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Ross P. Buckley

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Debt Exchanges Revisited: Lessons From Latin America for Eastern Europe

*Ross P. Buckley**

As John Kenneth Galbraith wrote in 1987, "[h]istory has a way of repeating itself in financial matters, because of a kind of sophisticated stupidity."[1] The Latin American debt crisis of 1982 was certainly an instance of such stupidity. The region has had a consistent history of a major debt crisis about every fifty years; however, crises in the 1820s,[2] 1870s,[3] and 1930s[4] were insufficient to restrain banks from their Latin lending frenzy in the 1970s.

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* Associate Professor of Law, Co-Director, Centre for Transnational Business Law, Bond University, Australia. The production of this article was supported by an Australian Research Council Small Grant. I am indebted to Lee C. Buchheit and Michael Pettis for their helpful comments on earlier drafts. All responsibility is mine.

[1] John K. Galbraith, *Insanity of 1929 Repeats Itself*, SUNDAY TIMES, Oct. 25, 1987, at 35, *quoted in* FRANK G. DAWSON, THE FIRST LATIN AMERICAN DEBT CRISIS: THE CITY OF LONDON AND THE 1822-1825 LOAN BUBBLE x (1990).

[2] With the exception of Brazil, Latin American countries issued £19 million of bonds in London in the 1820s. By 1828 all were in default. *See* CARLOS MARICHAL, A CENTURY OF DEBT CRISES IN LATIN AMERICA 43 (1989). *See generally* Dawson, *supra* note 1.

[3] The 1860s lending boom to Latin America culminated, in the first three years of the 1870s, with close to £75 million of bonds issued. The bubble burst in 1873 as the European stock markets crashed and worldwide trade declined precipitously. *See* MARICHAL, *supra* note 2, at 94-99.

[4] The most extensive payment interruption of Latin America's foreign obligations was in the 1930s in the aftermath of the Great Depression. By the mid-1930s, almost 70% of national Latin American government dollar denominated bonds and almost 90% of municipal, provincial and corporate bonds were in default. Debt servicing in most cases was not resumed until the mid to late 1940s. *See* Marilyn E. Skiles, *Latin American International Loan Defaults in the 1930s: Lessons for the 1980s?*, Federal Reserve Bank of New York, Research Paper No. 8812, at 1, 15, 17 (1988); MARICHAL, *supra* note 2, at 212-13.

Debt exchanges in the form of debt-equity swaps, privatizations for debt, debt-for-nature swaps, and debt buy-backs were employed in the 1980s in response to the Latin American debt crisis.[5] Latin American countries have continued to employ all of these techniques in the 1990s,[6] and these techniques are gaining popularity in Eastern Europe and elsewhere. The principal type of debt exchange in Eastern Europe to date has been privatizations for domestic debt. As we shall see, such swaps are far less detrimental for the debtor country than swaps for external (foreign) debt. However, some Eastern European countries are considering expanding their debt conversion programs to include external debt. Their experience with debt exchanges using domestic debt will be a poor guide to the likely impact of permitting external debt to be exchanged; the history of debt exchanges for external debt in Latin America is a far better guide.

This article analyses the role and effects of (i) debt-equity schemes, (ii) privatizations for debt, (iii) debt-for-nature and debt-for-development swaps, and (iv) debt buy-backs in Latin America in order to determine whether the expansion of programs in Eastern Europe and elsewhere to include external debt is likely to be another example of Galbraith's "sophisticated stupidity."

I. DEBT EXCHANGES TODAY

While the techniques of debt exchanges were developed in the 1980s in response to the Latin American debt crisis, the use of debt exchanges, particularly debt-equity schemes and privatizations for debt, has now spread far beyond Latin America and has served a range of purposes. In the 1990s, developed countries have often used debt-equity exchanges to enable banks to convert their non-performing loans into equity stakes in troubled debtor

[5] Claudio Milman, *Attitudes Towards Debt-Equity Swaps And Privatization of State-Owned Enterprises in Chile*, 8 PUB. BUDGETING & FIN. MANAGEMENT 170 (1996).

[6] Argentina has continued to promote debt-equity swaps in the 1990s and liberalized its foreign investment regime in 1993 so that foreign investors could invest in Argentina without prior approval and upon the same terms as local investors. *See* Bernardo E. Duggan & Victoria Zoldi, *Argentina, Guide To Energy, Natural Resources And Utilities Law Supplement*, INT'L FIN. L. REV., Apr. 1996. Brazil has likewise continued to promote debt-equity swaps. For example, the Central Bank of Brazil issued Resolution 2203 and Circular 2623 to broaden categories of Brazilian public sector foreign debt that could be tendered for conversion into equity in Brazil's ongoing privatization program. *See* James Leavy & M. Cecilia Gaviria, *Legal Notes*, EMERGING MARKETS DEBT REP., Dec 4, 1995, at 4. Chile liberalized its scheme in August 1995 by removing the ten-year lock-in period on capital repatriation and the limits on repatriation of liquid profits for investments made through debt-equity conversions. The purpose of this change was to increase liquidity in the system and reduce interest rates and thus inflation. *Consistently Sound Performance*, CORPORATE FINANCE FOREIGN EXCHANGE YEARBOOK 59 (1995/96); *Chile: Chile Ends Capital Repatriation Restrictions*, Reuters Econ. News, Aug. 7, 1995. In Mexico, debt-equity swaps have continued to play a major role. Robert Taylor, *Seedily Holds the Lid On*, BANKER, Aug. 1996, at 46.

companies. For instance, the recent restructuring of Eurotunnel, the tunnel linking England and France, involves a proposed swap of one billion pounds of debt for equity.[7] In Russia, debt-equity swaps were first mooted as early as July 1992,[8] and have since attracted a considerable deal of attention,[9] even though the swaps have not been implemented. The former Soviet satellites in Eastern Europe have been quicker off the mark.

Poland implemented an extensive privatization program in 1990 and had privatized half of all state-owned enterprises by the end of 1994.[10] Debt-equity swaps were introduced into the Polish process in 1994, principally for use by Polish banks in converting their non-performing loans into equity stakes in the debtor companies.[11] Foreign debt was not eligible for use in these Polish debt-equity swaps,[12] although there were suggestions in 1995 and 1996 that it should be.[13] Other Eastern European countries, such as Croatia,[14] the Czech Republic,[15] and Hungary,[16] have used debt-equity swaps to enable banks to exchange debt for equity in highly indebted local companies so that the local banks become shareholders in the companies. Bulgaria[17] has likewise made extensive use of debt-equity conversions,

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[7] Joe Ortiz, *Bankers See Debt Restructuring Signed Well Before Year End*, Reuters Eur. Bus. Rep., Jan. 22, 1997, *available in* LEXIS, Busfin Library, Reueub File; Mary Brasier, *Eurotunnel Asks for Debt-Equity Swap*, DAILY TELEGRAPH, June 20, 1996, at 19, *available in* LEXIS, News Library, Txtnws File.

[8] *Debt-for-Equity Swap Just An Idea*, RUSSIA & COMMONWEALTH BUS. L. REP., Aug. 7, 1992, at 15.

[9] *See generally* Thomas M. Reiter, *The Feasibility of Debt-Equity Swaps in Russia,* 15 MICH. J. INT'L L. 909 (1994); Nigel Stephenson, *Russia Aims for Foreign Debt/Equity Swap in 1997*, Reuters Fin. Serv., Dec. 13, 1995, *available in* LEXIS, News Library, Reufin File.

[10] *See* Ryszard Rapacki, *Privatization in Poland: Performance, Problems and Prospects,* 37 COMP. ECON. STUDIES 57, 59 (1995). The original, overly ambitious goal of the program was to reach this milestone by the end of 1992. *Id.* at 57.

[11] *Id.*

[12] *New Polish Privatization Law Passed*, PRIVATISATION INT'L, Oct. 1, 1996, *available in* LEXIS, Market Library, Iacnws File.

[13] *Polish Plans for 1996*, PRIVATISATION INT'L, Feb. 1, 1996, *available in* LEXIS, Market Library, Iacnws File.

[14] By early 1996, Croatian banks had converted well over DM 1 billion of non-performing loans into equity stakes in local companies. *See Painful Peace*, BANKER, May 1996, at 61.

[15] Jan Lopatka, *Czech Truckmaker Tatra Rescued*, Reuters Fin. Serv., Feb. 29, 1996, *available in* LEXIS, News Library, Reufin File.

[16] *See KH Bank Acquires 39% of Concordia Warehouse Firm*, MTI ECONEWS, Sept. 18, 1995, *available in* LEXIS, News Library, Txtnws File.

[17] Richard Lapper, *Conversion Deals Are Back in Fashion - Debt-Equity Programmes,* FIN. TIMES (London), Feb. 6, 1995, *available in* LEXIS, News Library, Allnws File; *Bulgaria Uses $17 Million of Bradys in Privatization*, Reuters Fin. Serv., Sept. 12, 1995, *available in* LEXIS, News Library, Reufin File; Robert Whitford, *Dynamic Debt: Brady Bonds Can Sweeten Bulgarian Acquisitions*, BUS. E. EUR., Feb. 19, 1996, at 4. Under Bulgaria's regulations, Brady bonds can be used to finance up to one-half of the price of a company to

principally of external debt in the form of Brady bonds.[18] In the words of one commentator, "[d]ebt-equity swaps have become a standard tool for foreign investment in Bulgaria, as they promise bargain prices for privatised assets."[19]

II. DEBT-EQUITY SWAPS

This section considers debt-equity swaps involving the exchange by a foreign investor of external debt incurred or guaranteed by a Latin American sovereign (the government of the debtor country) for an investment in a private sector company in the debtor country. The foreign investor will typically be either a multinational corporation, which has acquired the debt in the secondary market, or less often, a bank holding the debt as a result of its lending activities. For a multinational corporation making a new investment or expanding an existing one, a debt-equity swap offers the best exchange rate through which to make a capital injection into the private sector company.

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be privatized. *Investment Guide for Bulgaria*, EURO-E., Apr. 23, 1996, *available in* LEXIS, Eurcom Library, Eureas File.

[18] "Brady bonds" is the name commonly given to the collateralized bonds issued upon the securitization of a country's loans pursuant to a restructuring of the country's debt. They are named after the Brady Plan, a proposal by Nicholas Brady, then Secretary of the United States Treasury, first outlined in a speech to a joint meeting of the International Monetary Fund ("IMF") and the World Bank in Seoul, South Korea. *See* Nicholas Brady, Remarks before a Conference on Third World Debt (March 10, 1989), *in* DEP'T ST. BULL., May 1989, at 53-56. Secretary Brady proposed a series of individual market-based transactions in which (i) creditors would be invited to participate voluntarily, (ii) debt relief would be tied into the conversion of loans into collateralized bonds, (iii) debtor countries would be permitted to repurchase their own discounted debt on the secondary market and (iv) debt-equity schemes would be promoted. The proposal was seen as an expression of increased urgency from the U.S. government about the resolution of the debt crisis, a strong call for the development of capital-market-based solutions, and an official acceptance that some debt forgiveness was essential. *See* Lee C. Buchheit, *The Background to Brady's Initiative*, INT'L FIN. L. REV., Apr. 1990, at 29-31.

[19] Whitford, *supra* note 17. Further afield, Nigeria has operated a debt-equity scheme, with only a few interruptions, since 1988. *See* Tunde Obadina, *Nigeria to Resume Debt Equity Swaps Next Week*, Reuters World Serv., Mar. 20, 1995 *available in* LEXIS, News Library, Reuwld File. Jordan commenced its scheme in 1996 pursuant to an agreement with its official creditors. In April 1996, the United Kingdom's Export Credit Guarantee Department arranged to sell 35 million pounds sterling of its Jordanian debt at around 50% of face value for use in equity exchanges. *Jordan: Paris Club Debt/Equity Swap Approved*, MIDDLE E. ECON. DIG., Apr. 29, 1996, *available in* LEXIS, News Library, Txtnws File. France reached a similar agreement with respect to FF 325 million of Jordanian commercial debt. *Jordan: Debt/Equity Swap with France Approved*, MIDDLE E. ECON. DIG., July 15, 1996, *available in* LEXIS, News Library, Txtnws File. Negotiations with foreign commercial banks for more extensive conversion schemes were underway at the end of 1996. *Jordan Says 96 Budget Deficit Under 200 million Dinars*, Reuters Fin. Serv., Nov. 5, 1996, *available in* LEXIS, News Library, Reufin File.

In any debt-equity scheme, there are two methods used to convert debt into equity. Under the first method, the debt-equity scheme prescribes a set discount at which the debt may be converted into equity. For example, the debtor country's central bank may stipulate that it will retain twelve cents on the dollar so that, for every dollar of debt tendered, the investor receives local currency to the value of eighty-eight cents. Under the second method, the conversion rate may be set by an auction so that investors bid for the right to convert debt into equity and those willing to accept the largest discounts receive the right to convert their debt.

The attraction of these schemes to investors in Latin America in the 1980s becomes clear upon consideration of a typical example. In late 1986, Mexican sovereign debt was trading at fifty-seven cents on the dollar, and Mexico was taking an average redemption discount of eleven percent.[20] Allowing three cents on the dollar for the fees of a trader to assemble the package of convertible debt, an investor would receive eighty-nine cents worth of pesos for every sixty cents spent — an increase in buying power of over forty-eight percent.[21] Debt-equity swaps confer a preferential exchange rate upon foreign investors.[22] In exchange for such a preference there are usually limitations. Eligible investment is often limited to certain industries and restrictions are imposed on the repatriation of capital and the remittance of dividends.[23]

Debt-equity swaps were rapidly embraced in the 1980s by most banks and commentators, and, after a short period, by the U.S. government.[24] As a potential market-based response to the debt crisis, conversions into equity held out a hope against the spectre of mandatory debt forgiveness. In the 1980s, the major debt-equity schemes were operated in Argentina, Brazil,

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[20] RICHARD A. DEBS ET AL., FINANCE FOR DEVELOPING COUNTRIES: ALTERNATIVE SOURCES OF FINANCE: DEBT SWAPS 23 (1987)

[21] This example is modified from the one given by DEBS ET AL., *supra* note 20, to take account of the higher trader's fees and transaction costs which, from the author's experience, were typical in the market at that time.

[22] DEBS ET AL., *supra* note 20, at 23. For an analysis of the preferential exchange rate involved in debt-equity swaps, *see* George Anayiotos & Jaime De Pinies, *The Secondary Market and the International Debt Problem*, 18 WORLD DEVELOPMENT 1655, 1657 (1990).

[23] For instance, under the Chilean scheme, until 1995, capital could not be remitted in the first ten years of an investment, and dividends could only begin to be remitted in the fifth year, and then at a controlled rate. *See* Claudio Pardo, Remarks at the Heritage Foundation Center for International Economic Growth Conference on Debt/Equity Conversion: A Strategy for Easing Third World Debt 45, 48 (Jan. 21, 1987) (transcript on file with the *Northwestern Journal of International Law & Business*).

[24] *See generally* Mary Williamson, *Chile's Debt Conversion Program: Its Promises and Limitations*, 27 STAN. J. INT'L. LAW 437 (1991); Derek Asiedu-Akrofi, *A Comparative Analysis of Debt Equity Swap Programs in Five Major Debtor Countries*, 12 HASTINGS INT'L & COMP. L. REV. 537 (1989)

Chile, and Mexico[25] with less significant volumes of debt converted in Costa Rica, the Dominican Republic, Ecuador, Jamaica, Nigeria, Poland, the Philippines, Uruguay, and Venezuela.[26]

A. Potential Advantages of Debt-Equity Schemes

The potential advantages generally identified in the literature of debt-equity schemes for the debtor country include the following:

1. *Increased Investment*

The preferential exchange rate afforded by a debt-equity program may serve as an incentive for extra investment in the debtor country. Increased foreign direct investment is the most commonly cited advantage of debt-equity programs.[27]

2. *Recapture of Some of the Secondary Market Discount*

In virtually all debt-equity schemes, a portion of the secondary market discount is recaptured for the benefit of the debtor. Under Chile's auctions in the 1980s, between ten percent and fourteen percent of the face amount converted would generally go to the debtor. In the early 1990s, investors were prepared to pay substantially higher premiums to participate in con-

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[25] Between 1985 and 1993, these four Latin American countries were responsible for 79% of debt converted worldwide. Milman, *supra* note 5, at 170. The figure would have been much higher than 79% for the period 1985-89 considering that in excess of $2 billion of Chilean companies' external debt was converted through its formal program in 1987 and over $2.6 billion was so converted in 1988. *See* Williamson, *supra* note 24, at 490, Table 3 (1991); *see also* Asiedu-Akrofi, *supra* note 24, at 537. Argentina variously promoted and suspended its scheme throughout this period. However, once the price on Argentina's debts had fallen to the 20% range in 1988 and 1989, conversions became very attractive to the country because of the large amounts of debt erased by the conversions. Mexico's program was suspended in October 1987 amid concerns about its inflationary impact and effect on the allocation of new investments. Asiedu-Akrofi, *supra* note 24, at 560; *see also* Peter Truell, *Brazil Could Cut Foreign Bank Debt By $19 Billion By 1994, Study Says*, WALL ST. J., Aug. 23, 1988, at 6.

[26] Michael Chamberlin, et al., *Sovereign Debt Exchanges*, 1988 U. ILL. L. REV. 415, 417 n.17 (1988); Martin W. Schubert, A Debt Strategy for International Commercial Banks in 1988, Address at Bankers' Association for Foreign Trade Conference (Jan. 24-26, 1988) (on file with the *Northwestern Journal of International Law and Business*); Peter Truell & Charles F. McCoy, *Third World Creditors Give Debt-Equity Swaps a Try*, WALL ST. J., June 11, 1987, at 6.

[27] Lee C. Buchheit, *Debt Equity Conversion Programmes From the Debtor Country's Perspective*, *in* GUIDE TO DEBT EQUITY SWAPS: SPECIAL REPORT NO. 1104 33, 34 (Steven M. Rubin ed., 1987) [hereinafter GUIDE TO DEBT EQUITY SWAPS]; Elali, *Debt-Equity Swaps and the Alleviation of the LDCs Debt Problem*, 5 INT'L J. COM. & MGMT. 49, 64 (1995); Jay H. Newman, *Trends in the Market for Developing Country Debt and Debt Equity Conversions*, *in* GUIDE TO DEBT EQUITY SWAPS, *supra*, at 14; Lotfi Maktouf, *Some Reflections on Debt-for-Equity Conversions*, 23 INT'L LAW. 909, 910-915 (1989); Michael K. Phair, *Debt for Equity: A Portfolio Investment Approach*, *in* GUIDE TO DEBT EQUITY SWAPS, *supra*, at 80.

versions, but, overall, the proportion of the secondary market discount that Latin American debtors were able to appropriate remained small.[28]

3. *External Debt Relief*

As the debt converted into equity is extinguished, the repayment of interest and principal no longer burdens the debtor's economy and foreign exchange reserves.[29] Offsetting this benefit, however, is the immediate burden of repaying the external debt in local currency and the long-term drain on foreign exchange of dividends and capital repatriation on the equity investment.[30] In most debt-equity schemes, remittance of dividends and capital is restricted for a period of years, but eventually this outflow of foreign currency has to be permitted.[31] This outflow will exceed the interest that would have been due if the investments were successful as was the case, for the most part, in Latin America.[32]

4. *Encouragement of the Repatriation of Flight Capital*

The preferential exchange rate afforded by a debt-equity swap made the repatriation of flight capital by local investors more attractive, particularly as the typical limitations on repatriation of principal and payment of dividends did not affect local investors.[33] The return of flight capital is a commonly cited benefit of debt conversion programs.[34] However, this also heightened local criticism of the programs, which were seen as rewarding locals who had previously broken the exchange control laws by sending their money abroad.

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[28] Buchheit, *supra* note 27, at 34-35.

[29] *Id.*; Elali, *supra* note 27, at 62.

[30] ROBERT R. BENCH, REMARKS BEFORE THE EUROMONEY DEBT/EQUITY CONFERENCE: THE REGULATORY ENVIRONMENT FOR DEBT-EQUITY SWAPS (1987), *reprinted in* 6 OCC Q.J. 17 (1987); Williamson, *supra* note 24, at 475-77.

[31] Argentina, Brazil, Chile, Mexico, and the Philippines each imposed restrictions on capital repatriation and profit remittances in their debt-equity schemes. Asiedu-Akrofi, *supra* note 24, at 571.

[32] If the investment is in a field that does not generate foreign exchange, these dividend payments will deplete the country's foreign exchange reserves. *See* Tina Hofmann, *International Debt: Debt-to-Equity Swaps,* 28 HARV. INT'L L.J. 507, 513 (1987). The success of these investments was made more likely because the prices paid for them were set in a period of extreme economic hardship. *See* Ricardo A. Lagos, *Debt-Equity Swaps and the Consequences for Chile, in* THIRD WORLD DEBT: MANAGING THE CONSEQUENCES 139, 148 (Stephany Griffith-Jones ed., 1989) [hereinafter THIRD WORLD DEBT: MANAGING THE CONSEQUENCES].

[33] This remained true only if local investors were prepared to keep the funds in their country.

[34] *See* Asiedu-Akrofi, *supra* note 24, at 569; Elali, *supra* note 27, at 64; Lagos, *supra* note 32, at 143.

5. *Encouragement of Privatizations*

Facilitating the privatization of state-owned companies that were a burden to the economy has been identified by some commentators as a benefit of debt-equity programs.[35] Chile and the Philippines, in particular, used their debt conversion programs to facilitate extensive privatization programs.[36]

B. Potential Disadvantages of Debt-Equity Schemes

The generally identified potential disadvantages of debt-equity schemes include the following:

1. *Inflationary Impact*

The most widely criticised aspect of debt-equity schemes has been its effect on economies that typically were struggling to limit inflation. In the words of Jeffrey Sachs, "[t]he problem with a debt-equity swap is that it is highly inflationary, exactly [when] the government is desperately attempting to control inflation."[37] When a debtor country's central bank prints cash to fund conversions of the national debt, the impact is highly inflationary. More commonly, a country will issue bonds domestically in local currency to fund the conversions. The demand generated by such bonds puts upward pressure on local interest rates, which potentially increases the government's cost of funds and crowds out private investors.[38] Furthermore, since these local currency bonds are short-term, the bonds are so similar to money that their issuance fuels inflation directly by adding to the monetary supply.[39] In general, whenever credit to the economy is allowed to expand to fund conversions of debt, the result has been strong inflationary pressures.[40] For instance, Mexican officials calculated that for every $100 million of

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[35] *See* Asiedu-Akrofi, *supra* note 24, at 572; DEBS ET AL., *supra* note 20, at 27.

[36] *See* Asiedu-Akrofi, *supra* note 24, at 572.

[37] *International Economic Issues and Their Impact on the U.S. Financial System: Testimony Before the House Comm. on Banking, Finance and Urban Affairs*, 101st Cong. 355, 369 (1989) (statement of Jeffrey D. Sachs, Harvard University) [hereinafter Sachs' Testimony]; *see also* Steven M. Cohen, *Give Me Equity or Give Me Debt: Avoiding a Latin American Debt Revolution*, 10 U. PA. J. INT'L. BUS. L. 89, 121 (1988); Shilling & Toft, *Debt Equity Conversion Analysis – A Case Study of the Philippine Program*, World Bank Discussion Paper No. 76, ¶ 4.04 (1990); Williamson, *supra* note 24, at 478-79; WORLD BANK, DEVELOPING COUNTRY DEBT IMPLEMENTING THE CONSENSUS xxxii (1987).

[38] Michael Blackwell & Simon Nocera, *The Impact of Debt to Equity Conversion*, FINANCE & DEVELOPMENT, June 1988, at 17; Elali, *supra* note 27, at 65; Lagos, *supra* note 32, at 148; Reiter, *supra* note 9, at 960 (1994); Williamson, *supra* note 24, at 479.

[39] Sachs' Testimony, *supra* note 37, at 370.

[40] Shilling & Toft, *supra* note 37. Blackwell and Nocera calculated that the conversion of only 5 % of the outstanding debt could have led to an increase in the money supply ranging from 33 % for Brazil and the Philippines to 59 % for Mexico. Blackwell & Nocera, *supra* note 38, at 16.

debt converted to equity in the years 1986 and 1987, inflation increased by between three percent and five percent. This is a substantial increase considering that $100 million is a modest amount of debt.[41]

2. *Substitution for Fresh Investment*

Investment by way of debt-equity conversion does not result in extra foreign exchange and capital for the debtor economy as do other forms of foreign investment. Accordingly, if debt-equity conversion schemes are merely subsidising investments that would have been made anyway, the conversions are positively detrimental to the host country,[42] as the investments would have been made at more favorable exchange rates and accompanied by an injection of precious foreign currency.

3. *Short Term Costs and Benefits*

In the short term, a debt-equity conversion saves the debtor economy the interest payments over the few years following the conversion at the cost of paying around ninety percent[43] of the face value of the tendered debt in local currency immediately.[44] As local interest rates were usually higher than the interest rates on the foreign currency in which the external debt had been denominated,[45] and local currency denominated bonds were usually issued by the government to fund the conversions, debt-equity conversions typically resulted in significantly increased budgetary burdens on Latin American debtor governments.[46] As Buchheit wrote in 1987, "[s]ome countries therefore see these transactions as amounting to the immediate tender of 100 cents worth of local currency in return for seven or eight cents (at present interest rates) of debt service relief in each of the next few years."[47]

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[41] *See* Steven M. Rubin, GUIDE TO DEBT EQUITY SWAPS, *supra* note 27. However, inflation should be unaffected in the unusual case in which a sovereign funded the conversion from its internal resources. Shilling & Toft, *supra* note 37.

[42] *See* Blackwell & Nocera, *supra* note 38, at 17; Buchheit, *supra* note 27, at 35-36; Lagos, *supra* note 32, at 147; Shilling & Toft, *supra* note 37; WORLD BANK, *supra* note 37, at xxxii.

[43] This depends upon the proportion of the secondary market discount recaptured for the debtor's benefit.

[44] Buchheit, *supra* note 27, at 36.

[45] *See* Daniel H. Cole, *Debt-Equity Conversions, Debt-for-Nature Swaps, and the Continuing World Debt Crisis*, 30 COLUM. J. TRANSNAT'L L. 57, 64 n.1 (1992); Williamson, *supra* note 24, at 479.

[46] *See* Buchheit, *supra* note 27, at 36; Sachs' Testimony, *supra* note 37, at 369; WORLD BANK, *supra* note 37, at xxxii-xxxiii.

[47] Buchheit, *supra* note 27, at 36. Buchheit has not allowed here for the redemption discount which accrued to the debtor country. Buchheit's comparison should have been between 85 or 90 cents of local currency and the interest relief, but his point is otherwise well made.

4. Facilitation of Round Tripping Transactions

The round tripping of the proceeds of debt-equity conversions from the local currency generated by the conversion back into foreign currency and then back into local currency by another conversion has been described as "an irresistible arbitrage opportunity" for "those so inclined."[48] In essence, round tripping is a way to convert external debt into local currency in such a way that the foreign exchange value of the local currency exceeds the value of the converted external debt. However, round tripping is not alchemy — the corresponding cost is borne in higher local indebtedness for the debtor government.

Latin American countries attempted to prevent round tripping by ensuring that the proceeds of a conversion were invested in an approved project and by prohibiting the repatriation of principal or payment of dividends abroad from the investment for a number of years.[49] However, no country managed to stamp out round tripping entirely, and this abuse appears to be a cost of debt conversion schemes.[50]

5. Misallocation of Resources

Debt-equity schemes may misallocate resources by sending incorrect signals to investors. A debt conversion program provides a subsidized exchange rate which, like all departures from the market, may lead to inefficiencies such as the investment going into sectors of the economy sheltered by tariffs and quotas.[51] Most conversion programs provided incentives for investment in priority sectors or regions, but these incentives were not always sufficient to prevent debt conversion investment from worsening structural imbalances in the local economy.[52]

Unless investment in existing plants or companies was restricted, as it was in a few countries,[53] investments under debt conversion schemes tended to be in existing plants or firms whereas unsubsidised foreign direct invest-

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[48] *Id.* at 37; *see also* WORLD BANK, *supra* note 37, at xxxii.

[49] Buchheit, *supra* note 27, at 37.

[50] There are two methods by which round-tripping can be constrained: first, prohibiting the participation of local investors, or second, tightening exchange and capital controls. Elali, *supra* note 27, at 66. However, each method has detrimental side effects.

[51] DEBS ET AL., *supra* note 20, at 34; Blackwell & Nocera, *supra* note 38, at 17.

[52] Most host countries attempted to channel debt conversion funds into priority sectors of the economy, typically those that generated exports and foreign exchange, or into depressed geographical regions of the country. *See* Maktouf, *supra* note 27, at 942. To the extent such investments could be effectively channeled into export industries, the long-term balance of the debtor country's trade might be improved. *See* Cole, *supra* note 45, at 66. Typically, investment in a priority sector or a region resulted in a lower redemption discount, *i.e.*, less of the secondary market discount would go to the debtor country and more of the discount would go to the investor. *See* Maktouf, *supra* note 27, at 912-13.

[53] Argentina, Costa Rica, Ecuador, and the Philippines restricted investments in existing plants or companies. *See* Lagos, *supra* note 32, at 153, 157 n.34.

ment is more frequent in projects that increase the productive capacity of the economy.[54] As a result, most of the investments encouraged by debt conversion programs merely resulted in a transfer of ownership of existing assets rather than the creation of new productive assets.

Debt-equity schemes may also misallocate resources by using "the proceeds of foreign equity investment or returning flight capital for the retirement of external debt, thereby excluding other possible important uses."[55] It is highly questionable whether the prepayment of external debt was the most efficient use of the sale proceeds of the conversion programs.[56] The proceeds could have been used to pay for imports, repair infrastructure,[57] or other uses designed to improve the productive capacity of the country. As Ricardo Lagos wrote, "paying the principal of the debt in advance may not be good business since it has become a virtual fact that the external debt will not be paid in its actual terms . . . . [T]he resources used to pay the debt in advance are being diverted from other urgent possible uses."[58]

6. *Incentives for Privatisations*

While the facilitation of privatizations is, in some eyes, a benefit of debt-equity schemes, the corresponding incentive to sell off national assets is, in other eyes, a detriment, particularly because the assets sold are often the most profitable and efficient.[59] In many countries, the extent of privatizations has been massive. For example, by the end of 1995, Brazil had privatized most of its petro-chemical enterprises and virtually all of its state enterprises in the steel and fertilizer sectors.[60]

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[54] *Id.* at 154.

[55] DEBS ET AL., *supra* note 20, at 33; Cole, *supra* note 45, at 64-65. *Cf.* Blackwell & Nocera, *supra* note 38, at 17.

[56] The same argument could be made with respect to the use of scarce foreign exchange reserves to effect debt buy-backs, but the difference is one of degree. Buy-backs benefit debtor countries when secondary market prices are so low that the cost of the buy-back is in the order of two to four years of interest repayments. When a buy-back recaptures a discount of 70% and upwards for the debtor country, its effect is quite different from a debt-equity swap that recaptures perhaps 10% or 15% of the discount for the debtor. See *infra* text accompanying note 138 for consideration of the effects of buy-backs.

[57] The state of Chile's roads declined precipitously in the mid-to-late 1980s when the economic focus was on reducing external debt. The long-term costs to Chile of having to effectively rebuild roads, which would have only required routine maintenance to avert their disintegration, has been massive. Interview with A. Byl, International Bank for Reconstruction and Redevelopment, Bond University (Feb. 20, 1996).

[58] Lagos, *supra* note 32, at 148.

[59] *Id.* at 153.

[60] Preliminary Offering Memorandum for the MYDFA Trust, at C-22 (Sept. 30, 1996) (on file with the *Northwestern Journal of International Law and Business*). By year-end 1995, Brazil had privatized 41 enterprises for a nominal, face value consideration of $9.6 billion, the vast majority of which was paid in Brazilian debt. *Id.* at C-22, C-23.

7. *Equity Considerations for Local Investors*

Debt-equity schemes give investors a preferential exchange rate, but in most countries, local investors do not have access to the foreign exchange which is required to purchase the debt on the secondary market. In addition, local investors are not permitted to purchase foreign exchange for this purpose.[61] Such schemes are also seen as rewarding local investors who, in defiance of local exchange control regulations, had moved their foreign currency abroad prior to the debt-equity conversion.[62] In Chile, protests against these rewards were muted because local investors were permitted to participate in the debt buy-back programs, but still were not permitted to participate in the debt-equity programs.[63] In virtually all other countries, local investors were expressly or effectively excluded from all programs, and this exclusion resulted in substantial local resentment.

C. Chile's Debt-Equity Program

Debt-equity schemes were, and are, consistently promoted by reference to the success of Chile's programs.[64] Indeed, in the first three years of operation, based upon the most favorable figures, Chile's debt buy-back and debt-equity programs reduced Chile's total foreign debt by $3.8 billion, which represented about nineteen percent of the debt existing upon the programs' commencement.[65] This is indeed a meritorious performance, and Chile's programs were operated consistently over many years so that additional investment was likely encouraged. Furthermore, Chile had strict limitations on the repatriation of principal and remission of dividends abroad, which restricted the drain on its foreign exchange reserves. Thus, it is no coincidence that debt-equity's proponents always refer to the Chilean experience; it has been entirely exceptional.

The Chilean economy had a remarkable capacity to absorb extra credit without the credit expansion leading to inflationary pressures. This capacity permitted the program to be opened, in part, to local investors, which did

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[61] *See* Buchheit, *supra* note 27, at 37-38.

[62] *Id.* at 38. In Mexico local investors were not permitted to participate in such schemes because this was seen as rewarding capital flight. *Id.*

[63] Williamson, *supra* note 24, at 468, 470, 475. The unusual capacity of the Chilean economy to absorb fresh funds and to hold a particularly tight rein on inflation meant Chile could operate a liberal program and open the program to local participation. Chile's approach is unlikely to succeed in other debtor countries.

[64] Cole, *supra* note 45, at 69; Lagos, *supra* note 32, at 139; *see also* Williamson, *supra* note 24, at 479. In Cole's words, "Chile's debt-equity conversion program is the success story to which all debt-equity proponents point." Cole, *supra* note 45, at 69. For a contemporaneous example of Chile being held up as the successful model of a debt-equity program, see Ross, Putting Debt/Equity in Context: Recapitalizing the Developing Nations, Remarks at the Euromoney Conference on Debt-Equity Swaps, Santiago, Chile, at 9-12 (Apr. 26-28, 1988) (on file with author).

[65] Lagos, *supra* note 32, at 143, 151.

much to quell local opposition.[66] Furthermore, Chile was one of the most developed and successful of the Latin American economies and thus had a relatively large proportion of companies and projects that were attractive to foreign investors. The absence of inflationary pressure and domestic dissent enabled the programs to be operated consistently over the years so as to generate real benefits for Chile. Nonetheless, Chile's programs have been criticized heavily, particularly for their contribution to the sharp fall in foreign direct investment.[67] However, irrespective of whether Chile's programs benefited Chile, and persuasive arguments have been made that they did not,[68] no other country except Brazil was able to operate its program for sustained periods, and in Brazil's case, hyperinflation and economic malaise were the apparent result.[69] Accordingly, Chile's experiences do not answer the question whether debt-equity programs were generally beneficial for debtor countries. For that answer, we must return to the above analysis of factors for and against such programs.

D. Conclusion for Debt-Equity Schemes

As the preceding discussion indicates, there are five factors in favor of debt-equity schemes and seven factors against such schemes. However, simple arithmetic will not determine whether debt-equity programs are desirable. The quality and extent of the benefits and detriments must be considered.

The principal potential benefit of such programs is the encouragement of additional investment. This factor is generally recognized as the key de-

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[66]The programs of Argentina, Brazil (after June 1984, if the investor was an original creditor), Mexico, and the Philippines were also open to local investors. Asiedu-Akrofi, *supra* note 24, at 571. Yet, local participation in these countries did not quiet public criticism of the programs, as it did in Chile, perhaps because the programs were seen as contributing to ruinous inflations in a way they were not in Chile. Furthermore, Chile's debt purchase program under Chapter XVIII was more extensively used by locals in Chile than conversion programs were in these other countries. *See infra* note 107 and accompanying text.

[67]Direct foreign investment (the type that results in the inflow of foreign exchange) fell from the already low figure of about $200 million in 1983-84 to about $110 million in 1985-1986. Chile's debt conversion programs were introduced in May 1985. Lagos, *supra* note 32, at 151. For a thorough consideration of the effects of the programs on Chile, see *id.* at 151-54.

[68]*Id.*

[69]In a 1988 study, Arno Meyer and Maria Silvia Bastos Marques, two Brazilian economists, adjudged that Brazil's program harmed the country. *See* Alan Riding, *Debt-Equity Swaps Draw Latin Criticisms*, N.Y.TIMES, Jan. 2, 1989, at A30 (critiquing the study). Professor Sachs said in 1988 that "the debt-equity swaps in Brazil have been a major spur to inflation, and have contributed disastrously to Brazil's economy this year." Sachs' Testimony, *supra* note 37, at 370. Professor Sachs also stated that "the debt-equity program last year was a major contributor to a hyperinflation which is now destabilizing the economy and society." *Id.* at 369.

terminant of whether a debt-equity scheme offers major benefits.[70] However, the conception, planning and implementation of international investment require substantial time. Because of the time involved in learning the program, investigating potential investment opportunities, settling upon an investment, acquiring the debt or options on the debt in the secondary market, and bidding in the conversion process, a debt-equity program is unlikely to result in much additional investment in its first year of operation, beyond the portfolio investment in local shares, if permitted. However, only Brazil and Chile allowed their programs to run uninterrupted over many years. The programs in virtually all other debtor countries typically ran for a year or so, and then were shut down because of inflationary concerns and local investor resentment. After a year or two, the programs were reopened, only to be shut down again after about six to eighteen months of operation. Buchheit has rightly described additional investment as "[t]he only sensible justification for inaugurating a formal debt equity conversion programme. . . ."[71] Yet, the stop-start nature of most programs guaranteed that little additional investment could result from them.[72] These Latin American experiences show that if Eastern European and other countries choose to extend their debt-equity schemes to include external debt, they must do so for an extended period of time such as three years but preferably longer. Otherwise, they will risk obtaining all of the detriments of including external debt, rather than the principal benefit of such a move.

The repatriation of flight capital afforded by debt-equity schemes was a significant benefit for Latin American debtors. However, this benefit was achieved at the cost of rewarding people who had earlier broken the foreign exchange regulations. As debt-equity in this sense is merely a preferential exchange rate, the same end could have been achieved in Latin America by simpler means. Capital flight on the Latin American scale never occurred in Eastern Europe because the local currencies were not freely convertible. Accordingly, the repatriation of flight capital is unlikely to be a significant benefit in Eastern Europe's debt-equity schemes for external debt.

The other three benefits of debt-equity programs are: (1) debt service relief; (2) recapture of secondary market discount; and (3) facilitation of privatizations, were extremely modest in the Latin American context. The first two of these benefits must be set against the need to repay about ninety percent of the face value of the loan immediately in local currency, a debt usually funded by the issuance of domestic bonds. The typical result found in Latin America of inflationary pressures and an increased fiscal drain on the government due to domestic interest rates being invariably higher than foreign ones, will also be the case in Eastern Europe. The secondary mar-

[70] DEBS ET AL., *supra* note 20, at 28; Buchheit, *supra* note 27, at 35.

[71] Buchheit, *supra* note 27, at 35.

[72] Mexican officials maintained that up to 80% of debt conversion investment would have come into Mexico in any event. Riding, *supra* note 69, at A34.

ket discount recaptured by Latin American debtors was usually modest and grossly insufficient to offset the increased domestic funding costs. There is no reason to suggest that Eastern European debtors will be able to reclaim larger portions of the secondary market discount. Finally, it is debatable whether the facilitation of privatizations is a benefit to countries using debt-equity programs, but privatization is less of a benefit in the transformation of former command economies in Eastern Europe than it was in the "structural adjustment" of the economies of Latin America.

Against these modest benefits, the disadvantages of debt-equity schemes for external debt are very real. In particular, the major disadvantages include the loss of the foreign currency that would otherwise have accompanied foreign direct investment if not channelled through a debt-equity scheme, the massive budgetary burden of redeeming the debt in local funds, the inflationary pressures on the local economy, and the misallocation of resources. These disadvantages apply equally wherever such schemes for external debt are implemented. These factors combine to make debt-equity schemes, in the words of Professor Jeffrey Sachs, "the worst possible arrangement from the point of view of the debtor country."[73] Throughout the 1990s, Eastern European countries have struggled to contain severe inflationary pressures.[74] In this context, the added inflationary effects of debt-equity exchanges are likely to be ruinous.

III. PRIVATIZATIONS

A number of Latin American countries announced or implemented privatization schemes in the late 1980s.[75] Privatizations can be divided into two groups: first, those in which state-owned assets are sold for external debt, and second, those in which the assets are sold for domestic debt or cash. The previous analysis regarding debt-equity swaps applies for the most part to privatizations for external debt, which are, after all, simply massive one-shot debt-equity swaps. The principal difference between privatizations and other forms of debt-equity conversions is that in a privatization, the local currency issued to redeem the external debt is immediately paid to the government to acquire state-owned assets and therefore the in-

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[73] Sachs' Testimony, *supra* note 37, at 368. These comments of Professor Sachs were directed at Latin America, but apply equally to Eastern Europe.

[74] R.A. Selg & M.J. Ades, *Closed-Market to Open-Market Challenges Facing Eastern Europe* (visited Dec. 5, 1996) <http://www.srs.gov/shrine/html/general/sci-tech/stpubs/abstracts/161.html>.

[75] Brazil announced its privatization program in April 1988, listing 64 state-owned companies as potential candidates. *Better Brazilian Exit Bond Terms Sought*, 720 INT'L FIN. R. 1204 (Apr. 16, 1988).

flationary effects are minimized.[76] On the other hand, the assets that are privatized are usually among the more productive in public ownership.[77] Whether assets such as national airlines, oil companies and steel makers were an appropriate price to pay to reduce their debt of the 1970s is highly questionable given the banks' negligence and over-aggressive salesmanship in making the loans.[78] For economic rationalists, privatizations are beneficial because they reduce the total indebtedness of the debtor and result in the transfer of valuable assets from "inefficient" state control into "efficient" private sector control, but others have likened the sale of national assets to "some surrealistic capitalist fantasy . . . whose . . . hero sells off arms, legs, and much else to stay alive."[79] According to this view, the costs of privatizations will be borne by the citizens of Latin America well into the next century.[80] Overall, the desirability of privatizations is a vexed issue.

Wherever implemented, privatizations need to be handled with great care as they are irreversible and potent. Privatizations appear to be required to introduce private ownership of productive assets into former command economies. The case for privatizations in Eastern Europe is certainly more compelling than in Latin America.[81] With the exception of Bulgaria, most privatization schemes in Eastern Europe to date have been focussed on domestic investors. This is a wise policy choice by Eastern European governments because the sale of productive national assets to foreign interests

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[76] Stephen Fidler, *Debt Reduction: The Coming Game*, FIN. TIMES, Jan. 12, 1989, at 39; Letter from Lee C. Buchheit to author (Feb. 24, 1997) [hereinafter Buchheit Letter] (on file with the *Northwestern Journal of International Law & Business*).

[77] The Australian cartoonist and poet, Michael Leunig, deals with economic rationalism and privatizations in the following poem:

> They're privatising things we own together
> They're flogging off the people's common ground
> And though we're still connected by the weather
> They say that sharing things is now unsound....

MICHAEL LEUNIG, *The People's Treasure*, *in* A BUNCH OF POSEY 40 (1992).

[78] James W. Child, *The Limits of Creditors' Rights: The Case of Third World Debt*, 9 SOC. PHIL. & POL'Y 114, 138-39 n.1 (1992).

[79] LAWRENCE MALKIN, THE NATIONAL DEBT 125-26 (1987); *see also* Cohen, *supra* note 37, at 121. Privatizations provoked heated opposition in the debtor countries. *See Defusing the Debt Bomb the Less Painful Way*, WALL ST. J., Apr. 1, 1985, at A1; Eric N. Berg, *U.S. Banks Swap Latin Debt: Concerns Get Equity Stake*, N.Y.TIMES, Sept. 11, 1986, at D1.

[80] The arguments for and against privatization raged in Britain, where large scale privatization began under Margaret Thatcher, and continue today in Australia as the conservative federal government proposes the sale of the national airline, telecommunications company and other national assets. The arguments are the same whether in Britain or Brazil, Australia or Argentina. However, the consequences of these arguments are far greater in Latin America, a region so poor that economic errors cost lives.

[81] Yet, many authors have tried to make compelling cases for privatization in Latin America. *See* Sebastian Galiani & Diego Petrecolla, *The Changing Role of the Public Sector: An Ex-Post View of the Privatization Process in Argentina*, 36 Q. REV. ECON. & FIN. 131, 131, 149 n.2 (1996).

in times of economic distress will result in fire-sale prices, hardly a fair recompense. Sale to local interests retains the control and proceeds of the productive assets within the country.

In Britain and Australia, privatizations have been the choice of conservative governments focused on fiscal rectitude, balanced budgets and economic rationalism. In Latin America, notwithstanding the presentation of privatizations as "as a deliberate, freely adopted policy choice applauded by ideologues in Washington and local beneficiaries,"[82] privatizations were an economic necessity, not a choice.[83] Privatizations were "[t]he almost unavoidable result of dozens of governments' virtual bankruptcy."[84] This has not been the case in Eastern Europe where privatizations have been driven by the need to reform command economies into market economies.

IV. DEBT-FOR-NATURE AND DEBT-FOR-DEVELOPMENT SWAPS

A. Introduction

Debt-for-nature and debt-for-development swaps were significant in Latin America, and could be significant in Eastern Europe and elsewhere, for their capacity to fund nature conservancy and relief work. These types of debt exchanges were never conducted, and are unlikely ever to be conducted, on a scale sufficient to significantly effect a debtor's overall indebtedness. For example, the reduction in indebtedness of $80 million by the debt-for-nature swap in Costa Rica in the late 1980s[85] was less then one percent of the total debt, yet the local currency proceeds of the swaps were described by Costa Rica's Minister of Natural Resources, Energy and Mines, as being "absolutely essential. . . . There would [otherwise] have been no money to purchase land bridges between parks, to start tree nurseries for farmers, or even to fight forest fires."[86]

[82] JORGE G. CASTANEDA, UTOPIA UNARMED THE LATIN AMERICAN LEFT AFTER THE COLD WAR 419 (1993).

[83] *Id.*

[84] *Id.* The first privatization scheme in Chile was by choice rather than necessity and was remarkably extensive, resulting in the privatization of 551 of the 596 state-owned enterprises in existence in the late 1970s. Milman, *supra* note 5, at 172. However, necessity forced other Latin American countries such as Argentina, Brazil, and Mexico to privatize.

[85] WORLD BANK, WORLD DEBT TABLES 1996 – EXTERNAL FINANCE FOR DEVELOPING COUNTRIES 90 (1996) [hereinafter WORLD DEBT TABLES].

[86] Lincoln C. Wee, *Debt-for-Nature Swaps, A Reassessment of Their Significance in International Environmental Law*, 6 J. ENVTL. L. 57, 63 (1994); *see also* Alvaro Umana, *Costa Rica Swaps Debt for Trees*, WALL ST. J., Mar. 6, 1987, at 31.

B. Debt-for-Nature Swaps

The first-born offspring of debt-equity swaps were debt-for-nature swaps, of which there are two broad forms.[87] In the first form, a country's debts are purchased and canceled in exchange principally for the country's on-going protection of a designated part of its land.[88] In the second form of debt-for-nature swap, the debt is exchanged for local currency which is then used by local conservation groups, often in association with international conservation groups, for various environmental projects in the debtor country.[89] This second form of exchange has a number of advantages over the first. The perceived loss of sovereignty is far less when there are a range of projects selected with local input rather than when the entire transaction is for the preservation of one area of the country designated by a foreign conservation group. Sovereignty is a highly sensitive issue in many Less Developed Countries ("LDCs") where it was seriously eroded by the debt crisis and its consequences.[90]

Another advantage of using the second form of debt-for-nature swap is that the funds can be used for local needs because the local conservation groups determine the use of the funds. The designation of an area as pro-

[87] For an explanation of debt-for-nature swaps, see generally Priya Alagiri, *Give Us Sovereignty or Give Us Debt: Debtor Countries' Perspective on Debt-For-Nature Swaps*, 41 AM. U. L. REV. 485, 487 n.2 (1992); David Barrans, *Promoting International Environmental Protections Through Foreign Debt Exchange Transactions*, 24 CORNELL INT'L L.J. 65, 65 n.1 (1991); Cole, *supra* note 45, at 57; Tamara J. Hrynik, *Debt-for-Nature Swaps: Effective But Not Enforceable*, 22 CASE W. RES. J. INT'L L. 141 n.1 (1990); Julian C. Juergensmeyer & James C. Nicholas, *Debt For Nature Swaps: A Modest But Meaningful Response to Two International Crises*, 5 FLORIDA INT'L L.J. 193, 194 n.2 (1990); Wee, *supra* note 86, at 57 n.1.

[88] An example of the first form of debt-for-nature swaps is the first debt-for-nature swap in July 1987 in which Conservation International, a U.S. conservation group, purchased about $650,000 face value of Bolivian debt for $100,000. Under an agreement with the Bolivian government, the external debt was cancelled in exchange for commitments to protect some 1.2 million acres of biosphere reserve and adjoining land and 2.8 million acres of forest reserve, and commitments to establish a fund in local currency for the on-going management and protection of the biosphere reserve. *See* Chamberlin et al., *supra* note 26, at 441-43; Hrynik, *supra* note 87, at 142-45; Wee, *supra* note 86, at 61; *Debt-for-Nature Option*, SWAPS: THE NEWSLETTER OF NEW FIN. INSTRUMENTS, Nov. 1988, at 1, 4 [hereinafter *Debt-for-Nature Option*].

[89] An example of this form of transaction is, coincidentally, the second debt-for-nature swap, which was between the World Wildlife Fund (WWF) and Ecuador in December 1987. The WWF acquired Ecuadorian debt with a face value of $1 million and assigned this debt to Fundacion Natura (Ecuador's leading private conservation organization). Under a prior agreement, this was then exchanged with the Ecuadorian government for local currency bonds to the value of $1 million at the official exchange rate. Fundacion Natura then applied the interest on these bonds to a range of its activities concerned with protecting and managing natural areas. Upon maturity, the principal of the bonds will establish an endowment fund for Fundacion Natura. Chamberlin et al., *supra* note 26, at 443-45.

[90] For a discussion of sovereignty and local input issues, see generally Alagiri, *supra* note 87, at 496-503; Barrans, *supra* note 87, at 79-80; Wee, *supra* note 86, at 63-65.

tected is a developed world notion, which may not be entirely appropriate when applied in the context of a LDC in which people still have to forage for food and fuel in the designated areas.[91] Other examples include Poland, a country with catastrophic pollution problems, in which a pollution cleanup to protect people was seen locally to be a far higher priority than the preservation of bird life habitats by the foreign sponsored debt-for-nature swap.[92]

Debt-for-nature exchanges have also been implemented in Costa Rica, the Dominican Republic, the Philippines,[93] Madagascar, Bolivia, Ecuador, Mexico, Poland, and Zambia.[94] Between 1987 and 1994, debt-for-nature swaps resulted in about $178 million face value of debt being exchanged for environmental protection.[95] Their success should be seen in offsetting to a limited extent the environmental damage, particularly deforestation,[96] occasioned by the need to earn foreign exchange to service foreign debts, rather than in terms of the ever-so-slight reduction in the debt burden of some countries.[97]

C. Debt-for-Development and Debt-for-Education Swaps

Furthermore, debt-for-nature swaps themselves spawned two further useful variants: debt-for-development swaps and debt-for-education swaps. Debt-for-development swaps typically involve the donation of debt to, or acquisition of debt by, an aid agency which, by prior agreement with the host country's central bank, exchanges the debt for local currency to be

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[91] The first debt-for-nature swap, in Bolivia, attracted criticism on these grounds. *See* Alagiri, *supra* note 87, at 499-501; Wee, *supra* note 86, at 64 & n.71; Barrans, *supra* note 87, at 81-82.

[92] D.H. Cole, *Cleaning Up Krakow: Poland's Ecological Crisis and the Political Economy of International Environmental Assistance,* 2 COLO. J. INT'L ENVTL. L. & POL'Y 205, 241-43 n.2 (1991); Cole, *supra* note 45, at 76. Scientists predict that up to "25 percent of all Poles will contract some form of pollution-related cancer." *Id.*

[93] The Philippines exchange involved the WWF and was in the second form. The relevant Philippine government department, a local environmental foundation, and the WWF governed the application of the funds. *See* Chamberlin et al., *supra* note 26, at 444-45 & n.114.

[94] Facundo Gomez Minujin, *Debt-for-Nature Swaps - A Financial Mechanism to Reduce Debt and Preserve the Environment,* 21 ENVTL. POL'Y & L. 146, 147 n.3&4 (1991). Furthermore, debt-for-nature swaps have been expanded dramatically in scope by the donation of debt by some governments; the U.S. government donated up to $100 million of debt and the German government donated $60 million of debt to Poland to finance environmental programs. Cole, *supra* note 45, at 80-81.

[95] WORLD DEBT TABLES, *supra* note 85, at 89-90.

[96] J. Eugene Gibson & Randall K. Curtis, *A Debt-for-Nature Blueprint,* 28 COLUM. J. TRANSNAT'L L. 331, 332 (1990).

[97] Wee, *supra* note 86, at 57-59; *Debt-for-Nature Option, supra* note 88, at 1.

used to fight hunger and disease and promote development in that country.[98] Debt-for-development swaps are a highly effective means for aid agencies to increase the buying power of their foreign currency in local currency. If handled properly they pose none of the infringement of sovereignty problems associated with some styles of debt-for-nature swaps and they "enhance the ability of aid organizations to operate programs that make people their first concern."[99] The scale of debt-for-development swaps, which grew out of debt-for-nature swaps, has far eclipsed debt-for-nature swaps. It has been estimated that from 1987 to 1994 between U.S. $750 million and U.S. $1 billion face value of foreign debt was cancelled in debt-for-development swaps[100] with UNICEF alone converting nearly U.S. $193 million of debt-for-development.[101] In the same period, a total of about U.S. $177 million of foreign debt was converted in debt-for-nature swaps.[102]

Debt-for-education swaps are another application of the basic principle that the acquisition of debt and its tender to the debtor country for discharge can, by virtue of the debt's secondary market discount, magnify the purchasing power of one's hard currency for local currency; the only difference in this case is that the local currency supports educational rather than developmental goals.[103] In the first debt-for-education swap, Harvard University multiplied its purchasing power almost three times.[104]

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[98] For instance, in December 1988, Midland Bank donated some $800,000 face value of Sudanese debt to the United Nations Children's Fund (UNICEF). UNICEF arranged for the Sudanese government to continue servicing the debt in local currency (as opposed to the foreign currency in which it was denominated) and these interest payments were invested in water, sanitation, reforestation, and health education programs administered by UNICEF in the Sudan. Stephany Griffith-Jones & David Wainman, *Donations of LDC Debt by Banks to Charities, in* THIRD WORLD DEBT, *supra* note 32, at 99-100.

[99] Eve Burton, *Debt for Development: A New Opportunity for Nonprofits, Commercial Banks, and Developing States*, 31 HARV. INT'L. L.J. 233, 243 (1990).

[100] KAISER & LAMBERT, DEBT SWAPS FOR SUSTAINABLE DEVELOPMENT - A PRACTICAL GUIDE FOR NGO'S 14 (1996). Much of the debt converted in debt-for-development swaps was official bilateral debt (*i.e.* loans made by developed countries to the LDCs) and was donated by the developed countries for development purposes. For instance, in 1994 Canada forgave 75% of the C$ 22.7 million of Peru's official bilateral debt and converted the balance for development purposes. Similar arrangements were entered into between Finland and Peru (1995), Germany and Peru (1994), Switzerland and Bulgaria (1995), and the United States and the Philippines (1995). *Id.* at 8.

[101] *Id.* at 16.

[102] *Id.* at 12-13.

[103] The discount in the secondary market is the main significance of all of these debt exchanges. Minujin, *supra* note 94, at 147-48.

[104] In 1990, Harvard University and Ecuador entered into a debt-for-education agreement. Harvard acquired $5 million of Ecuadorian debt at 15.5% of face value for $775,000 and exchanged it with the Central Bank of Ecuador for 50% of face value in local currency bonds. The bonds were transferred to a newly formed local Ecuadorian educational foundation which sold the bonds in Ecuador and used the proceeds to purchase US dollars in the

D. Conclusion — Debt-for-Nature, Debt-for-Development, and Debt-for-Education Swaps

Debt-for-nature, debt-for-development, and debt-for-education swaps made no significant difference to the total indebtedness of Latin American countries. However, measuring the effect of the swaps on debt levels misses the important roles that the swaps did play. Bolivia, a desperately poor country, was able to reduce its debt burden dramatically and preserve some of its ravaged environment, through debt-for-nature swaps using donated funds.[105] Costa Rica received funding for conservation efforts where none would otherwise have been available. Villages in Peru, the Sudan and elsewhere have drinking water today because of debt-for-development swaps. The effect of these debt exchanges on the debt crisis was negligible. However, the effect of these debt exchanges on nature conservancy and development programs was far from negligible, and these types of debt exchanges were one of the very few positives to flow from the debt crisis.[106]

V. DEBT BUY-BACKS

A. Debt Buy-Backs in Latin America

As their name implies, debt buy-backs involve the acquisition of debt by the debtor either directly from creditors or through the secondary market. Chile implemented Latin America's first buy-back scheme in 1985. Chile's debt conversion program had two main limbs, which are commonly referred to as Chapter XVIII and Chapter XIX after the implementing laws. Chapter XVIII was a debt purchase program for Chilean companies or persons wishing to purchase foreign debt and convert it into local currency.[107] The

local market. The proceeds amounted to some $2 million, or almost three times Harvard's initial contribution. These funds, now owned by the local foundation, were invested in the United States. The investments are designed to realize about $150,000 per annum of which about 85% will be used to fund scholarships for Ecuadorian students to attend Harvard and the balance will fund local costs for research and study in Ecuador by Harvard faculty and students. Jennifer F. Zaiser, Note, *Swapping Debt for Education: Harvard and Ecuador Provide a Model for Relief*, 12 B. C. THIRD WORLD L.J. 157, 180-83 (1992).

[105] Jeffrey D. Sachs, *Comprehensive Debt Retirement: The Bolivian Example*, 2 BROOKINGS PAPERS ON ECON. ACTIVITY 705 (1988).

[106] Although, on balance, the harm done to the environment because of the debt crisis outweighed many times the repair efforts funded by debt-for-nature swaps.

[107] The consideration of Chile's debt conversion programs in this article has been simplified. For example, certain debt-equity swaps could be conducted under Chapter XVIII and conversions were also possible under Decree Law 600, which represented a third limb of the conversion program. In addition, some 32% of conversions between 1985 and 1990 occurred outside the formal program, typically by way of direct agreements between debtor companies and their creditors. For a full consideration of Chile's debt conversion program, see generally Williamson, *supra* note 24, and for more information on informal conversions, see Williamson, *supra* note 24, at 465-66.

international banking community was not pleased with Chile's proposed debt repurchase scheme, but the banking community did not attempt to block the scheme and, by 1988, even permitted Chile itself to buy back its own debt.[108] The cause of this surprising degree of acceptance is not known. One reason may have been Chile's economic growth and stability[109]. Also, Chile's orderly and efficient administration of these debt conversion programs made Chile the international banks' favorite LDC debtor. Another possible explanation may have been that the transactions were commonly called Chapter XVIII conversions rather than debt buy backs. Regardless of the explanation, Chile's debt conversion programs have been consistently hailed as the most successful of any debtor nation and the appropriate precedent for other debtors to follow.[110] One of the central components of Chile's debt conversion programs was a debt purchase scheme.

Under Chapter XVIII, the Chilean government held regular, fortnightly auctions at which local companies would tender the amount of discount they were prepared to accept in exchange for the right to purchase and convert external debt.[111] A typical discount was about fifteen percent of the face amount of the debt.[112] If the Chilean government accepted a local company's tender, the Chilean entity would then buy the external debt of Chile in the secondary market with dollars. The Chilean entity would acquire these dollars either at a slight premium within Chile,[113] or perhaps more commonly, from dollars already held abroad.[114] The external debt

[108] In the words of Chile's chief debt negotiator, Hernan Somerville, "We have signed at least two amendments (one that allowed the buyback) and we have been able to get endorsement of 100% of banks in record time." *Free Fall in Secondary Market*, 750 INT'L FIN. R. 3864, 3865 (Nov. 12, 1988). For instance, Chile repurchased some $229 million face value of its debt in October 1988 at an average price of 56.3% of the face amount of the debt. *Id.*

[109] Economic growth averaged about 5% per annum throughout this period, and in 1988 Chile's trade surplus approached $1.85 billion. *See* Peter Truell, *Chile Buy-Back of Foreign Debt at Discount Set*, WALL ST. J., Sept. 22, 1988, at 4.

[110] Peter Truell, *Chile Pushes Debt-Conversion Program*, WALL ST. J., Dec. 9, 1987, at 34; Williamson, *supra* note 24, at 441-42. It is intriguing that while that many other countries implemented debt-equity schemes along the lines of Chapter XIX, few implemented debt buy-back schemes similar to Chapter XVIII. This may be because few other economies shared Chile's distinctive capacity to absorb new long-term debt. *See* Williamson, *supra* note 24, at 443.

[111] The government would accept the bids of those companies willing to accept the largest discounts.

[112] William G. Foulke, Remarks at the Heritage Foundation Center for International Economic Growth Conference on Debt/Equity Conversion: A Strategy for Easing Third World Debt 35, 37 (Jan. 21, 1987) (transcript available at the *Northwestern Journal of International Law and Business*).

[113] The typical premium was about five percent.

[114] Chapter XVIII can be viewed as a scheme to facilitate and make attractive the repatriation of flight capital because participants under a Chapter XVIII conversion do not need to reveal the origins of the foreign debt being converted whereas under Chapter XIX, de-

would then be converted at the official exchange rate, less the tendered discount, into peso-denominated bonds which could be sold in the local market.[115] Hence, a company that purchased the debt at sixty-five percent on the secondary market, and tendered a discount of fifteen percent, would have received eighty-five cents worth of pesos for sixty-five cents of U.S. currency and would have increased the value of its foreign currency some thirty percent, less associated transaction costs. These transactions were debt purchases rather than debt buy-backs because the debt purchaser was not necessarily the debtor because these transactions were open to Chileans. Because the transactions were open to Chileans, the common criticism that debt-equity programs subsidised foreign investors at the expense of locals was rarely heard in Chile.

Chapter XIX was a conventional debt-equity scheme distinguished by the consistent and timely efficiency of its operation.[116] Interestingly, while Chile was repeatedly applauded for its Chapter XIX debt-equity scheme by international banks, more debt was converted under Chapter XVIII than Chapter XIX,[117] and yet Chapter XVIII attracted relatively little attention.[118]

One of the more significant uses of buy-backs in the 1980s was in the repurchase of private sector debt by Latin American corporations. For instance, between 1983 and 1988, Mexican corporations almost halved their level of indebtedness, from $22.3 billion to $14.5 billion,[119] principally through buy-backs. In a mixed debt buy-back and equity swap, the Alfa Group, one of Mexico's largest corporations, agreed with its foreign creditors in 1988 to exchange $25 million in cash, $200 million in Mexican government paper, and forty-five percent of the group's stock in exchange for $920 million of the Alfa Group's debt.[120] During this period, Argentine and Brazilian companies also repurchased their debt by negotiating private buy-backs with their creditors.[121] In Brazil, local banks and industrial compa-

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tailed information was required on the source of the funds and nature of the investment. *See* Asiedu-Akrofi, *supra* note 24, at 543 n.14; Williamson, *supra* note 24, at 450.

[115] Asiedu-Akrofi, *supra* note 24, at 542-43.

[116] Foulke, *supra* note 112, at 38.

[117] *Id.* Up to December 1987, about $1.5 billion of debt had been converted through Chapter XVIII and about $660 million through Chapter XIX. *See* Truell, *supra* note 110.

[118] This may well be an example of the international banks controlling the debate. As Professor Sachs has written, "It is no accident that Citicorp, rather than the debtor countries, is the world's leading advocate of debt-equity swaps." Sachs, *supra* note 105, at 705.

[119] Peter Truell, *Latin American Debt Prompts Action*, WALL ST. J., Sept. 22, 1988, at 12.

[120] Asiedu-Akrofi, *supra* note 24, at 557.

[121] Martin W. Schubert, Overview of Financial Business Trends for 1989: How to Profit from the Use of Debt as a Means of Exchange in a Changing Latin America, Address at Latin American Investors Issues: 1988-89 – Salient Trends and How to Profit from Them (Sept. 16, 1988) (on file with author).

nies were particularly active, buying back about $150 million of their debt each month through much of 1988 in informal transactions.[122]

In addition to the formal debt-exchange auctions and informal buy-backs by local companies, foreign investors in need of local currency in this period began to initiate private buy-backs, most often in Brazil. The foreign investor would seek an agreement with a private sector debtor for the debtor to repay the debt in local currency. The investor would then acquire, at a substantial discount, the external debt of that debtor and swap it with the debtor for the local currency.[123] The investor would thus obtain local currency without the limitations on the use of the proceeds imposed in the formal debt-exchange auctions, and usually at a more advantageous price. It has been estimated that $3 billion of Brazilian debt was discharged in this manner in 1988.[124]

Neither buy-backs nor debt-equity swaps were a new idea.[125] However, while debt-equity swaps were received enthusiastically by the banking community, debt buy-backs met with tremendous resistance and were only tolerated initially for "basket case" countries like Bolivia[126] and, anomalously, for Chile. There were three reasons for this resistance. First, buy-backs were seen to result in the transfer of the debtor's foreign exchange reserves to the selling banks. However, this transfer would only have occurred if the buyback prices overvalued the debt, *i.e.* if the "real" value of the debt was less than the price that the debtor paid to repurchase it. Yet the money-centre banks that objected to buy-backs on these grounds had long argued that the secondary market undervalued the debt and that buy-backs

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[122] *Better Brazilian Exit Bond Terms Sought,* 720 INT'L FIN. R. 1204 (Apr. 16, 1988). Banks did these conversions under Resolution 63 and industrial companies under Resolution 4131.

[123] Chamberlin et al., *supra* note 26, at 459; *see also Brazilian Debt Arbitrage May be Too Good to Last*, EUROMONEY, Apr. 1988, at 40.

[124] Jeremy Bulow & Kenneth Rogoff, *The Buyback Boondoggle*, 2 BROOKINGS PAPERS ON ECON. ACTIVITY 675, 699 (1988) (comments of Rudiger Dornbusch); *see also* Chamberlin et al., *supra* note 26, at 459 n.166.

[125] In the 1880s, Peru crafted a resolution of its indebtedness in one, novel, massive debt-equity swap: British bonds were exchanged for stock in Peruvian Corp., the owner of the state railways, lands, and mining concessions. MARICHAL, *supra* note 2, at 120. Between 1935 and 1939, Chile repurchased about one-third of its bonds at an average price of 15% of face value. Anayiotos & De Pinies, *supra* note 22, at 1655.

[126] Bolivia established a buy-back scheme in July 1987 in which the foreign exchange was donated by anonymous sources thought to be The Netherlands, Spain and some wealthier Latin American countries. Bolivia offered to repurchase its debt directly from all of its 131 creditors in a coordinated scheme at a price of 11 cents on the dollar. At the time, Bolivian debt traded at six to eleven cents in the secondary market, interest payments having ceased in mid-1985. For an outlay of $34 million, the country repurchased some $308 million of debt, which represented about 46% of its $670 million foreign commercial bank debt. *See generally* Sachs, *supra* note 105; Peter Truell, *Bolivia Buys Back Nearly Half of Its Debt at a Fraction of the Face Value*, WALL ST. J., Mar. 18, 1988, at 23.

were usually at a price that was close to the secondary market price. Such flawed reasoning served as a major impediment to the growth of buy-backs.[127]

The second reason for bank opposition to buy-backs was because the debt forgiveness was so obvious. The realpolitik of rescheduling in the 1980s could accommodate covert debt forgiveness but blanched at the prospect of overt forgiveness. The third reason was the 'moral hazard' occasioned by buy-backs. In sovereign debt terms, 'moral hazard' describes any situation that rewards the sovereign debtor for financial misbehavior.[128] Informal debt buy-backs are a classic example of moral hazard because the secondary market price of the debt is acutely sensitive to the actions of the debtor country.[129] If a country institutes a moratorium on interest payments, the price of a country's debt falls through the floor as Brazil's did between July 1989 and early 1991 when Brazilian debt could be acquired for as little as twenty-two cents on the dollar.[130] In such a situation, two years of unpaid interest not only deflates the price of a country's debt, it liberates the funds to purchase it.[131]

Formal debt buy-backs usually require the consent of the creditors as such conduct is generally considered to be in breach of the mandatory prepayment and sharing clauses typically found in sovereign loan agreements.[132] However, consents are only required if the debtor repurchases its own debt. In the typical informal buy-back, the debtor uses either a state-owned company to acquire the debts or appoints a third party to buy the debts and acquires beneficial ownership of the debts through a participation

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[127] Comments of Michael Pettis, Managing Director, Bear Stearns & Co, New York City (Feb. 20, 1996) (on file with the *Northwestern Journal of International Law & Business*).

[128] Lee C. Buchheit, *Moral Hazards and Other Delights*, INT'L FIN. LAW REV. 10 (Apr. 1991). In mid-1990, bankers were reportedly "growing increasingly frustrated at the fact that there is not much they can do to Brazil, which has well over U.S. $8 billion in foreign reserves, and has made no attempt to start talks or to even make a token payment on more than U.S. $5 billion of overdue interest." *Brazil Debt Downgrade on Hold,* 831 INT'L FIN. R. 26 (June 16, 1990).

[129] Buchheit, *supra* note 128, at 10, 11; Anayiotos & De Pinies, *supra* note 22, at 1657.

[130] For instance, Brazilian debt traded at 22 cents on the dollar in March 1990, *LDC Secondary Market Prices*, 819 INT'L FIN. R., Mar. 24, 1990, 35; 24 cents on the dollar in July 1990, *LDC Secondary Market Prices*, 835 INT'L FIN. R., July 14, 1990, 29; 22 cents on the dollar again in October, *LDC Secondary Market Prices*, 847 INT'L FIN. R., Oct. 6, 1990, 29; and 24 cents on the dollar in January 1991, *LDC Secondary Market Prices*, 861 INT'L FIN. R., Jan. 19, 1991, 23.

[131] A further example of moral hazard arose in mid-1989 when Yugoslavia was accused of attempting to sell $50 million of its debt on the secondary market to drive down the price. *Yugoslavia Tries to Drive Debt Price Down*, 781 INT'L FIN. R., June 24, 1989, 26. Yugoslavia's debt buy-back scheme was particularly active at the time and a lower price would have resulted in less Yugoslavian foreign exchange reserves being used in the buy-backs.

[132] Buchheit, *supra* note 128, at 11; Andrew Yianni, *The Implications of the Brady Initiative on the Process of Rescheduling*, 10 ANN. REV. OF BANKING 329, 332-33 (1991).

share.[133] Neither of these cases infringes the typical mandatory prepayment clause or the sharing clause. Indeed in these cases the banks may not even know the debtor has effectively extinguished its own debts. The numbers, if not the morals, of interest moratoria and debt buy-backs are highly attractive to debtors[134] and are, in Lee Buchheit's words, "the nightmare of every banker."[135] The fact that debtors could only repurchase debt that some banks were willing to sell at the depressed price did not in the eyes of the banking community make the conduct less reprehensible.

In hindsight, debt buy-backs proved to be the principal source of debt relief for Latin American debtors. They certainly afforded many times the amount of debt relief of debt-equity programs while attracting a fraction of the attention. Indeed, the very degree of relief contributed to the parties keeping quiet about these transactions.

From the debtor's perspective, buy-backs suffered from few of the disadvantages of debt-equity conversion programs (although even buy-backs have had their trenchant critics).[136] Buy-backs were independent from, and did not replace, direct foreign investment. Particularly when secondary market prices for the country's debt were low (Brazil effected the majority of its buy-backs at prices around twenty cents on the dollar), the short-term costs of the buy-back were entirely reasonable as those short-term costs could be recouped entirely by the interest savings of the next few years.[137] Buy-backs were made in foreign currency and funded from foreign exchange reserves and were not funded by printing money or by issuing local

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[133] Buchheit, *supra* note 128, at 10.

[134] For example, consider the case in which a debtor declares a two-year moratorium on repayments of principal or interest. After twelve months or so, in the case of both Argentina and Brazil, such a moratorium drove the secondary market price of their debt to around 20 cents on the dollar. If the price of a country's debts falls to 20% and the country saves all the funds it would have paid out in interest at, say, 9% per annum, after a year it can begin repurchasing its debt progressively on the secondary market. Over the two years the nation will have saved enough money by not making repayments to retire effectively all of its outstanding debt. This is a neat and highly tempting alternative to the indefinite repayment of interest on the full face value of the debt. Of course, not all of a country's debts will be available for repurchase on the secondary market as many lenders will not part with their portfolios at that price. This point only applies with respect to the debt available on the secondary market.

[135] Buchheit, *supra* note 128, at 11.

[136] Bulow & Rogoff, *supra* note 124. Bulow and Rogoff criticize buy-backs on the following two grounds: first, buybacks overvalue the debt as the debtor pays a price equal to the average value of the debt while the debt reduction achieved is only at the margin, and the marginal value of the debt is less than the average; and second, because a sovereign debt buy-back, unlike a domestic buy-back, does not reduce the size of the pool of assets available to creditors upon default, it serves the creditors' interests more than the debtors. *Id.* However, even Bulow and Rogoff write that "it is better for a debtor country to agree to buy back debt at 30 cents on the dollar than to use the same resources to pay interest, which amounts to buying back debt at face value." *Id.* at 698.

[137] *See supra* note 134.

currency bonds. Thus, the buy-backs were not inflationary. Buy-backs did not provide a preferential exchange rate for investors, thereby leaving far less scope for misallocation of resources.[138] Buy-backs did not attract criticism in the debtor countries because: (i) the buy-backs did not favor foreign investors over local investors; (ii) the debtor country recaptured the entire secondary market discount; and (iii) the debtor nation retained its productive national assets. Indeed, of all the disadvantages of debt-equity schemes, only round-tripping abuses remained a problem with buy-backs. As the largest buy-backs during this period were by governments (in various forms) and parastatals, round-tripping, for the most part, could be controlled administratively.

If further evidence of the debtor's desirability for buy-backs is required, one need only look to the behavior of the debtor countries. While no countries other than Brazil and Chile were able to sustain debt-equity programs for more than one or two years, and while Brazil only managed to do so at the price of severe economic dislocation, most debtor countries pursued buy-back schemes aggressively and consistently over a number of years. With buy-backs, the stop-start indecision, which characterized the implementation of debt-equity schemes, was absent. From the perspective of a Latin American debtor in the 1980s, buy-backs were the most effective method of debt reduction available.[139]

B. The Effectiveness of Debt Buy-Backs In Eastern Europe

Given the effectiveness of debt buy-backs for debtors in Latin America, why have Eastern European and other debtor countries in the mid-1990s embraced debt-equity and privatization schemes and largely ignored buy-backs?

The answer to this question has four elements. The first is that Eastern European countries, in the main, have wisely limited their debt-equity and privatization schemes to local participants using domestic debt. This avoids most of the problems associated with debt-equity and privatization schemes while retaining most of their benefits.

The second element of the answer is the power of the economic views promoted by the World Bank, the International Monetary Fund and the international commercial banks. Ideas are far more powerful than is com-

[138] It is arguable that a country's foreign exchange reserves could be put to a better use than a debt buy-back, but unless the country was prepared to default completely on its external debt when secondary market prices were low, better uses for the reserves were not available to Latin American debtors in the 1980s.

[139] In 1988, Professor Sachs recommended that the IMF and World Bank support the institution of buy-back schemes. Sachs' Testimony, *supra* note 37, at 373. The result Professor Sachs sought was eventually achieved, at least in part, through informal schemes, but not the formal ones he had advocated.

monly realized. Keynes, in his seminal work, expressed this well when he wrote:

> [T]he ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachments of ideas. . . . [S]oon or late, it is ideas, not vested interests, which are dangerous for good or evil.[140]

The idea of debt-equity swaps has a great many proponents, far fewer detractors and a superficial attractiveness. Debt buy-backs, on the other hand, have few proponents, many detractors, and put temptations before debtors which, in the eyes of banks, are illicit. However, it was buy-backs, not debt-equity swaps, which promoted the interests of those who suffered the most from the debt crisis and did most to remedy the power imbalance between the banks and the debtors.

The third element of the answer is the interests of the international financial community. Debt-equity swaps permit the actual losses which are occasioned on the exchange too largely be concealed and not recorded in the bank's books. Debt buy-backs permit no such fuzziness — a sale for cash requires a write-down, which, if reserves are inadequate, adversely affects profits in the current quarter. The actual value of the equity in a swap may be no more than the cash received in a buy-back but the equity's value is difficult to quantify and may increase over time. Debt-equity swaps allow banks to postpone the day of accounting reckoning and throughout the 1980s the international banks chose transactions which preserved their balance sheets over transactions which actually lost less, or made more, money. Furthermore, history proved kind to bank investors in debt-equity swaps in Latin America. A sustained bull run in Latin equities markets meant many such investments were highly lucrative. For these reasons, the international financial community will seek to participate in debt-equity and privatization schemes in Eastern Europe and elsewhere. This will present a choice to the Eastern European debtor countries, which they will have to exercise most carefully.[141]

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[140] JOHN M. KEYNES, THE GENERAL THEORY OF EMPLOYMENT INTEREST AND MONEY 383-84 (1962).

[141] The history of the attitudes of Bank Advisory Committees ("BACs") to debt-equity schemes in Latin America is interesting. Initially, BACs were opposed to the concept of debt-equity schemes and expressed their extreme displeasure when Chile proposed, in 1985, to amend existing restructuring agreements to permit debt-equity conversions. However, within a short five years, BACs underwent a complete about-face and routinely insisted, sometimes over the opposition of the debtor countries (as in the case of Mexico), that restructuring agreements (including Brady bonds) expressly authorize debt-equity conversions.

The fourth and final element in why debt-equity has been so popular in Eastern Europe and elsewhere is the personal interests of the decision-makers in the debtor countries. As Professor Luiz Carlos Bresser Pereira, Brazil's Minister of Finance, wrote in 1987,

> debt-equity conversions [are] . . . a form of coopting the elites of the debtor countries, making their interests common to the interests of the major creditor banks. . . . [T]he ones who make large profits from these conversions are a small, but influential, minority in the debtor countries. Thus the debt-equity conversions are a powerful – and subtle – instrument to turn a significant part of the elites in the debtor countries contrary to or at least uninterested in a global debt reduction scheme.[142]

In Latin America in the 1980s, debt-equity swaps served to spread the benefits of the secondary market discount among the elites of the debtor countries so that the elites would support the status quo. Certainly, debt-equity schemes in Eastern Europe today offer the economic elite many opportunities to profit whereas debt buy-backs do not, thus explaining the elites' support of debt-equity schemes. As Cole has written, "For most investors, debt-equity exchanges are truly a no-lose situation, offering increased profit potential on investments they would have made anyway."[143] The popularity of debt-equity schemes in Eastern Europe and elsewhere is a potent example of the power of ideas, for evil as well as good.

VI. CONCLUSION

This article has considered the principal types of debt exchanges. From a debtor's perspective, the promotion of debt-equity schemes using external debt and privatizations for external debt may enrich the debtor's rich today at the cost of impoverishing their poor both today and for generations to come. To use Professor Rudiger Dornbusch's word, the advocacy of such debt-equity schemes by the International Monetary Fund, World Bank and U.S. Treasury has been "obscene."[144]

See Buchheit Letter, *supra* note 76, at 1. At the bank level, much of the reason for this about-face had to do with the upward pressure on secondary market debt prices exerted by the demand for debt for use in debt-equity conversions. At the political level, until Nicholas Brady endorsed explicit debt relief in his speech in March 1989 (see description of Brady Plan *supra* note 18), debt-equity schemes were one of the few market-based voluntary initiatives that held out any hope of reducing the debt burden for LDCs, and thus were promoted by the policy makers in Washington, DC.

[142] *Solving the Debt Crisis: Debt Relief and Adjustment, International Economic Issues, and Their Impact on the U.S. Financial System: Hearing Before the House Comm. on Banking, Fin. and Urban Affairs*, 101st Cong. 330, 340 (1989) (statement of Luiz Carlos Bresser Pereira).

[143] Cole, *supra* note 45, at 68.

[144] The full quotation is as follows: "Washington has been obscene in advocating debt-equity swaps and in insisting that they be part of the debt strategy. The U.S. Treasury has made this dogma, and the IMF and the World Bank, against their staffs' professional advice and judgment, have simply caved in." *Panel Discussion on Latin American Adjustment:*

Governments in Eastern Europe and elsewhere need to think carefully before allowing external debt to be used in debt-equity and privatization programs. To date, most debt-equity and privatization schemes in Eastern Europe have only permitted the use of local debt. Such schemes suffer from few of the significant problems considered earlier. The use of local debt leaves the money supply unchanged, and thus should not fuel inflation.[145] The use of local debt imposes no extraordinary budgetary burdens on the domestic government, does not facilitate round-tripping, should not result in the misallocation of resources provided that investment is open across all sectors of the economy and poses no equity considerations for local investors. Indeed, the only potential disadvantage of debt-equity schemes that use local debt is that the schemes may be subsidizing, by the public purse, investment that would have been made anyway.

The expansion of debt-equity or privatization programs in Eastern Europe to include external debt is thus a very large step as it will bring with it the litany of troubles considered earlier.[146] In particular, most Eastern European economies appear poorly adapted to withstand the inflationary pressures that will accompany debt-equity schemes that use external debt.[147] While Eastern European decision-makers may have considerable experience with debt-equity and privatization schemes using local debt, if they permit the use of external debt, they are embarking on an entirely new enterprise for which the appropriate precedent is the history of debt exchanges for external debt in Latin America — a precedent that, from a debtor's perspective, is far from encouraging. It would be a tragedy if Eastern Europe provides yet another example of the "sophisticated stupidity," identified by Galbraith, which is so often at work in financial matters.

The Record and Next Steps, *in* LATIN AMERICAN ADJUSTMENT: HOW MUCH HAS HAPPENED? 312, 324 (John Williamson ed., 1990).

[145] The local debt issued to fund the equity acquisitions is mostly counterbalanced by the local debt surrendered in the conversion process.

[146] External debt is currently prohibited from use in debt-equity swaps and privatizations in Poland by Article 23(2)(3) of the Act of August 30, 1996 on Commercialisation and Privatisation of State Enterprises. However, while this Act was being debated, strong arguments were made to extend its operation to include external debt. For a description on privatization schemes in Eastern Europe, see generally ALICE H. AMSDEN ET AL., THE MARKET MEETS ITS MATCH - RESTRUCTURING THE ECONOMIES OF EASTERN EUROPE (1994).

[147] *See* text accompanying note 78.