November 8, 1989

ENERGIZING THIRD WORLD ECONOMIES: THE ROLE OF DEBT-EQUITY SWAPS

INTRODUCTION

Debtors, creditors, governments, and international institutions have sought ways to deal with the Third World debt crisis. From 1985 to 1988, various private sector techniques reduced the foreign debt of the fifteen major debtor countries by more than $28 billion. Conversions of foreign debt into equity investments in the debtor countries, called debt-equity swaps, accounted for $12.5 billion of this amount. Through this technique, investors purchase part of a country's debt from a creditor bank at a substantial discount and exchange the debt for local currency, bonds, or state-owned equity shares from the debtor government.

Swaps offer other important benefits, in addition to whittling away at the debt of less developed countries. Among them:

1) **They attract new foreign investment.**

2) **They attract back home "flight capital" funds** held in overseas banks by citizens of less developed countries (generally called LDCs).

3) **They provide long-term financing** for LDC companies when domestic credit markets are tight.

4) They frequently finance new export-oriented investments, which earn much needed hard currency.

U.S. officials have acknowledged that any beneficiary country of Treasury Secretary Nicholas Brady's new debt reduction initiative[1] should have in place a "viable" debt-equity swap program as a sign of its commitment to attracting private foreign capital.[2] Nearly a dozen LDCs have some type of debt-equity swap program in place, but few of these qualify as viable. The trouble is that most of these programs impose terms deterring potential investors. Many programs, moreover, are intermittently restricted or suspended, because it is incorrectly feared that they are inflationary or are a subsidy for foreign investments that would have been made in any event. Evidence refutes these concerns. Latin America's most successful debt-equity program, for example, is in the nation that has the region's lowest inflation rate – Chile. Largely through its debt-equity swaps, Chile has reduced its foreign commercial bank debt by more than half, to just $6.7 billion.[3]

No debt relief should be extended under the new Brady Plan unless an LDC is aggressively seeking to attract foreign capital and its own citizens' flight capital through an active debt-equity program. LDCs should stop trying to overregulate this useful investment vehicle and instead should examine Chile's highly successful debt-swap program, which combines objectives of debt management, privatization, and capital market development.

DEBT-EQUITY SWAPS

Restrictions placed by many LDC governments on foreign direct investment (FDI) have contributed to massive government borrowing and wasteful government spending, and thus to the debt crisis. LDCs received a total of $13.6 billion in FDI from 1979 to 1982, but only $10.1 billion from 1983 to 1985. The Reagan Administration sought to deal with the debt crisis

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1 Under Brady's plan, the World Bank and International Monetary Fund (IMF) will subsidize debt reduction packages that innovative debtor countries and foreign bankers previously have worked out on their own. Debtor countries will utilize some of their World Bank and IMF loans to buy back their commercial bank debt directly or, alternatively, to purchase the collateral needed to back discounted debt-for-bonds exchanges with their foriegn bankers. In some cases, World Bank/IMF funds will even be used to guarantee debtor nations' future interest payments to Western commmercial banks.

2 Testimony of U.S. Treasury Secretary Nicholas F. Brady before a House Appropriations Subcommittee, April 19, 1989, p. 3; testimony of then Assistant Treasury Secretary David C. Mulford before a Senate Banking Subcommittee, March 16, 1989, p. 5.

3 Barbara Durr, "Chilean Debt Swaps Soar in First Half," *Financial Times*, July 20, 1989.

through new lending. What LDCs really need is not new loans from industrial countries but more FDI in the private sector.[4]

Discounted Doubt. The most successful plan so far for dealing with debt involves converting debt into local currency or bonds for investment or equity shares of enterprises in the debtor country. In such a typical debt-equity swap, a U.S. bank, anxious to avoid a debtor default or tedious periodical rescheduling negotiations, sells the debt that it holds, at a discount of, say, 50 cents for each dollar of debt, to a business wishing to make a new investment or expand its existing operations in the debtor country.

The investor presents the purchased debt to the debtor country's government for redemption through government stock holdings in some local enterprise or through local currency to be used for investment purposes. The debtor country will give the investor currency, bonds, or assets valued at somewhat less than the face value of the debt being exchanged. For example, if the investor purchases $200 million in debt notes for $100 million, a 50 percent discount, the debtor government might redeem the notes by paying the investor only $170 million in local currency. Most of the discount goes to the investor, but the debtor government captures a significant part of the discount for itself as well.

The U.S. creditor bank, in recouping a portion of its original loan in cash, avoids the possible loss of the entire investment. The business makes an investment, obtaining equity in an enterprise in the debtor country, and the debtor government retires some of its external debt at a discount, which represents partial debt forgiveness.

U.S. REGULATORY AND ACCOUNTING ISSUES

The U.S. Federal Reserve Board made revisions in 1987 and 1988 to its Regulation K to permit U.S. banks to take up to a 40 percent equity stake in private foreign companies and full ownership of companies acquired from foreign governments, subject to divestiture within a period of five to fifteen years.[5] Normally, banks are prohibited from owning equity shares of businesses. Regulation K has been administered flexibly for swaps, however, and is no longer a serious obstacle to the banks' investment desires.[6]

4 For LDCs, the critical advantage of FDI, over commercial bank loans, is that the payments associated with FDI are not a fixed burden. If a business is unprofitable, either of its own making or due to an economic slump, dividends are cut accordingly. Loans from foreign commercial banks, on the other hand, carry with them fixed interest and principal obligations which must be serviced despite the profitability of the investment made (or not made) with the borrowed funds. Since most foreign loans carry variable interest rates, this can be a further source of trouble.

5 J.P. Morgan, *World Financial Markets*, Issue 7, December 30, 1988, p. 8. (Prior to mid-1987, Regulation K required U.S. banks to keep their investment in any one nonfinancial foreign company below $15 million, below 20 percent of its voting shares, and for no longer than five years.)

6 Joel Bergsman and Wayne Edisis, *Debt-Equity Swaps and Foreign Direct Investment in Latin America*, International Finance Corporation discussion paper No. 2, 1988, p. 10.

Some members of the American accounting profession maintain that banks selling some part of a debtor's portfolio at a discount should mark down the value of the remaining part of that portfolio to the price received for the traded debt. Yet the American Institute of Certified Public Accountants maintains that this is not required. Banks typically distinguish between loans as part of an investment portfolio, which is carried at face value, and a trading portfolio (meaning debt swapping), which is discounted. The accounting issue poses no significant obstacle at this time to debt-equity swaps.

THE ADDITIONALITY DEBATE

LDC officials frequently complain that debt-equity swaps lack "additionality," that is, they do not pull new foreign investment funds into debtor countries, but merely subsidize investments that would have been made in any event. Yet in a November 1988 study of 104 transactions in Argentina, Brazil, Chile, and Mexico, the International Finance Corporation (IFC), an arm of the World Bank, finds that the swap mechanism made a difference in nearly half of the swaps by multinational corporations as well as in all of the swaps arranged by creditor banks for their own accounts – a total of 61 percent of the swap transactions studied.

The IFC also finds that additionality increases as swap programs mature. Since foreign investments are one to two years in gestation, most investments in the early stages of a swap program would have occurred anyway. As more and more investors become aware of the benefits of a program, these benefits become decisive for a larger percentage of transactions. In Chile, for example, investors from many parts of the world, including countries that have not had close business ties with Chile, have started to look there for investment possibilities.

Important Catalyst. Additionality is also higher for investments in export-oriented industries, which earn the host country much needed hard currency.[7] In several cases, swaps caused businesses to create new export-oriented companies in Latin America rather than in Southeast Asia. In other cases, investments in pre-existing companies led soon to increases in capacity and to startups of entirely new lines of production.

The table below suggests further that debt-equity swaps can be an important catalyst for sorely needed foreign direct investment. Such investments in Mexico and Chile were highest during the period when debt-equity swaps were in use.

Sometimes Third World debtors hamstring their swap programs by stipulating that the foreign investor may finance only a certain percentage of a new investment with the local currency proceeds of swaps, say 70 percent,

7 Conversely, investments oriented toward domestic markets tend to be those that would have been made anyway.

Foreign Direct Investment (FDI) through Swaps and before Swap Programs: Chile and Mexico ($US millions; annual averages)

	FDI through Swaps (1985-87)	Normal FDI (1979-82)	Depressed FDI (1983-86)
Chile	400	139	65
Mexico	1,133	791	141

Source: International Finance Corporation, *op. cit.* p. 3.

and that the remainder must be financed through new money brought into the country outside the swap mechanism.

THE CHILEAN MODEL

Largely through its debt-swap program, Chile has retired approximately $7.6 billion of its foreign debt since May 1985.[8] The $2.9 billion net reduction (rather than $7.6 billion) is due to Chile's approximately $5 billion in new borrowing since 1985. This new borrowing was mainly for productive business activities that strengthened the Chilean economy.

As a result of this aggressive debt-swap program and pro-growth economic policies, Chile's debt service ratio, or the annual debt payments as a percent of export revenue, fell to 28 percent last year, from 73 percent in 1982, the year the debt crisis erupted. This means that Chile has basically conquered its foreign debt crisis.

Under Chapter 19 of Chile's investment code, foreigners present the Central Bank with Chilean foreign debt purchased on the secondary market — now selling for 60 cents to 65 cents on the dollar — and receive about 85 cents to 87 cents on the dollar for their investments. If left unchecked, these swaps could swell Chile's money supply and fuel inflation. To prevent this, the Central Bank pays investors with 15-year inflation-indexed bonds rather than pesos; investors then use Chile's domestic capital market to find Chilean nationals willing to buy the bond in return for cash, which is used to finance the investment. The fact that the Central Bank does not print new money to finance its conversions, together with monthly ceilings of $100 million in Chapter 19 conversions, acts to sterilize the potential inflationary effect.

Repatriating Capital. After four years, foreign investors may begin to repatriate 25 percent of accumulated dividends and all future dividends. After ten years, they can repatriate their principal. These rules are considerably stricter than those covering foreign investments made with new money outside the swap mechanism to avoid granting the swap subsidy to all foreign investments.

8 Total Chilean debt dropped to $16.7 billion from a 1986 peak of $19.6 billion.

In one of the largest debt-equity swaps to date, Scott Paper Company of the U.S., Citibank, N.A. of the U.S., and Shell Chile, S.A., a subsidiary of the Anglo-Dutch oil company Royal Dutch Shell, last year jointly swapped $277 million (face value) in Chilean debt, for which they paid $120 million, to purchase a half-finished Chilean pulp mill mired in debt and mismanagement. They plan a total investment of $450 million, including $200 million in expenditures to redesign and expand the plant.[9]

Attracting Investments. Western Agri-Management Company, a Colorado firm, last year arranged a $15 million swap to finance construction of a fruit production and processing operation in Chile. Western expects to generate first year sales of approximately $20.5 million. Each year thereafter, Western plans to convert $15 million into pesos to meet various operating expenses. In Chile, debt swaps also have been used to create stock market investment funds. Last year the World Bank's International Finance Corporation with Britain's Midland Bank put together a $30 million fund to invest in Santiago's thriving stock market. Chile's large foreign creditor banks obtained pesos through debt swaps to subscribe to this fund.

Largely through debt conversion, Chile in the past two years has attracted investments of $200 million from Australia, $250 million from South Korea, $250 million from Taiwan, and $600 million from New Zealand.[10]

Chilean nationals account for $2.4 billion in debt reduction through swaps, nearly equal to the $2.6 billion from foreign investors.[11] Under the regulatory scheme, the Central Bank holds a monthly auction at which local banks, acting as agents for Chilean nationals holding foreign debt they purchased at a discount with their "flight capital," bid for the right to convert the debt into domestic currency. Chileans receive cash or long-term bonds which can be used to repay local debts or purchase certain assets. Johns Hopkins University economist Steve Hanke estimates that about $1.4 billion of flight capital was returned to Chile from 1985 to 1986 through this mechanism.[12]

Privatization Strategy. The success of the Chilean program also is due to the government's simultaneous efforts at privatization. The state telephone system, national electricity network, and state insurance company were privatized in large part through debt-equity swaps. Since 1974, the government has received over $1.5 billion from such sales, most of it since 1982. The frequent use of employee stock ownership plans in these privatizations, moreover, has helped broaden and democratize the ownership of economic assets. As part of a steel company privatization, for example, one-third of the shares were sold to 4,000 of the 6,500 employees. And when

9 Imogen Mark, "Deal of the Year," *Euromoney*, September 1988 (Special Supplement), p. 42.
10James Brooke, "Peru [sic] Trying to Shift Focus of Trade to Pacific," *The New York Times*, July 19, 1989, p. D10.
11Durr, *op. cit.*
12Steve H. Hanke, "The Anatomy of a Successful Debt Swap," in Hanke, ed., *Privatization and Development*, (San Francisco: ICS Press), 1987, pp. 166167.

a computer services firm was privatized for $1.5 million, 114 of the 120 employees participated in the sale.[13]

Contributing to the program's success is the favorable investment climate produced by Chile's sound macroeconomic management. Public expenditures have been cut back from 43.5 percent of GNP in 1972 to 24.3 percent in 1988. The fiscal deficit was cut from 13 percent of GNP in 1973 to about 1 percent in 1988. Santiago now targets 60 percent of total government expense for social projects to help the truly needy. Spending restraint has even facilitated a recent 20 percent cut in the value-added tax, Chile's most important revenue source. Chile's 1988 inflation rate was a manageable 12 percent -- the lowest in Latin America. Economic growth has averaged 5.8 percent over the past three years.

MEXICO

Mexico's debt-equity swap program, from April 1986 until its suspension in November 1987, retired $3 billion of Mexico's $107 billion foreign debt. International automobile manufacturers, including Chrysler Corporation of the U.S., Ford Motor Company of the U.S., Nissan Motor Company, Ltd., of Japan, and Volkswagen AG of Germany made use of this device to expand their Mexican operations. In the tourism sector, some 35 swaps were used to invest $400 million, much of it to construct 2,000 new hotel rooms.

What halted the swap program were fears of its inflationary impact and concerns that the swaps were subsidizing investments that would have taken place in any event.[14] The problem was that the Mexican government, rather than copying Chile's technique of issuing bonds, was printing pesos to pay for the swaps.

Condition of Assitance. In recent years Mexico has privatized a number of state-owned enterprises. More divestitures are planned for the future. Debt-equity swaps for privatization of state-owned enterprises remain a valuable but little used tool with which Mexico might deal with its economic problems. Such swaps have no inflationary effect when the debt is redeemed with shares in a government enterprise rather than with currency. Mexico's recently concluded debt reduction agreement includes a vague provision requiring it to allow $1 billion in debt-equity swaps annually over the three and a half years beginning January 1990. Investments are to include shares of up to 50 percent in public sector companies being privatized. This provision is encouraging. Still, the U.S. government, the World Bank, and the International Monetary Fund should condition assistance to Mexico under

13*Ibid.*

14Since automobile firms were planning expansion prior to the advent of the swap program, the transactions are often cited as evidence of a lack of "additionality" in the Mexican program. Planned expansions, in fact, were the result of an early 1986 Mexican government decree that the foreign auto firms step up exports or leave. In addition, as mentioned earlier, the first swaps in any program will be linked to investments previously under consideration.

the Brady Plan on an aggressive program of debt swaps for privatization, removing the 50 percent ownership share limit.

BRAZIL

Through formal and informal debt-equity swaps, Brazil cut its foreign debt by $7 billion in 1988 to $114 billion.[15] The Brazilian government, for its part, estimates 1988 swaps at $8 billion to $9 billion. (The informal swaps are difficult to estimate.) This has reduced Brazil's annual interest payments by $800 million. Under a February 1988 scheme, the Central Bank held monthly auctions for the conversion of a maximum of $150 million (face value) of Brazil's foreign debt into equity. Half of the approved investments, $75 million, were for projects in a special incentive area in the poor regions of the North and Northwest.[16] The dividends from these investments are remittable immediately, subject to Brazil's general restrictions on foreign investment.[17] The principal of the investment may be repatriated after twelve years. No majority foreign interest in a Brazilian entity is allowed.

Among the Brazilian swaps completed, Chase Manhattan Bank, N.A., converted $200 million, receiving full face value, into an investment in the Autolatina S.A. car company. Manufacturers Hanover Trust Company converted $168 million of its $2.1 billion Brazilian debt in order to fund three industrial projects and to capitalize a new local investment bank with Brazilian partners. Banque Paribas of France put together Brazil's first venture capital firm, Equitypar, with $85.5 million of swapped debt.[18]

Linking Strategies. Brazil's failure to deregulate the economy and to slash its fiscal deficit by cutting wasteful state spending is chiefly responsible for its 1,000 percent annual inflation. As part of Brazilian President Jose Sarney's January 1989 plan to control inflation, debt-equity auctions were suspended. Yet Jacques Kemp, general manager of NMB, a Dutch bank, points out that: "The [Brazilian] Central Bank's own studies show conversions are only responsible for 3 percent of the expansion of the monetary base."[19]

In January, Sarney also announced intentions to sell six very large money-losing state companies and part of the government holdings in three others. In his request to Brazil's Congress, Sarney promised a role for foreign participation in the privatizations. He now should link debt-equity swap and privatization programs, particularly since such swaps have no inflationary effect.

15*The New York Times*, December 30, 1988, p. D3.
16At the November 1988 auction – the last auction before the January 1989 suspension – Brazilian foreign debt (trading in the secondary market at around 40 cents on the dollar) was honored at discounts from par of 13.5 percent to 50 percent for the free area and 0.5 percent to 21 percent for the incentive area.
17A 25 percent withholding tax for the U.S. and U.K.; 12.5 percent for Japan and 15 percent for the rest of the world.
18D. Bartholomew, "No Time for New Toys," *Euromoney*, September 1988 (special supplement), p. 34.
19.P. Sharp, "Converted Debtor," *Euromoney*, March 1989, p. 69.

ARGENTINA

Argentina, with an international debt of around $60 billion, launched its current, rather restrictive, debt-swap program in October 1987. Proceeds from a swap may not be used to purchase existing enterprises, including state-owned companies. In addition, there is a 30 percent new money requirement. Rather than being a true debt-equity swap program, this is really an industrial promotion program open to both Argentine nationals and foreign investors. Eligible investments include: 1) the purchase of new equipment, 2) the construction of new plant, or 3) other investments "which tend to increase the efficiency, productivity and supply of services." Not eligible: 1) the acquisition of real estate or working capital, 2) the purchase of shares or other corporate participations, 3) financial investments, or 4) the purchase of used movable goods (machinery).

Argentina met its modest targets for 1988, retiring about $785 million of foreign debt through a public debt-equity program and $89 million through a program for private debts. As with the Chilean program, foreign investors may remit dividends after four years and the principal of their investment after ten years.

The great uncertainties about Argentina's economy during the past two years have sent the price of its debt plunging in the secondary market. Lower quotations for Argentine debt, together with the dimmer economic prospects these represented, fueled some banks' interest in dumping their Argentine debt. The difference between the purchase price of the debt in the secondary market and what is received for it in the Argentine auction — which might typically be only 15 cents/dollar — is taxed at about 45 percent. In the six 1988 auctions, converted Argentine debt was acquired by participating investors at an average of only 19 cents on the dollar. Strong competition among these bidders[20] meant that the Argentine government could redeem the debt at an average of only 38 cents on the dollar.

Chief Culprit. Argentina's state corporations are a chief cause of the debt and economic crisis. In 1987 state industries lost an average of $8.5 million every day of the year, including a $2 million per day loss at the state railway. Each year the government has to find 30 percent of the total financing costs of 117 state industries.[21] Argentina's budget deficit reached 10 percent of gross domestic product in 1988.

In July, Argentina's new president, Carlos Saul Menem, announced plans to privatize the state telephone company and two television stations and to partially privatize the national airline, railroad, shipping line, oil company, and mail service.[22] Argentine citizens are estimated to hold some $46 billion in assets abroad, valued at three-quarters of Argentina's foreign debt. Buenos

20 Foreign investors have not even been deterred by the heavy tax burden.
21 Gary Mead, "Mistrust Fans the Flames of Troubled Privatization," *Financial Times*, March 22, 1989.
22 James Brooke, "Latin Nations Discover the Free Market," *The New York Times*, July 30, 1989, p. E2.

Aires could target the recapture of this flight capital by linking the privatization and debt-swap programs. Argentine citizens with hard currency held abroad could purchase discounted Argentine foreign debt and swap this for shares of an Argentine state company being privatized. But under the current Argentine debt-equity program, state companies remain off limits. This restriction should be ended.

THE PHILIPPINES

The Philippines is burdened with nearly $30 billion in foreign debt. Its debt-equity swap program is mired in bureaucratic delays and restrictions. At the end of last year, although $1.2 billion of the $1.8 billion in applications to convert debt had been approved, only $584.5 million was converted.[23] One problem is that the Philippine government imposes a 20 percent Central Bank fee on debt swaps, effectively halving the discount the investor receives, and a new money requirement as well.

In February 1988, the Central Bank, fearing the swaps' inflationary impact, set a $180 million ceiling per year on debt swaps.[24] The Central Bank also announced that preference would be given to new investments over equity investments in existing facilities. Preference is also given to: 1) investments that are labor intensive, generate employment, and located in regions not yet heavily industrialized, 2) activities in which at least 80 percent of production is for export, and 3) export products that are new and not subject to foreign quotas.[25] These restrictions have largely halted the swap activity. As the debt-swap program has languished, so too has Manila's privatization effort.

Using Chile's Model. The Philippines would do well to adopt a number of provisions of the Chilean program. For example, in a recent Letter of Intent to the IMF, the Manila government makes a brief reference to restarting its debt conversion program by the end of this year and to renewing privatization efforts. Philippine President Corazon Aquino could link these two programs, as has been done in Chile, to reduce the debt through noninflationary debt-equity swaps, while ridding the government of inefficient state enterprises. This would allow Aquino to raise the $180 million per year ceiling on debt conversions without fear of inflation. Further, if the requirement that a "new money" investment accompany debt-equity swaps were dropped, businesses would have greater incentive to make such swaps.

23The Philippine program allows gradual capital repatriation after three years for preferred-sector investments and after five years for others; dividend payments can be made from the outset for preferred-sector investments and after four years for others.

24Investors could still swap as much private sector debt as they wished (with no Central Bank fee) because these swaps do not expand the money supply. But there is very little private sector debt paper available. See Richard Gourlay, "Manila Frustrates Potential Investors," *The Financial Times*, April 26, 1988, p. 29.

25See testimony of J.H. Fall, Acting Deputy Assistant Secretary for Developing Nations, U.S. Treasury, before a House Foreign Affairs subcommittee, March 7, 1989, p. 8.

OTHER DEBT-EQUITY ACTIVITY

Costa Rica. Not a debt for equity program, but a small debt-for-development effort to promote investments in conservation, education, and small business, this program aims to reduce the country's $5 billion debt by only $15 million annually during 1989, 1990, and 1991.

Egypt. Cairo has not allowed debt-equity swaps to date. However, a draft of a new investment law, under study by the cabinet, contains a debt-equity swap provision to help deal with the country's $37 billion foreign debt.

Honduras. The National Congress passed broad debt-equity swap guidelines last December, which appear to establish a viable program. Debt is redeemed at close to face value, there is no new money requirement, and priority is given to the purchase of government enterprises under Honduras's privatization program. Honduras has a debt of about $3 billion.

Nigeria. After retiring about $965 million of its $26 billion debt through a swap mechanism, Nigeria recently revamped its program in an attempt to contain what is known as the "roundtripping" problem. This occurs when investors use hard currency to acquire local currency at a discount through swaps, only to turn it back into foreign exchange again in the informal foreign exchange market, thereby driving up the exchange rate. Controls on foreign investment were eased this year to make debt-equity swaps more attractive.[26]

Peru. Lima effectively defaulted on its $19 billion debt in 1985 when it announced it would only use 10 percent of its export earnings to service its foreign debt. Seeking investment to generate Pacific Rim exports, Lima has been trying to launch a swap program since this March. In early August, however, the program was put on indefinite hold because the government could find no money to finance it. The program will be open to nationals, as well as foreigners. Converted debt can finance only 70 percent of local project costs, and the remaining local costs and all import costs will require new money.

Uruguay. With a $5 billion foreign debt, Montevideo launched a debt-equity swap program in April 1988 which astutely uses an auction procedure that sterilizes against inflation by redeeming the debt with tradeable bonds. The program, however, also contains an onerous 30 percent new money requirement. The program is very modest; only $55 million (face value) is to be converted between 1988 and 1989.

Venezuela. Attempting to deal with a $35 billion external debt, the Caracas program allows debt to be converted in order to finance new enterprises that produce at least 80 percent of their products for export. This program contains a very restrictive requirement that 40 percent to 60 percent of such

26President Ibrahim Babangida in January announced that foreign investors would be allowed to acquire a 100 percent stake in a Nigerian enterprise, with the exception of banking, insurance, petroleum prospecting, and mining, where the previous 40 percent limit on foreign ownership remains. *Financial Times*, January 17, 1989.

enterprises be financed with new money. Stumbling since April 1987, the program has yet to complete a major deal.

Zambia. As of this February, Zambia, with a total debt of $4 billion, had converted $55 million in trade debt, out of a total trade debt of $450 million, into equity investments in export-oriented agricultural schemes.

CONCLUSION

Chile's successful combination of debt reduction, economic deregulation, and privatization testifies that developing countries can reduce their foreign debt and replace it with productive direct investment. Debtor countries desiring to replicate these successes should:

1) **Maintain continuity** in the debt-equity swap program for several years at least; an on-again, off-again program creates economic uncertainty, thus discouraging potential investors.

2) **Avoid unreasonable restrictions** on the freedom of investors to repatriate dividends and capital associated with swap investments.

3) **Avoid new money requirements** or other restrictions that lower the incentive to investors.

4) **Give investors** using the swap mechanism tradeable government bonds or equity in local enterprises to avoid fueling inflation.

5) **Use debt-equity swaps** as part of an effort to privatize state-owned enterprises.

6) **Deregulate the economy** as a means of attracting investors and giving enterprises the opportunity to be as productive as possible.

The Bush Administration, international lending agencies, private banks, and governments of developing countries continue to seek ways to manage the Third World debt problem. To manage the debt and promote economic growth, new capital investments in developing countries are imperative. Citizens of debtor countries have hundreds of billions of dollars deposited in foreign banks because they lack confidence in their own governments or economies. Debt-equity swaps, combined with privatization and economic reform, can attract this flight capital back home, and along with investments from foreign citizens, bring new economic opportunities and debt relief to the Third World.

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