Arrangements

The grant agreement for US$5 million will be signed with the Banco Central of the Dominican Republic which will have the implementation responsibility for the Project. A host country contract will be issued to obtain an institutional contractor to assist in project implementation, obtain the resident TA contractors, develop seminars and procure the necessary computer equipment. A subgrant or a contract of US$500,000 with the Investment Promotion Council from the Central Bank will be issued to provide for the promotional services required by the Project.

USAID will directly procure, through a company or a personal services contracting basis, a technical assistance contractor who will be housed in the Private Enterprise Division of USAID/DR. The USAID Advisor's role will be one of Project monitoring, coordination and oversight. The contractor will assist with conditions precedent, Project start-up, development of the RFTP and implementation procedures.

PROMOTING FINANCIAL INVESTMENTS AND TRANSFERS PROJECT (PROFIT)

WORK STATEMENT

C.1. SERVICES

The purpose of this Requirements contract is to provide USAID missions and AID/W Bureaus and Offices with facilities, materials, and personnel necessary to increase developing country resources for family planning by encouraging greater private sector involvement. The increase in resources will be effected in terms of funds, services and commodities.

C.2. OBJECTIVES

The purpose of this contract is to increase developing country resources for family planning by encouraging greater private sector involvement. The increase in resources will be effected in terms of funds, services and commodities.

To do this, the contractor will work primarily in the areas of (1) Innovative Investments, (2) Private Health Care Providers, and (3) Employer-Provided Family Planning.

(1) Included under the rubric of Innovative Investments are the following components: local production of contraceptives; assessing and reducing trade barriers; and financial transfer mechanisms, such as use of corporate blocked funds and debt conversions.

(2) Encouraging and assisting Private Health Care Providers to incorporate family planning products and services into their existing health care channels is the objective of the second major area of PROFIT services. These providers include both clinicians, such as doctors, nurses and midwives, and financial providers such as insurance companies, group health and pension plans. Also included under this rubric are efforts in privatizing public services.

(3) The third major area of service for the PROFIT contract is expansion of Employer-Provided Services. The contractor shall assist in the initial analysis, design and preliminary implementation of these services to ensure a viable service delivery program

provided by the employer and designed to continue beyond the period of A.I.D. assistance.

C.3. SCOPE OF WORK

The contractor shall provide technical services (staff, labor, management) to A.I.D. Missions and Bureaus in the areas of business, marketing, and finance as they relate to for-profit ventures, to increase private, for-profit sector participation in family planning services.

a. Project Design and Implementation

Based on the planning visits and country assessments conducted under companion contract number DPE- -C-00- -00, the contractor shall develop and implement an integrated series of interventions in the areas of Innovative Investments, Private Health Care Providers and Employer-Provided Services. as directed by the Cognizant Technical Officer in response to requests of USAID Missions and A.I.D. Bureaus and Offices.

(1) Innovative Investments

The contractor shall investigate and assist in local production of contraceptives, assessing trade barriers, and transacting favorable debt conversions on behalf of local developing country organizations.

Because these are new areas for A.I.D. in the field of population, the contractor shall conduct preliminary research and analysis to determine the potential benefits of each investment or combinations of investments to contract targets. The contractor shall collect information critical for deciding where, when and how to initiate an activity including demographic and family planning specific data, but concentrating most centrally on the necessary economic and financial data. From the data collected, the contractor shall develop specific proposals, considering which initiatives have the most potential benefit for population and should be undertaken, relay those proposals to potential investors, including donors, and finance suitable activities in selected countries. The contractor may not invest in any activities undertaken under this contract.

(a) Local Production of Contraceptives

(1) The contractor shall conduct feasability and marketing studies to investigate the possibilities of facilitating private sector contraceptive manufacture in selected developing countries. These studies should include examination of such issues as:

(a) Subsidies - Notwithstanding a renewed emphasis on local production, A.I.D. would continue to purchase the bulk of its commodity requirements from U.S.-based manufacturers. In certain cases, however, it is possible that A.I.D. contribution to domestic production will include the purchase of locally-produced contraceptives for a limited time period. In order to initiate production in a developing country where the market is nascent, multinational pharmaceutical companies often request a guaranteed purchase of at least some portion of the output. Such guarantees are designed to support the new manufacturing operation in its first two to three years of production. With the benefit of previous experience, A.I.D. does not wish to create a heavily protected "infant industry" which has no chance of growing up. A.I.D.'s involvement would therefore be both temporary and financially limited. The contractor shall also investigate the potential impact of local production on U.S.-based contraceptive manufacturers;

(b) Contraceptive supply for existing A.I.D. grantees;

(c) Donor coordination; and

(d) Quality Control, regulation and responsibility, and legal liability - Quality control proved to be a very serious issue in the manufacture of ORS sachets, which are a simple product in comparison with contraceptive commodities. Quality assurance audits can be costly and time consuming. An important component of any local production will therefore be the provision for accountability on the part of the local manufacturer, perhaps in conjunction with the local national agency responsible for regulating drugs. In addition, the contractor shall investigate the question of A.I.D.'s legal liability for products manufactured with financial assistance from A.I.D.

(2) Based on the feasibility and market studies described above, the contractor shall develop proposals, relay them to potential investors, including donors, and upon approval by the Cognizant Technical Officer, finance suitable components of local production activities such as not locally available equipment, technical assistance, or on and off-site training. It is not anticipated that A.I.D. will finance a full-scale local production operation.

(b) <u>Trade Barriers & Regulatory Reform</u>

The availability and price of contraceptives in developing countries are closely related to the trade policies of these countries. Tariffs, quotas, indirect controls and the Standard Industrial and Trade Classifications employed for contraceptives are all elements of the trade regimes that have an impact on the quantity and price of contraceptives. The contractor shall investigate these issues in depth, focusing primarily on the selected emphasis countries.

(1) The contractor shall identify and analyze specific trade barriers for contraceptive commodities (including importation of raw materials for local products), study their impact, and work for their removal.

(2) The contractor shall investigate and analyze the regulatory framework for private providers, including taxation policies, price controls, marketing and advertising restrictions and provider certification requirements, and assist in the development of a regulatory framework that permits the expansion of private sector family planning services, both through individual clinicians and through intermediaries that might include insurance companies, prepaid plans, HMOs and other institutions.

(c) Financial Transfer Mechanisms

The contractor shall transact financial transfers in debt conversion and corporate blocked funds conversion on behalf of developing country organizations in order to increase the resources devoted to family planning.

Local currencies which are generated as the result of debt conversions and/or blocked funds may be subsequently used by private sector organizations in the developing country. The contractor shall identify debt conversion opportunities where the subsequent funds could be programmed in a private sector family planning project. Debt conversions are not limited to such circumstances. Indeed, it is envisaged that the contractor will act not only to convert funds for the purposes stated above, but will also act as a central source of information on financial transfers for the Office of Population. Where appropriate conversions can be transacted, the contractor shall do so as directed by the CTO; the contractor shall conduct debt swaps from which the resultant local currencies will be donated to other Office of Population cooperating agencies for use in supporting debtor country population activities, also as directed by the CTO. [For purposes of preparing a proposal, the offeror should assume that on the order of $2,600,000 is anticipated for debt conversions through buy-ins under this requirements contract.]

(1) Debt Conversion

The contractor shall:

(a) identify advantageous debt conversion opportunities;

(b) ascertain that the acquisition of the debt instrument identified is consistent with U.S. and multilateral economic policy and A.I.D. programmatic priorities;

(c) negotiate with the government representatives of the debtor country to reach an agreement on terms, conditions and schedule for the retirement of debt in exchange for local currency; and

(d) confirm the availability and price of the debt instrument on the secondary commercial market,

(e) prepare a proposal for A.I.D. approval outlining the following:

- the objectives, confirmed by the designated local beneficiary and the participating cooperating agency, if applicable, of the in-country development activities;

- the expected role of debt exchange in financing these projects;

- the availability of debt for purchase;

- the willingness of the debtor country government to provide local currency in exchange for retirement of the debt; and

- a plan for use of the local currency generated to meet project objectives.

All debt conversion activities will be conducted in accordance with the Debt for Development Initiative guidelines published by A.I.D. in February, 1989 and amended in March, 1990.

(2) Blocked Funds

In a number of LDCs, multinational corporations have large amounts of blocked funds, profits which they cannot repatriate. These funds are generally held in bank accounts at low rates of taxable interest; it may appeal to some of the larger companies to donate them to a charitable cause in the host country and claim a deduction in their country of origin. In an environment where family planning has active government support, population related institutions would be possible recipients of corporate donations of blocked funds. In Zimbabwe, for example, it is estimated that there are approximately $350 million worth of profits held in special blocked funds accounts.

Worldwide, it is estimated that there are up to $200 billion of corporate blocked funds, $19 billion in

Nigeria alone. In addition to outright donations, possibilities exist for multinationals operating abroad to offer to interested parties preferential exchange rates for their local currencies. For example, the Coca-Cola Company in Mexico may have very large sums of Mexican currency which it cannot repatriate, and which it would sell for foreign exchange at a discounted price to a party in need of that local currency.

The contractor shall investigate the opportunities presented by corporate donation of blocked funds and/or discount sales of such local currencies in countries of project activity; and pursue appropriate venues. Only transactions that are legal, and approved by the local central bank and USAID Mission, will be undertaken.

(3) Mixed Credits

The contractor shall investigate the possible provision of mixed credits through the Export-Import Bank to private U.S. companies for population related investments, most notably in the area of local production of contraceptives. Recently, A.I.D. provided support to AT&T, which was assisted by the Export-Import Bank in its bid to supply to the Government of Indonesia an advanced telecommunications package. This package would provide Indonesia with a sound and badly needed infrastructure, doubling the number of trunk lines in a country with fewer phones per capita than China. The contractor shall identify meaningful opportunities for mixed credit interventions, and act in those transactions as a broker.

(2) Private Health Care Providers

The contractor shall encourage and assist potential Private Health Care Providers to integrate the provision of family planning products and services into their existing programs. Target areas include the following health care markets that exist in developing countries.

-Transition to privatization;

-Health care personnel, such as doctors, nurses and midwives; and

-Financial providers, such as insurance companies, group health plans and pension plans.

(a) For each emphasis country, the contractor shall identify the relative market share of each category of service providers, e.g., public and private providers, organized industries, HMO schemes, etc., and analyze who is served.

(b) Within the framework of this information, the contractor shall identify opportunities for working with specific commercial providers and develop subcontracts based on consideration of the following criteria:

- the potential of the provider for creating or expanding the market for quality family planning services;
- the potential of the provider to sustain and institutionalize family planning services of significant scope initiated under this contract;
- the potential of the provider to influence wider associations or networks to similarly adopt or expand family planning services; and
- the willingness of the provider to accept a share of financial risk in order to initiate the services.

(c) The contractor shall provide technical assistance to include family planning in private health care provision and where appropriate, provide some venture capital and in-country start-up costs for privatization efforts.

(d) The contractor shall work through medical and professional associations to increase awareness among private health care providers, of the potential demand and resultant increased revenues from provision of family planning service delivery.

(3) Employer Provided Services

The contractor shall provide technical assistance to employers, including multinational corporations, and other private sector institutions that fill the role of health care provider sometimes assumed by employers (ie. labor unions, employers' associations or workers' associations) to analyze, design and implement family planning services.

(a) For each emphasis country, the contractor shall gather aggregate data on total recorded employment by sector and use this data to target critical sectors and industries for investment in family planning services for their employees. When targetting the for-profit companies, the following selection criteria should be used:

(1) the potential to provide safe, acceptable services to the greatest number of people;

(2) the ability to pay for family planning services;

(3) the potential to serve as an example and induce other companies to introduce or expand family planning services;

(4) the existence of employee benefit programs;

(5) potential for the company's future growth in employment;

(6) location

(7) type of ownership; and

(8) age, gender and income distribution of the employees.

(b) Upon approval of the CTO, the contractor shall provide these targeted entities with technical assistance, training, where needed, and a certain amount of start up costs for family planning services.

C.4 CATEGORIES OF SPECIALISTS

The following is a list of the essential functional labor specialties which represent the Government's minimum personnel requirements for this contract. The Contractor must provide qualified personnel in all of the essential functional labor specialties. It is possible that one individual will have skills in more than one specialty. [Individuals being proposed for more than one specialty should be clearly identified in the proposal.]

Trade & Investment Specialists
Commercial Banking Specialists
Marketing Specialists
Pharmaceutical Manufacturing Specialists
Statisticians
Enumerators/Survey Research Specialists
Evaluation Specialists
Contraceptive Quality Assurance Specialists
Materials Engineers
Physicians
Pharmacists
Quality Control Specialists
Procurement Specialists
Trainers
Managerial Specialists
Financial Specialists
Economists
Development Specialists
Family Planning/Public Health Specialists
Demographers
Logistics Planners
Program Specialists
Computer Analysts
Computer Programmers
Mass Media Experts
Editors
Translators
Program Planners
Information Specialists
Financial Specialists
Contract Specialists

As set forth herein, these specialists are intended for use in providing technical assistance in developing countries. Clerical and secretarial support which is equivalent to two days or less shall be recovered through the fixed multiplier set forth in Section B. Clerical and secretarial support in excess of this amount may be negotiated into delivery orders as "other direct costs". This list is not intended to supplement or modify home office core support. Labor categories not specified above will not be negotiated into delivery orders as burdened labor costs. [Offerors should carefully review this list and may propose changes/additions for consideration.]

CONTRACTOR EMPLOYEE BIOGRAPHICAL DATA SHEET

(SEE PRIVACY ACT STATEMENT ON REVERSE)

INSTRUCTIONS: Submit in triplicate to contracting officer. See reverse for Contractor Certification.

1. Name *(Last, First, Middle)* ☐ Mr. ☐ Mrs. ☐ Miss ☐ Ms.	2. Contractor's Name		
3. Address *(include ZIP Code)*	4. Contract No.	5. Position Under Contract	
	6. Proposed Salary	7. Country of Assignment	8. Duration of Assignment
9. Telephone Number *(include area code)* / 10. Marital Status ☐ Married ☐ Single ☐ Other *(specify)*	11. Names and Ages of Dependents to Accompany Individual *(if applicable)*		
12. Date of Birth / 13. Place of Birth			
14. Citizenship *(if non-U.S. citizen, give visa status)*			

15. EDUCATION *(include all secondary, business college or university training)*

NAME AND LOCATION OF INSTITUTION	MAJOR SUBJECTS	Credits Completed		Type of Degree	Date of Degree
		Semester Hours	Quarter Hours		

16. EMPLOYMENT HISTORY

1. Give last three (3) years. Continue on reverse to list all employment related to duties of proposed assignment.
2. Salary definition - basic periodic payment for services rendered. Exclude bonuses, profit-sharing arrangemnets, commissions, consultant fees, extra or overtime work payments, overseas differential, or quarters, cost of of living or dependent education allowances.

POSITION TITLE	EMPLOYER'S NAME AND ADDRESS	Dates of Employment *(Mo., Yr.)*		Salary	
		From	To	Dollars	Per

17. SPECIFIC CONSULTANT SERVICES *(give last three (3) years)*

SERVICE PERFORMED	EMPLOYER'S NAME AND ADDRESS	Dates of Employment *(Mo., Day, Yr.)*		DAILY RATE
		From	To	

18. LANGUAGE PROFICIENCY

LANGUAGE	Speaking			Reading			Writing			Understanding		
	Fair	Good	Excl.	Fair	Good	Excl.	Fair	Good	Excl.	Fair	Good	Excl.

19. Special Qualifications *(honors, professional societies, special licenses, publications, research, special skills, and relevant education not previously mentioned; use reverse side of form, if necessary)*

20. CERTIFICATION: To the best of my knowledge, the above facts as stated are true and correct.

Signature of Employee	Date

AID 1420-17 (3-80)

(Use this space for continuation of Blocks 16 and 19)

CONTRACTOR'S CERTIFICATION *(To be completed by responsible representative of Contractor)*

A. I hereby certify that *('X' appropriate box)*:

☐ The initial salary proposed herein meets the salary standards prescribed in the contract.

☐ The salary increase proposed herein conforms to the customery policy and practice for this organization for periodic salary increases.

B. Justification or Remarks

Signature	Title	Date

PRIVACY ACT STATEMENT

The following statement is required by the Privacy Act of 1974 (Public Law 93-579; 88 Statute 1896).

The information requested on this form is needed by AID to evaluate your suitability for the position for which you have been nominated as a contract employee. It is necessary that you provide the information for AID to consider your nomination. The Foreign Assistance Act of 1961, as amended, constitutes authority for its collection.

Employers and educational institutions you list may be contacted for verification of the information provided. Disclosure may otherwise be made in whole or in part to any (a) foreign government concerned if required by that government in connection with their review of your nomination and (b) pursuant to any other applicable routine use listed under AID's Civil Service Employee Office Personnel Record System, AID-2 in AID's Notice of Systems of Records for implementing the Privacy Act as published in the Federal Register, or (c) when disclosure without the employee's consent is authorized by the Privacy Act and provided for in AID Regulation 15. *(A copy of the Regulation and Notice of System of Records is available from AID Distribution on request.)*