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DEBT-EQUITY CONVERSION AND INDUSTRIAL DEVELOPMENT*

by

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* Prepared for UNIDO.

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1. Introduction

Seven years after the outbreak of the debt crisis, there is still no sign of improvement in the situation of developing countries. In spite of substantial efforts to stabilize and restructure their economies, external debt of developing countries, and particularly of 17 highly indebted countries (HICs), keeps growing, as well as their debt service burden, while economic growth of these countries has been practically halted. In an almost complete drying up of external resources, the implementation of severe recessionary adjustment has resulted in a substantial net transfer of resources. For HICs, it amounted to 105 billion US $ in the period 1985-1988. Persistent negative transfer of resources based on artificially produced positive trade balances has occurred mainly through reduction of imports and investment. In the period 1982-1988, HICs average annual growth rate of imports was -3.4% and of investment -1.5% (World Debt Tables, 1989, p.XVII and XVIII).

The period since 1982 strongly confirmed that a combination of restrictive oriented stabilization programmes and repeated reschedulings accompanied by "involuntary" lending cannot provide a long-term and lasting solution to the debt crisis. This strategy was based on the assumption that concerted lending (fresh money) would give enough time for debtor countries to adjust. Unfortunately this assumption has proved to be wrong. Namely, due to a number of factors, the most important being that heavily indebted countries were unlikely to become creditworthy for some time, commercial banks have been showing an increasing willingness to sell off their claims on developing countries at a discount or below face value. This, in effect, implies debt reduction and also some losses for banks. They have implicitely overtaken one part of the debt crisis' costs of adjustment from the shoulders of developing countries.

A whole set of debt instruments has been developed for trading below the face value. Debt conversions in their broadest sense comprise schemes which aim at converting debt into other forms of liabilities (for example debt-equity conversions, debt securization), allowing thereby an easing of the debt servicing burden, and other schemes which aim at repaying debt by buying back debt (debt-debt swaps) or by direct exports to creditors (debt-exports swaps) (Tran-Nguyen, 1988, p.4 and 5).

This paper will analyze only the most widely applied form of debt conversions, i.e., where debtor countries permit private investors to convert debt into equity shares in new or existing companies. Within this context, the objective of the paper is to determine the extent to which debt-equity conversion arrangements increase the flow of finance to industry in highly indebted developing countries. Attention will also be given to the policy framework which has specifically facilitated such flows to industry. A further objective of the paper is to identify those measures which should be taken, if national decision makers wish to use debt-equity conversions as a mechanism both to decrease the stock of external debt and to increase the flow of funds directed towards promising projects for industrial rehabilitation/restructuring and expansion.

Some countries, for example Argentina, do not permit privatization acquisition swaps, others, for example, Brazil, impose significant restrictions while the third group, for example, Chile and the Philippines, allow swap operations of this type.

The main arguments debtor countries have against the acquisition type of DES are "denationalization" and an implicit viewpoint that the foreign investor should have the incentive of a DES only if he uses local currency to increase a firm's productive capacity. The counter argument is that when a foreign investor acquires an existing local company, the enterprise may benefit from an immediate injection of managerial know-how. In addition, buy-outs are often followed by increases in capacities and even in introductions of entirely new lines of production.

In the last few years, banks are becoming increasingly involved in acquisition or acquire minority shares in existing non-financial entities where they act as a silent partner (banks do not have managerial expertise) or go in jointly with a TNC to establish a new company where the bank provides finance while the TNC provides management input.

Financial Restructuring: This type of DES has been predominantly used by TNCs (parent companies) with the aim of strengthening the financial position of their subsidiaries in debtor countries. Through this operation, part of the company's debt is converted into equity of the company, and this reduces the volume of debt and the interest payments and increases the debt/equity ratio of the company. Similar to acquisitions, financial restructurings also do not contribute to increased production facilities. Arguments pro and con financial restructurings are more or less the same as for acquisitions.

New capacity and new company: The results of the IFC study indicate that companies add new capacities or create a new company when they perceive a market opportunity for higher sales. The decision is therefore crucially dependent on market conditions. In this respect, characteristics of export markets and domestic markets are very different.

Export companies are highly conscious of costs when evaluating whether to add new capacity or to create a new company. In this context the existence of swaps proved to be an important factor in the investment decision. On the other hand, companies oriented toward sales in the domestic market base their investment decisions on strategic considerations and would proceed with most of their investment even without swap programmes. This means that financial benefits provided by a swap could not be a substitute for strategic considerations in determining whether to invest or not.

2.5. Volume of Debt-Equity Swaps

The volume of debt conversions in the secondary market has grown significantly since 1983, from almost nothing in 1983 to over 1.3 billion US $ in 1985 and around 18 billion US $ in 1988. Most of the growth has been in Argentina, Brazil, Chile, Mexico and the Philippines (see Table 1).

Table 1: Volume of debt conversions of developing countries,* 1984-1988 (in US $ million)

Country	1984	1985	1986	1987	1988
Argentina	31	469	-	-	1507
Brazil	731	537	176	300	6224
Bolivia	-	-	-	-	349
Chile	-	324	987	1983	2357
Colombia	-	-	-	-	-
Costa Rica	-	-	7	146	-
Ecuador	-	-	-	125	102
Honduras	-	-	-	6	11
Jamaica	-	-	-	1	102
Mexico	-	-	416	6140	6670
Nigeria	-	-	-	-	40
Peru	-	-	-	-	15
Phillipines	-	-	15	266	635
Uruguay	-	-	-	-	97
Venezuela	-	-	-	-	130
Yugoslavia	-	-	-	-	50
Total	762	1330	1601	8966	18288

* Includes debt-equity swaps, debt-peso swaps, loan-to-bond conversions (important particularly for Mexico), debt repurchases (Bolivia, Chile).

Source: Ashari Hossein. Towards the Restoration of Creditworthiness in the Debt Problem Countries. Paris: OECD Development Centre (working paper), February 1989.

DESs are in fact dual-purpose instruments. First; because debtor countries redeem the swapped debt at less than its face value, swaps permit early retirement of foreign debt at discount. Second; because the governments redeem the swapped debt at more than its current market value, swaps reduce the cost of an investment, and are thus incentives to investors. The question arises how successful DESs are in reducing the level of debt and at the same time increasing the volume of FDI.

Taking into account that the total volume of debt conversions of HICs amounted to 30.9 billion US $ in the period 1984-1988, this total is only a small fraction - 6% - of the total outstanding debt of those 17 countries, estimated at 529 billion US $ at the end of 1988 (World Debt Tables, 1989, p.XVIII). If only DESs are taken into consideration, some 8 billion US $ (Tran-Nguyen, 1988, p.21) or 1.5% of their total debt and 2.0% of their private debt was converted in the period 1984-1987. These figures differ significantly from country to country. Chile, for example, had retired more than 10% of the country's total debt (Parhizgari, 1988, p.46), while for all other countries with DES programmes these figures are not higher than a few per cent.

Precise data on the volume of FDI financed through DESs are lacking. According to Table 1, these flows in Latin America are estimated to be about 7.0-7.5 billion US $ in the period 1983-1987 (Blackwell, Nocera, 1988, p.227). Since total FDI flows to Latin America have been in the range of 3 to 4 billion US $ per annum (UN CTC, 1987, p.31) some 40% of these investments have been financed through DESs. This means that DESs have been significant as a proportion of FDI to Latin America and this was largely because all investment flows to this regions had been drastically curtailed.

Taking into account the marginal impact of DES on debt reduction on the one hand and their much more sizeable contribution to an increased flow of FDI to indebted countries on the other, debt-equity swap programmes should be considered primarily as an additional policy instrument for stimulating FDI rather than a mechanism for reducing the level of debtor countries' external debt.

2.6. Perspectives of Debt-Equity Swaps

The amounts of future DESs are likely to remain small, in spite of the decisions of several debtor countries to engage in DES transactions. The reasons are basically of two kinds. On the one hand, economic conditions in HIC are not stimulative for investment, either domestic or foreign. On the other hand, the amounts of debt available for swaps are relatively small, although the decision of US money center banks to increase loan loss reserves on developing countries' loans has opened up the market for a larger volume of transactions. A calculation made by Spieles for five Latin American countries, assuming a willingness on the part of the top US banks to sell 15% of their exposure and 30% of all others, would limit the secondary market supply to not more than 22%-26% of their total debt. Even in this case, DES volume would not be likely to be of sufficient magnitude to reduce significantly the volume of outstanding debt (Spieles, 1987, p.122). According to some authors, a total volume of DESs may never exceed 40-50 billion US $ (Parhizgari, 1988, p.46; Morton, 1987, p.117).

When discussing the perspectives of DESs, one has to take into consideration that the driving force behind these transactions is the discount at which developing countries' debt is traded on the secondary market. The discount clearly reflects the ability of those countries to service regularly their obligations to foreign creditors. As the market matures and the transaction volume grows, but more particularly as economic conditions in debtor countries improve and debt servicing capacity therefore increases, the discount on debt will shrink and the market price will approach face value or nominal price. The disappearance of DES transactions will be a signal for the return of those countries on international capital markets (UN CTC, 1987, p.34).

3. Major Advantages and Disadvantages of Debt-Equity Swaps*

3.1. Debtor Countries

3.1.1. Advantages

Additionality: From the point of view of this research, additionality or the extent to which DESs are increase flow of financial resources to industrial sector has to be analyzed in some details.

Proponents of DES argue that it gives the debtor countries access to needed investments, since investors, encouraged by the debt discount, are more willing to take risks and consider investing in the context of an uncertain investing climate in debtor countries. On the other hand, opponents contend that the money would have come to the country anyway or that DES merely provides a cheaper way for TNC and nationals to invest money they had already planned to invest. The argument goes further, saying that DES can reduce the flow of FDI which normally would have come, therefore DES can promote investment only if it brings in additional investments above the level which investors had already planned.

The above indicates how difficult it is to quantify investment additionality of DESs. Investment additionality of DESs could be defined in different ways. At the broadest level (national level), the inflationary or interest rate effect of swaps will partly reduce domestic investment elsewhere in the economy. At a somewhat narrower level, an investment for which a swap was crucial to a particular investor might have been done by a different investor without a swap programme (Bergsman, Edisis, 1988, p.7). Like the IFC study, this research is also limited to a narrower level of investment additionality of DESs, i.e. to the individual transaction. At this level, the DES transaction is defined as additional if the particular investor would not have made the investment if a swap deal were not available. In cases where a swap deal accelerated the timing and/or augmented the amount of originally planned investment, it will be categorized as "partly" additional.

The authors of the IFC study, which was done on the basis of interviews covering 104 DES transactions, came to the following conclusion regarding additionality for 99 transactions: virtually every investment done by the banks (30) was additional and would not have happened without a swap programme. As far as DES made by TNCs are concerned (69), 23, or 33%, were clearly additional and another 7, or 10%, were partly additional (Bergsman, Edisis, 1988, p.7 and 8).

The reason why all the money invested by banks through DES is considered additional lies in the fact that banks had not planned to invest in the debtor countries at the time the loans were made. The primary interest of banks is in lending, and not equity investment in a non-financial sector. However, due to growing problems of debtor countries with regular debt servicing, banks were forced to take actions aimed at reducing exposure in debtor countries, to diversify portfolio and finally to liquidate their doubtful claims in debtor countries sooner than would be possible through reschedulings. It means that the main interest banks see in DES is an opportunity to reduce exposure and eventually to get out of debt problem countries.

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* See Table Annex 1.

In spite of the general attractiveness of DES for banks, there are very few banks which have transformed a substantial part of their own loans into non-financial equity and within this context also in industrial sector projects (capitalization of their own subsidiaries is not counted). One of the reasons is the lack of professional expertise and management ability in non-financial areas which are crucial for investing in non-financial projects. Therefore, banks like to join TNCs in arranging DES transactions, where the TNC provides professional expertize and management while the banks contribute part of the financial resources needed for the transaction. They play a de facto role of a sleeping partner in these deals.

A more active role by banks in DES transactions is also expected from closed-end funds which have been established or are under consideration in debtor countries. It seems that these funds hold substantial potential for bringing about additionality. They are intended primarily to attract debts from smaller banks, since these banks normally lack the potential for investment selection and for managing the equity.

According to the already mentioned IFC study, about one third of investments made by TNC using swaps would not have happened if a swap programme were not available, and another ten per cent were "partly" additional. This means that more than one half of the TNC investments that used swaps were not additional and would have happened anyway (Bergsman, Edisis, 1988, p.8).

There are a number of factors which influence TNC investment decisions. One of these is the presence of investment incentives. Since debt-equity swap transactions provide a certain investment incentive through reduced cost of the investment, these transactions have a potential for inducing additional FDI, if not as "totally" additional than at least as "partly" additional FDI. There is much fragmented information confirming this conclusion. For example, Business International says "that most projects today (projects which have been undertaken as DESs), especially the large ones, have involved the expansion of existing facilities by existing companies, expansion which may well have been planned long before the conversion programme became available. On the other hand, the programmes have achieved two objectives: first to secure net new investment that would not have been approved by firms were it not for the financing break received; and second, to expand the level of investment beyond what would have been committed in their absence" (BI DES, 1987, p.2). According to Frank Fountain, assistant treasurer of the Chrysler Corporation, Chrysler's 100 million US $ investment would not have been as large if Mexico had not had a debt equity programme. He also reported that Mexico's debt equity programme itself was a major intangible factor in approving the investment because it showed that the Mexican government supported foreign investment (taken from Rodriguez, 1988, p.17 and 18).

The IFC study identified another feature relevant to additionality of DES transactions and which is of crucial importance for investment in the industrial sector. The study points out that lower costs of the investment as an investment incentive have more effect on export oriented projects than on projects aimed at the domestic market. This is because costs are more important for export projects. They must compete in the world market and usually cannot pass higher costs on their customers. Greater additionality in the case of export-oriented investment applies only to manufacturing investments, and not mining or other natural resource projects for which the quality of the resource is the main factor determining location (Bergsman, Edisis, 1988, p.11).

Additionality also depends on how long a swap programme has been operating. According to the IFC study, additionality increases as a swap programme continues over time. The explanation is that investor need time to become aware of benefits of the programme. However, a general investment climate is of crucial importance for an increased flow of FDI and therefore also for an increased interest on the part of investors in DESs.

Reduction of debtor countries' external debt and debt-service costs: The ultimate result of each DES is the extinguishing of the debt used for transaction and consequently the reduction of the debt servicing burden by replacing debt liabilities which require immediate hard currency payments with equity liabilities that may be more favourably matched with economic cycles by readjusting the debt-equity structure of capital inflows (Moreno, 1987, p.38). DESs have a positive impact, in the short run on the balance of payments, but only if the capital invested is not shortly thereafter withdrawn by foreign investors and dividend remittances do not counterbalance the reduction of interest payments on debt. In order to achieve these positive balance of payments effects, debtor countries have imposed restrictions on capital repatriation and profit remittances in their DES programme.

Return of flight capital: In the case of return of capital flight, there is a positive saving on the payment of interest without the disadvantage of a loss of foreign exchange through debt payments or subsequent remittances. In principle, new assets created by DESs, or more precisely debt-peso swaps, would require future servicing only in local currency. Since the central bank of the debtor country regulates the conditions of DES, including the discount, the benefits to the country can be even greater. Therefore, the repatriation of capital is without doubt a positive characteristic of DES, assuming that round tripping (see below) is prevented. Return of flight capital is the most important objective of debt-peso swaps. They provide de facto amnesty for nationals who have taken funds out of the country and are willing to bring the money back.

3.1.2. Disadvantages

Monetary and fiscal impact: The domestic monetary impact results from the release of local currency by the central bank at the moment the external debt paper is redeemed.The local currency is provided through money creation or the issuance of domestic public debt. This creates inflationary pressure, unless the local original borrowers are required to redeem their debt in local currency out of their existing assets (Tran-Nguyen, 1988, p.23 and 24). In many countries, public sector borrowers do not have the local currency necessary to redeem external debt without relying on credit extended by the national government.

There are several ways in which debtor countries attempt to regulate the monetary implications of DES. Some of them are the following: the government restricts the aggregate amount of DESs through a quota system, the government approves specific transactions on a case-by-case basis, authorities closely monitor the release of local currency, etc. In spite of all these mechanisms aimed at neutralizing monetary impact, the inflationary argument is absolutely valid and is one of the most important ones against DES.

Domestic interest rates could also be affected by DES transactions and this depends on the extent of sophistication in the local financial market where the foreign ebt is exchanged for locally denominated obligations. In case the market is relatively well developed and the volume of swaps is relatively small in relation to the national money base, interest rates are likely to remain stable. If the market is thin, an increase in government borrowing arising from debt conversions would raise domestic interest rates. This increase would worsen the government budget deficit, which might result in additional cuts in government investments.

Round Tripping: Some countries have used DES programmes to encourage the repatriation of flight capital. By converting a foreign debt at a discount, an investor obtains local currency at a preferential exchange rate. This preferential exchange rate is an implicit subsidy to capital inflows generated through DES and thereby opens opportunities for so-called "round tripping". By round tripping capital is repatriated through debt conversion in order to benefit from the discount on the secondary market and is then expatriated through the parallel exchange market. An increased demand pushes up the exchange rate on the parallel market, which could have a negative impact on the country's foreign exchange reserves and consequently would create additional pressure for local currency devaluation.

Increased foreign ownership of domestic business (denationalization): Through DES an investor can obtain discounted local currency for the purpose of equity investment in local companies. The precondition for DES is that the investor have access to the foreign exchange. Since some DES programmes limit participation of local investors (due to round tripping), these programmes offer an advantage to foreign investors (denationalization) in comparison to local investors. This, of course, creates political problems since local investors legitimately complain that they are being discriminated against in favour of foreign investors. The problem is particularly apparent where the debtor countries have started with "privatization" programmes, where equity prices of public sector assets have been often pushed down by the weak conditions in the country's economy and by the desire of local government to pursue privatization as quickly as possible. As a consequence, it is estimated (in the case of Chile) that rates of return for swapped capital would be significantly larger than interest rates.

The increasing role of banks in DES is an important concern of critics of DES programmes. Ricardo Ffrench Davies says in this context that "there is a need for 'productive' rather than 'financial' attitudes and skills. Today we have an imbalance in the influence of these two forces on economic and political decisions. The management of debt has given to much relative weight to short-term financial views" (UN CTC, 1987, p.35).

To address the problem of denationalization, most DES programmes have restrictions on the size of foreign investment and the industries eligible for these transactions. Such restrictions have to be balanced against the needs of the foreign investors so that they are not discouraged from entering into investments.

Others constraints: There are other constraints surrounding DES as perceived from the debtor countries' point of view, for example, the effect of DES on bank lending. These and other debt conversion operations reduce the number of banks from which new money for debtor countries is potentially available. In the period since 1982, banks have participated in lender consortia new money arrangements in proportion to their exposure. In the event that, a larger number of banks would reduce their exposure by selling their debt, the amount of new money available could be substantially reduced. The other point frequently mentioned by the bankers is that a reduction of the banks' exposure would contribute to a resumption of voluntary lending. This point was rightly criticised by Ffrench-Davies along the following lines: Let us consider reduction of Latin American commercial debt for 10% or 26 billion US$. If converted through DES, it will increase the stock of FDI in the continent by 50%. It is doubtful that foreign investors would be willing to make such a large investment in a relatively short period, and, even more important, the debt overhang would be reduced only slightly and therefore it is unlikely that creditor banks would be willing to resume voluntary lending (UN CTC, 1987, p.35).

3.2. Banks

For the bank holding the debt, DES provide a flexible way to reduce their exposure by selling loans for cash to third investors as well as to convert their loans into their own equity investment which will be kept in their portfolio. It is therefore a good portfolio management tool for the banks. Beside allowing them to reduce the exposure and increase bank's short-term liquidity (in case of outright sale), DESs also provide the bank lender with an opportunity to improve the quality of its assets, i.e. to diversify or redeploy their exposure (in case they use their own debt to acquire equity interest in the debtor country). This means that DESs provide banks with an option for liquidating a portion of their portfolio either sooner or at a better rate or both than if they had kept their loans in their books (Bentley, 1986, p.38).

DESs also have a number of drawbacks for the banks. The most important is that they have to recognize it as an upfront loss on their portfolio. This is also the main reason for the very different reactions of banks, particularly US banks, on transactions offered by secondary market alternatives. In the first group are large money centre banks of the US. They have a relatively weaker capital position (greater exposure to debtor countries) and a stronger interest in maintaining a long-term financing role in the debtor countries, thus debt conversions may be for them more attractive because such conversions involve less of an accounting loss, require longer-term interest in the debtor country and necessitate continued presence in the country. The second group is composed of banks with relatively low exposure - US regional banks and most European and Japanese banks. These banks are more ready for straight debt sales which will result in substantial losses.

3.3. Investors

The main attraction of DES for the investor is that domestic currency is received at a discount or in the form of a preferential exchange rate (Roberts, Remolina, 1987, p.23). This provides the investor with the opportunity to make an investment at a reduced cost. The net value at which a corporation exchanges currencies through DES is obtained by subtracting the brokers' discounts and the administrative or governmental fees from the proceeds paid in the secondary market adjusted by the redemption exchange rate.

By reducing the up front investment required, DES provide an incentive needed to carry out investments which were held back and/or provide the higher return needed to compensate for the higher risk. In this context, DESs expedite stalled and new projects fitting with global competitive strategy. Besides, the idea of converting debt into equity is also used in the reorganization of entreprises with financial problems. Part of the debt is converted into equity, thus reducing debt level and interest payments. Certain investors, banks in particular, also use DES as a mechanism for entering into certain developing countries' markets without increasing their exposure.

As far as disadvantages for investors are concerned, the most important results from the regulations covering dividend remittances and capital repatriation. In most cases these regulations are tougher than if the investment had been made by bringing fresh money into the country.

4. Main Features of DES Programmes with Particular Reference to their Effects on Industrial Development*

In establishing a debt-equity programme or in improving features of one which already exists, a debtor or country must take into account all potential benefits and costs of the DES. Within this context, each programme has to examine and resolve the following issues: the exchange rate at which the swap takes place, the participation of country residents in the programmes, the quotas and ceilings on the amount of debt that can be swapped, the types of debt that can be used, the discount applied by the central bank according to priority sectors or to macro-economic purposes, the condition that new investment should bring in additional foreign exchange funds and the restrictions that are placed on profit remittances and capital repatriaton.

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* DES Programmes for 9 countries have been analysed: Argentina, Brazil, Chile, Costa Rica, Jamaica, Mexico, Philippines, Uruguay and Venezuela. In the case of Argentina, the analysis covers DES under the programme passed in October 1987 and does not include rediscounts DES and onlending swaps. As far as Brazil is concerned, the analysis covers only formal DES carried out through auction and does not include other forms, such as formal DES outside auction, informal swaps, relending swaps and conversion funds.

  Information on DESs have been gathered primarily from the following sources:
  - The Debt-Equity Swap Handbook. Business International, February 1989, 245 p.
  - Business Latin America (weekly); various issues in 1986, 1987, 1988 and 1989.
  - Latin American Monitor (monthly); various issues in 1987, 1988 and 1989.
  - Lahera, Eugenio: The Conversion of Foreign Debt Viewed from Latin America. CEPAL Review, No. 32, August 1987, p. 103-122.
  - Rubin, Steven. Guide to Debt Equity Swaps. Economist. September 1987, 212 p.
  - Debt-Equity Swaps: How To Tap an Emerging Market. Business International, August 1987, 157 p.

4.1. Exchange Rate Used and Distribution of The Secondary Market Discount

Once the project has been approved by the local authorities, the company, usually through an intermediary, purchases foreign debt at a discount of face value in the secondary market. The purchased debt is then presented to the central bank of the debtor country which redeems it in local currency. The central bank usually pays less than face value but more than the value of the loan in the secondary market. There are two significant differences between DES programmes when discussing transformation of the hard-currency debt obligation into local currency or local currency denominated bonds. First, exchange rate used for conversion, and second, the distribution of the secondary market discount between the government and the investor.

Exchange rate: Argentina, Mexico and from April 1989 also Venezuela are the only three of the nine countries studied to convert hard currency debt obligation into local currency at the market exchange rate. All other countries use the official exchange rate. Taking into account substantial gap between official and the market exchange rate in most of the countries with DES programmes, investors would strongly prefer conversion at the free rate.

The distribution of the secondary market discount: The difference between the face value of the debt and the secondary market price of that debt is the discount in the secondary market. This discount consists of two parts (Bergsman, Edisis, 1988, p.18):

a) government's share in discount: difference between face value and redemption price, i.e. price at which the debtor country redeems the debt to the investor, expressed as a percentage of the discount,
b) incentive to investor: difference between secondary market price and redemption price, expressed as a percentage of the latter.

By establishing the redemption price, the debtor country de facto defines what percentage of the discount will be captured by the government and what will be the share of the investor in the discount. There are two main mechanisms for setting the redemption price in DES transactions:

a) auctions, where redemption price is established by market forces,
b) case by case, where redemption price is established through negotiations.

On the basis of the Annex 1 the following summary tables have been prepared:

Table 2: Mechanisms for Setting the Redemption Price and Exchange Rates Applied in DES Transactions

Country	Year	How redemption price is established	Exchange rate
Argentina	1988	auction	free
Brazil	1988	auction	official
Chile(Chapter 18)	1988	auction	official
Chile(Chapter 19)	1988	case by case	official
Mexico	1987	case by case	free
Philippines	1988	case by case	official
Venezuela*	1988	case by case	official
Costa Rica	1986	case by case	official
Uruguay	1988	case by case	official
Jamaica	1988	case by case	official

Source: Annex 1.

* In April 1989 the scheme was revised; an auction system was introduced and all swaps became eligible for conversion at free market rate.

Table 3: Distribution of the Secondary Market Discount

Country	Market price	Redemption price	Government's share	Incentive to investor
Argentina	26	43	77%	40%
Brazil(free area)	48	68	62	29%
Brazil(incentive area)		87	25	45%
Chile(Chapter 18)	58	85-90	71	29%
Chile(Chapter 19)		83-87	36	32%
Mexico(January)	56	85	34	34%
Mexico(November)	53	68	68	22%
Philippines	50	n.a.	n.a.	n.a.
Venezuela	52	100	0	48%
Costa Rica	45	67	60	33%
Uruguay	58	81-88	29-45	28-34%
Jamaica	50	95	10	47%

Source: Annex 1.

4.2. Eligible investments and priority investments

Each of the nine DES programmes in the nine countries studied defines what swaps can be used for, and most of these programmes, in an attempt to channel investments, have certain priorities on a sectoral or regional basis or provide specific investment incentives for export oriented projects. For a detailed country-by-country overview see Annex 2.

When comparing the DES programmes of the countries studied, projects in the industrial sector have the following status:

Table 4: Industrial Sector Projects: Eligible and Priority Investments within Debt-Equity Swap Programmes

Country	Eligible	Explicit priority	Priority of export-oriented projects	No priority
Argentina	Yes		X	
Brazil	Yes			X
Chile (Chapter 19)	Yes		X	
Mexico	Yes		X	
Philippines	Yes	X		
Uruguay	Yes		X	
Venezuela	Yes	X		
Costa Rica	Yes		X	
Yamaica	Yes			

Source: Annex 2.

Projects in the industrial sector are eligible for DES transactions in all nine countries studied. In two of them (the Philippines and Costa Rica) projects in the industrial sector are explicitly categorized as priority projects for DES, while in the remaining seven countries they do not have explicit priority status. However, in all these countries (the only exception is Brazil) export-oriented projects are considered as the highest priority. Since industrial projects carried out through DES are to a great extent export oriented, it is fairly safe to conclude that industrial sector projects de facto have a priority status in DES programmes of all the countries considered.

4.3. Who Can Participate in DES Programmes?

Return of flight capital is one of the debtor countries' objectives when introducing DES programmes. However, due to potential problems of round tripping, only some of the countries under consideration have allowed local residents to participate in DES transactions. A country by country overview about eligible participants in DES programmes is given in Annex Table 2.

On the basis of the Annex Table 2, it could be concluded that seven countries (Argentina, Chile - Chapter 18, Mexico, Philippines, Uruguay, Venezuela and Costa Rica) allow participation of foreign and national investors in DES transactions, while two countries (Brazil, Jamaica, and Chile in Chapter 19) limit DES transactions to foreign investors only.

4.4. Fresh Money Requirements

Argentina and Uruguay are the only two countries studied to impose a general requirement for fresh money.

Under the original Argentina programme (May 1987), only 50% of the total cost of a proposed project was allowed to be financed through a DES transaction, while the remaining 50% had to be financed by the investor in foreign exchange. This one-to-one new money matching clause was the main reason for weak interest on the part of DES potential investors in the country. In October 1987, the clause was changed in the following three respects:

a) up to 70% of the project's total cost, excluding imports, can be financed with DES while the remaining 30% must be obtained from other sources, such as FDI or loans,
b) fresh money could be provided in local currency,
c) the exchange rate was changed from the official to the free rate.

Under the Uruguay programme, the maximum amount of financing allowed through DES is 80% of the total project cost. The remaining 20% must consist of new money.

Under the revised Venezuelan Decree 1988 (regulates only certain DESs - see Annex 3) 40% of projects below 100 million US $ and 60% for projects over 100 million US $ may be financed through swaps. The Philippine programme does not require a new money component, but provides higher redemption prices for projects with fresh money funding. The higher the percentage of fresh money funding in the total project cost, the higher the redemption price for the project. As far as Chile is concerned, the negotiation process is sometimes used to request new money as part of the total project financing.

All other countries studied do not require new money financing. However, projects which do have a fresh money component are normally considered by debtor countries as more attractive than those ones without fresh money component.

4.5. Restrictions on Dividends and Repatriation

Due to balance of payments effects, the DES programmes of all the countries under consideration forbid the payment of dividends and/or the repatriation of capital for several years. According to the IFC study, these restrictions may improve short-term balance of payments while on the other side they are not considered by investors as major obstacles for DES programmes (Bergsman, Edisis, 1989, p.25). This is particularly so for corporate investors which normally use swap programmes as one of the mechanisms for staying and/or entering in the countries for a long-term period. On the other side, banks as investors are more interested only in shorter term investments. For an overview of restrictions on dividends and capital repatriation of countries under study see Annex Table 3.

4.6. Other Features

Qualifying external debt: Virtually all programmes determine which categories or rescheduled debt, prepaid debt or maturing debt are eligible for DES transactions. For example, Brazil's auction scheme allows only private sector debt taken over by the Central Bank to be converted, Chile and the Philippines consider all restructured debt as eligible for swaps while in Uruguay and Venezuela eligible debt is limited to the scheduled public sector foreign debt.

Quota and ceilings on the amount of debt which can be swapped: The increase of the money supply pursuant to a DES programme varies among the countries considered, depending on the magnitude of the conversion programme relative to the monetary base of the debtor country, how the local currency is invested (timetable for the disbursement of funds) and government measures to neutralize such increases. The government can issue local currency debt or can establish quota and ceilings on the amount which can be swapped.

In Argentina, the yearly quotas were announced as follows: 1988 - 300 million US $; 1989 - 400 million US $; 1990 - 400 million US $; 1991 - 400 million US$ and 1992 - 400 million US $ (Paz, Tecson, 1988, p.82). The Central Bank called five tenders in 1988 with auction ceilings ranging from 50 to 75 million US $ (BLA, December 12, 1988, p.395).

Brazilian authorities have limited the ceiling on the dollar volume of swaps permitted at each auction to around 150 million US $, half for incentive areas and another half to free areas. It is expected that the ceiling at each auction will be reduced to 100 million US $.

Other countries which approve DES transactions through negotiations on a case by case basis normally do not explicitly define quotas or ceilings. Rather, they process DES proposals according to their internal guidelines which take into consideration the monetary impact of DES deals. However, Mexico for example, set a limit of 1.2 billion US $ in debt swaps for 1987 (BLA, February 9, 1987, p.47), while Uruguay established quotas of 25 million US $ for 1988 and 30 million US $ for 1989.

Continuity: In only five out of nine countries under study DES programmes were completely operational at the end of 1988 (Chile, the Philippines, Uruguay, Venezuela and Jamaica), in two countries programmes were suspended and are expected to be revised in 1989 (Mexico, Costa Rica), while in two countries programmes are formally operational, but auctions were delayed (Argentina, Brazil). See Annex Table 4 for details. Taking into account that most of the programmes were introduced only in 1987 and 1988 (only three countries introduced programmes earlier - Chile, the Philippines, Costa Rica) it could be concluded that most of the programmes (except in Chile) are not stable and continuous. Lack of continuity has, according to the IFC study, negative implications on the success of the programme since it decreases additionality (Bergsman, Edisis, 1988, p.25).

5. Debt-Equity Swaps in the Industrial Sector: An Empirical Overview

5.1. Argentina

The Argentine DES programme has been in effect since the beginning of 1988. The main goal of the programme is not to reduce the external debt but to increase investment. Five public auctions have been held in 1988 by the Central Bank of Argentina and all of them have been very competitive, with bids showing increasing discounts; from 37% at the first bidding to 72% at the fifth bidding (see Annex 1, table 1).

There were 80 winning bids in the 1988 auctions. Of the total 695.1 million US$ in investment, 310.3 million US $ was financed by debt conversions and the remaining 384.8 million US $ was contributed by other sources, such as direct investment or loans.* Fresh money component represented 55% of total investment and therefore goes well with the government's mandatory requirement that a minimum portion of 30% should comprise new investment. The index that relates the total cost of winning projects to debt/equity financing increased from 1.89 at the January auction to 2.92 at the third one in June. Later on, the index had fallen to 1.91 at the December auction. A high index demonstrates that the programme constitutes a good incentive for investment without indications for substituting other sources of financing. The Central Bank has retired some 810 million US $ of its foreign debt using the programme (Debt-Equity Swap Handbook, 1989, p.29). The programme also saved 73 million US $ in annual interest payments (Euromoney, March 1989, p.76).

Up to now, only non-financial companies have participated in Argentina's scheme, as it requires investment in new facilities (expansion or new entity) as a prerequisite for eligibility. This is in contrast with some other Latin American countries where commercial banks have taken advantage of DES programmes for changing part of their loan portfolios for equity investments in productive assets as well as in financial institutions. Up to now, the programme has not been tied with the country's privatization programme. However, there are indications that government will allow some legal maneuvering in this area (Spain's Telefonica is expected to take over 40% in the telephone company Entel; there are indications that government is willing to sell 49% of national airline Aerolineas Argentinas to SAS) (BLA, March 28, 1988, p.97 and 98).

The Argentine programme does not specify priority regions or priority sectors in order to give approval for projects. Therefore, results of the auctions indicate the preferences of investors. In five tenders conducted in 1988 projects in various sectors were approved.

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* By December 1988, through rediscounts for equity swaps Argentina has converted a total of 475.2 million US $ of face value (155.6 million US $ of effective value) while 90.2 million US $ has been repurchased through onlending swaps.

Table 5: Argentina - Breakdown of Investment Projects by Activity for a Total of 36 Winning Bids in the First Three Tenders in 1988

Activity	Total cost of projects Amount(mil.US$)	Share(%)
- Motor vehicle and engineering	79.5	18.6
- Hotel and resort	77.6	18.2
- Meat packing and refrigeration	76.0	17.8
- Food and beverages	74.4	17.4
- Building materials	34.8	8.1
- Chemicals and pharmaceuticals	32.3	7.5
- Apparel and shoe manufacturing	24.4	5.7
- Agro-industry	12.7	3.0
- Farming	7.8	1.8
- Energy and gas	3.0	0.7
- Textiles	2.8	0.7
- Publishing	1.4	0.3
- Paper production	1.0	0.2
TOTAL	427.7	100.0

Source: Euromoney, Special Supplement, September 1988, p.16.

The table indicates that areas selected for investment reflect the preference of investors for particularly dynamic sectors of the economy. A large proportion of approved projects have been export-oriented, but this is particularly because of preferences that exporters have enjoyed in the country through competitive exchange rates and other incentives.

The table also indicates that at least 70% of total investment (around 300 million US $) was channelled for projects in the industrial sector. If building materials production is included, the share of the industrial sector approaches 80%. This means that the industrial sector is predominant in the Argentine DES programme with hotels and resorts development as the only remaining sector of significant importance (18% of total investment).

There is no available statistical data for the structure of investment projects by activity for all five tenders in 1988. However, it is fairly safe to assume that the overall structural patterns remained more or less the same. One of the reasons for such a conclusion is that 9 out 13 or 7 out of the 8 biggest projects with total costs of over 20 million US $ each were approved in one of the first three auctions and were therefore included in the table 5.

The programme requires investors to act through an agent bank established in the country. In practice, foreign as well as local banks, both private and official, have been involved in debt conversion operations. However, local banks have been far more successful. Results from the three auctions show that eleven local banks had the four largest projects and accounted for 30 of the 36 winning bids (Banco Rio 9, Banco de Credito Argentino 5) (Euromoney, Special Supplement, September 1988, p.17).

TNCs are widely availing themselves of the programme for project financing in their Argentinian affiliates. However, local companies, both large and small, are also taking part in the programme. There is a special 5 million US $ sub-limit within the total auction quota for small and medium-sized investors. The aim of this provision has been to achieve a high level of participation in small projects (Evans, 1988, p.38). In fact, more than 57% (46 projects) of winning projects involve investments less than 5 million US $ with an average investment of 1.5 million US $. Another 20 projects range from 5 to 20 million US $ per project. The remaining 14 projects are over 20 million US $. Most industrial projects within this group have been carried out as investments by TNCs in their respective affiliates. Some of the projects of this kind are: Swift Afgentina SA (Campbell Soup Co; value 70.9 million US $; meat production); Coca-Cola SA (Coca-Cola; value 22.8 million US$; beverages production); Renault Argentina SA (Renault; value 27.7 million US$; car production).

According to available information (for example, Campbell and Saab Scania investments), some TNCs have been using the Argentine DES programme as a mechanism which has stimulated investment in terms of timing and also volume. However, it did not have a decisive role in TNCs' investment decisions. In this context, these investments could be classified as "partly" additional (Debt-Equity Swap Handbook, 1989, p.39-41).

5.2. Brazil

Of the total Brazilian debt subject to conversion, 43 billion US $ is unmatured and thus serves primarily as an informal conversion mechanism* and 25 billion US $ is matured and deposited with the Central Bank and thus serves only for the formal conversion programme effected by means of the auction system (Noronha-Adogados, 1989, p.38).

* Unmatured debt is not subject of auctions. There is about 43 billion US $ worth of such debt, of which 28 billion US $ is public sector debt that may be converted only in the public sector. However, private sector unmatured debt amounting to approximately 11 billion US $ may be converted into either private of public sector projects (Hieronymus, 1988, p.30). Informal conversions with unmatured debt developed by local entrepreneurs are of significant importance in Brazil. They are negotiated directly between investor and borrower, without the participation of the Central Bank. While informal swaps have received the tacit approval of the authorities, none of the proceeds from these deals can be registered as foreign investment; therefore, the recipient of cruzados has no repatriation of remittance rights based on the conversion. Given this constraint, foreign companies are usually interested in informal swaps only if they are in immediate need of cash locally or they have excess remittance capability due to poor profit levels in the past. According to available information, informal swaps in Brazil totaled over 4.0 billion US $ in 1988 with state company deals accounting for 80% of this total (Debt Equity Swap Handbook, 1989, p.44) There is no available information on players and main patterns of Brazilian informal swaps.

Prior to the initiation of the Brazilian DES programme (February 1988) debt conversions were restricted to the original creditors converting loans from their own portfolio at 100% of face value. The mechanism was therefore used for capitalization purposes and for investment in local companies; the sale of debt to third partlies was not allowed. Under the 1988 programme 10 auctions were held. A total of 370 projects were approved and the total amount converted (face value minus discount) amounted to 1,465.7 million US $.

Most DESs in Brazil have been undertaken by foreign corporate investors (there is no stated prohibition on participation of Brazilian citizens in the auctions if they reside abroad) with the aim to invest in existing firms and expand and technologically upgrade subsidiary operations. Bidders must be represented at the auctions by a local brokerage house. In 1988, six of the top eight brokerage houses were subsidiaries of foreign banks. They have converted a total of 1,012.7 million US $ or 68.9% of total amount converted in 1988 (see Annex Table 5).

In the past, transnational banks (TNBs) have not been interested in entering into DES transactions with their own portfolio, but they have became extremely active as intermediaries, where they convert third-party paper and where they earn substantial commissions. Nevertheless, there is a growing expectation that the large original creditors will start converting some of their Brazilian loan portfolio. The first major creditor to make such a deal was Manufacturers Hanover Trust. The swap funds (60.4 million US $) will be invested in pulp and paper projects by the local Suzano paper company (Debt-Equity Swap Handbook, 1989, p.51).

According to available information, most DES projects have as a target export oriented industries.

Table 6: Brazil - Distribution of Auction Conversions by Activity, 1988

Activity	Amount converted(mil.US$)	Share of total(%)
Industry	787.2	53.6
- electronics	157.4	10.7
- pulp and paper	105.6	7.2
- mechanics/capital goods	99.9	6.8
- chemicals/petrochemicals	93.8	6.4
- food	57.4	3.9
- textiles	38.8	2.6
- nonferrous metals	28.8	2.0
- iron and steel	14.8	1.0
- drugs	13.8	0.9
- rubber products	13.6	0.9
- photography	13.2	0.9
- hygiene/sanitary	11.0	0.7
- glass	10.0	0.7
- toys	10.0	0.7
- cotton prcessing	10.0	0.7
- fruit processing	8.7	0.6
auto parts	8.6	0.6
- leather	7.1	0.5

Activity	Amount converted(mil.US$)	Share of total(%)
- aluminium	7.0	0.5
- hospital equipment	6.0	0.4
- plastics	5.5	0.4
- consumer goods	4.7	0.3
- publishing/printing	4.4	0.3
- safety equipment	3.0	0.2
- timber	1.1	0.1
- beverages	1.1	0.1
- other	52.0	3.5
Commerce	135.4	9.2
Banking/finance	84.4	5.7
Tourism/hotels/leisure	76.6	5.2
Agriculture/livestock	90.4	6.1
Mining	55.8	3.8
Costruction	11.2	0.8
Other	231.2	15.8
TOTAL	1.472.2	100.2

Source: Debt-Equity Swap Handbook, Business International, February 1989, p.34.

Table 6 indicates that the industrial sector accounted for 53% of the total funds converted through the Brazilian auction mechanism in 1988. Some important patterns of industrial sector swaps are the following:

- Investors have been, with the exception of Manufacturers Hanover, exclusively foreign corporations, mainly TNCs.
- Investments have been channeled into very different industrial branches (more than 25), yet four highly export oriented branches (electronics, pulp and paper, mechanics and capital goods, chemical and petrochemicals) accounted for almost 60% in total industrial sector swaps.
- There is no data on whether the programme has concentrated on projects of relatively small volume or not. The average conversion per project (not only the industrial sector) has been less than 4.0 million US $. However, projects range from very small ones to projects worth over 50 million US $.
- There is no information on the fresh money component of projects in the industrial sector.
- Taking into account that most projects in the industrial sector are highly export oriented, it is assumed that they have contributed to an increased flow of FDI in the country. Some of the projects could be classified as "partly" additional. This conclusion emerges on the basis of some fragmented information acquired through published case studies of industrial debt swaps, for example Dow Corning and Coats-Viyella investments. In both cases, TNCs had already decided to invest. However, Dow Corning admits that the DES programme was important in influencing the timing of the investment (Debt-Equity Swap Handbook, 1989, p.54-55). On the other side, Coats Viyella decided to invest in a project in the "incentive area" part of Brazil, since it offered a more attractive discount than is available for conversions in other areas of the country.
- DESs have been used primarily as a mechanism for expansion and technological modernization of subsidiary operations. The programme has not been used for buy-outs and within this context privatization.

5.3. Chile

As a result of debt-equity conversions, Chile's external debt has been reduced by 6.4 billion US $ from June 1985 to January 1989. In 1988 alone external debt was reduced from 19.2 billion US $ to 17.7 billion or for 1.5 billion US $ (Garces, 1989, p.13).

According to existing Chilean legislation, debt-equity conversions may be done under Chapter 18, under Chapter 19 of the Compendium of Foreign Exchange Rules or under Decree Law No. 600 (DL 600) which governs foreign investment. The conversion funds are regulated by the conditions stated in Annex 2 of Chapter 19.

Article 2e of DL 600 allows conversion of debt into equity provided that the firm being capitalized is the one that originally contracted the debt. This "straightforward" debt-equity conversion mechanism has been used by TNCs and TNBs aiming to strengthen financially their affiliates in Chile. Conversions done under this scheme cannot be used to make an initial investment, but only to add to an existing investment. The volume of transactions under Article 2e of DL 600 amounted to 273.2 million US $ as of January 1989 (Garces, 1989, p.12). There is no data on sectoral breakdown of transactions under this legal provision.

Chapter 18 converts foreign debt into domestic debt or refinances local debt. In 1988, Chapter 18 was supplemented by Annex 4 whereby foreign debt instruments may be applied to subscribe and pay for shares in existing firms to capitalize banks. As well as by Annex 5 whereby natural and juridical person may use, for one time only, foreign debt instruments for the exclusive purpose of applying them towards total or partial payment of mortgage obligations. The creation of Annex 4 came about as a result of official concerns that Chapter 18 transactions would increase demand for US $ in the parallel market and therefore create an increasing gap between the official and parallel exchange rates. Normally under 10% in May 1988 it increased to 18%. In order to ease pressure on the parallel market, the Central Bank drastically reduced monthly quotas on Chapter 18 conversions, from a maximum of 120 million US $ in January 1988 to only 5 million US $ in July 1988 (Debt-Equity Swap Handbook, 1989, p.58). From June 1985 and until January 1989 the volume of transactions under Chapter 18 amounted to 2,156.8 million US $. About 80% of the swaps were done by local banks and the remainder were investments by companies. There is no data on the sectoral breakdown of these transactions (Garces, 1989, p.12).

Transactions under Chapter 19 which regulates conversion of foreign debt into domestic equity amounted to 1,930.2 million US $ in the period June 1985 - December 1988.

Table 7: Chile - Sectoral Breakdown of the Investments under Chapter 19 (as of September 30, 1988)

Economic sectors	Amount(mil.US$)	Share total(%)
Forestry	520.9	32.0
Financial services	202.3	12.4
Miscellaneous*	189.3	11.6
Manufacturing	163.7	10.0
Agriculture	136.9	8.4
Mining	113.7	7.0
Fishing	96.5	5.9
Other services	75.6	4.6
Commerce and transportation	65.7	4.0
Electricity, gas, water	43.4	2.7
Communications	22.2	1.4
TOTAL	1,630.2	100.0

* Includes capital increases made by recipient enterprises whose activity is to carry out investment in numerous economic sectors.

Source: Garces, Francisco: Alternative Foreign Investment Mechanism in Chile: Recent Developments. Presented at IMF/World Bank Meeting 1988.

The bulk of the participants in the Chapter 19 conversions have been TNCs, with over 100 participating to date. The most common use by TNC has been to use debt to recapitalize local subsidiaries. Some of the companies which have used DES for operations of this kind are for example Unisys (USA), Mitsubishi (Japan), Pepsi Cola (USA), Abbot Int. (USA), Johnson and Johnson (USA), Burroughs (USA), Eastman Kodak (USA), etc.

The scheme has also proved its worth for financing new projects. For example France's Spie Batignolle used Chapter 19 to convert old debt into investment in the development of a ski resort (Trade Finance, September 1987, p.29). There have been also a number of joint ventures established under this Chapter. New Zealand's Carter Holt Harvey Ltd for example entered0into joint venture with Chilean partner (50-50) to establish a medium density fiberboard plant (BLA, March 30, 1987, p.47, 102)

The Chilean debt conversion programme (not only under Chapter 19) has been used for companies' buy-outs. In addition, it has also been linked to the country's privatization efforts. For example, the Australian firm Alan Bond has a 263 million US $ majority stake in the now largely private telephone company CTC. Privatization, and especially sales to foreign companies, have created public frictions arguing that the price paid seemed excessively favourable to the new owner (Pilmaiquen was one case; the steel company CAP and telephone company CTC were others) (Mark, 1989, p.84, 86).

In contrast to the experiences of other Latin American countries, there has been strong activity on the part of foreign banks converting debt for their own accounts. Banks have used swap transactions for various uses. First of all, some banks have swapped their loans for shares in their Chilean subsidiaries, as California's Security Pacific (Trade Finance, September 1987, p.29). In addition, banks have invested a lot into local banks and other financial institutions. Some deals of this kind are for example: Credit Lyonnais' investment in Banco Continental (Trade Finance, February 1988, p.6), investment by the National Bank of Canada into Banco Osorno, etc.

On the other hand, banks have been very keen to convert part of their Chilean debts into industrial assets. Citibank made 160 million US $ worth of DESs in Chile in 1988 and plans another 100 million US $ by the end of this year (not exclusively in the non-financial sector). Manufacturers Hanover, Chase Manhattan, Marine Midland and some other TNBs have all done swaps and are all looking for other opportunities (BI DES, 1987, p.46). Some of them have joined conversion funds. While three conversion funds have received approvals, so far only one is active. The fund with 30 million US $ was set up by Midland Bank and IFC in September 1987 (Debt-Equity Swap Handbook, 1989, p. 61). It has been so successful that it is now planning to double its capital.

Some conversions combine industrial and financial investment. A typical case is Bankers Trust. In 1985, it converted 60 million US $ in debt. Of this 43 million US $ was used for the purchase of a 40% stake in Provida, Chile's largest fund, and 96% of Consorcio, a life assurance company. The performance of the Fund was much higher than projected (35% against 19%) and Bankers Trust has used the extra money to acquire the hidroelectric power station Pilmaiquen for around 21 million US $ (Trade Finance, September 1988, p.29). Just recently, Bankers Trust sold nearly half of its stake in the Provida/Consorcio for a price close to the amount it originally paid for the entire package. Most foreign banks have chosen to buy stocks in former state companies (privatization process) directly or more discreetly, often in the name of a local broker.

The largest swap investment today, completed in July 1988, is the venture, called Forestal e Industrial Santa Fe. It involved a strategic alliance between two TNCs and one bank. The total investment is expected to be in the range of 425 mil. US $, of which some 285 will be financed with a swap. In the consortium, Scott Paper (USA) - 20% and Shell Overseas Investment (Dutch) - 60% - are contributing management expertise, while Citibank (USA) - 20% is taking on the role of a silent partner who is interested in gradually reducing its Chilean exposure (Mark, 1988, p.42; BLA, October 3, 1988, p.315). There is another big project in forestry and paper pulp industry in the pipeline - 600 million US $ investment by US companies and banks (BLA, February 13, 1989, p.45).

The table 7 indicates that the industrial sector, including the natural resource sectors (forestry, mining, fishing), and at least part of "miscellaneous" cover around 60% of total investment under Chapter 19. The other important sectors are services (financial services, other services, part of miscellaneous) with around 20% and agriculture with 8%.

Industrial projects, carried out under Chapter 19, have the following basic patterns:

- Investors are both, TNCs and TNBs which convert from their own portfolio.
- The forestry and paper and pulp industry is by far the most important segment of the deals approved so far with a number of large transactions.
- Industrial sector projects range from very small ones below 1.0 million US $ - to projects worth more 50 million US $.
- There is no information on the fresh money component of projects in the industrial sector.
- The DES programme has been used for a wide spectrum of transactions in the industrial sector ranging from straight buy-outs and privatization through pure financial restructurings to investments for financing expansion of existing capacities and/or to build up completely new ones.
- There is no data on additionality of industrial sector projects. The fact that natural resource sectors have been the most important segment of DES transactions in this sector is an argument against greater additionality (Bergsman, Edisis, 1988, p.11). On the other hand, Chile has attracted TNBs' resources in the industrial sector DESs, which are, according to Bergsman and Edisis, 100% additional.

5.4. Mexico

Mexico's DES programme was formally launched in April 1986 and was finally suspended in November 1987.* Monetary and fiscal effects are normally cited as the main reasons for suspension. During this period, an estimated 2.5 billion US $ was converted while another 60 or so projects (worth 450 mil. US $) were left in the pipeline (Debt-Equity Swap Handbook, 1989, p.69). After the formal DES programme was suspended, only a few investments in the tourism sector were approved. One was the construction of a 300-room luxury hotel in Mexico City. The project, worth 48 million US $ was approved in April 1989 with Paribas, a French bank, as a foreign investor (Latin America Monitor, May 1989, p.655).

According to foreign investment law, a 51/49% equity ratio is required in all new investment, including expansions of established operations. In the auto parts and secondary petrochemical sectors, foreign companies are restricted to 40% equity. The chief exception is the maquiladora sector, where 100% foreign capital is allowed. In practice, new investments that meet other national interest criteria can obtain also majority and even 100% foreign ownership (see privatization). The programme was at the beginning open only to foreigners. However some domestic companies got around this by arranging deals through US, Panamanian or Cayman firms (Bartholomew, 1988, p.19). Later on (in February 1987), Mexican firms were also authorized for DES transactions.

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* Mexico started with debt capitalization already in 1982. Following the outbreak of the debt crisis, a large number of foreign subsidiaries were faced with a severe debt service problem because of massive devaluation and shortage of foreign exchange. Many parent companies used debt capitalization as a mechanism of giving financial strength to their Mexican subsidiaries. By the end of 1985, officials approved 769 million US $ in investment to be made via capitalization of debt, the purchase abroad of foreign debt to be transferred to a Mexican affiliate and registered as capital (BI DES, 1987, p.51). All these conversions were accomplished without publicity, in the absence of an official programme, and were concerned mostly with private external debt.

Mexico's DES programme includes only official conversion programmea and does not govern the use of private DES deals. The biggest example of this kind of transaction to date is the swap financed restructuring of the Groupo Industrial Alfa. In an effort to keep the company from bankruptcy, the company's foreign creditors (banks) arranged to capitalize a reported 920 million US $ in private foreign debt, turning it into a 45% equity stake (BI DES, 1987, p.53).

Initially, the Mexican DES programme favoured projects with large TNC that guarantee substantial export income. Of particular interest were expansion projects in industrial sectors where the multinational investor was not competing directly with Mexican companies.

The Mexican automotive industry was the most important in this context. It is composed exclusively of foreign TNC and is surpassed only by the oil industry as the country's largest exporter. Of the 2.5 billion US $ of DESs done to date, 24% or around 600 million US $ of swap transactions were made in this sector. All the auto firms were operating with the same strategy i.e., to use Mexico as a low cost source location for supplying the North American sector. It has to be stressed that DESs in the automotive sector can be classified as partly additional investments since plans for plants' expansions were in place well in advance of the availability of the conversion programme (the Crysler case is illustrative) (Bergsman, Edisis, 1988, p.7). Foreign companies have participated in DES investment in the automotive sector for two essential reasons, i.e., to undertake new investments (a new project or expansion) with the benefit of heavily discounted (20-40%) peso funds and to a lesser extent, to repay debts. Automotive DESs have tended to be large, with volumes for individual projects running over 100 million US $.

Table 8: Mexico - Major Debt-Equity Swap Transactions in the Automotive Industry, 1986 and 1987

Foreign TNC	DES investment (mil. US $)
- Nissan (Japan)	60
- Crysler (USA)	100
- Ford (USA)	50
- Daimler Benz (Germany)	25
- Volkswagen (Germany)	141
- Renault (France)	15
- Honda (Japan)	n.a.
- Komatsu (Japan)	n.a.
- General Motors (USA)	n.a.

Source: Various press accounts.

Tourism sector investments comprise the largest single sector in the Mexican DES programme. 34% or 850 million US $ of total debt swaps have been done this way. According to available information, most of the large hotel and resort development projects of the last few years have been undertaken with DES financing. Mexico's officials were especially encouraging swap generated investments in three state-backed beach resort projects: Cancun, Puerto Escondido and Bahias de Huatulco (Guide to Debt-Equity Swaps, 1987, p.103). Projects in the tourism sector range from large scale projects of over 100 million US $ to numerous relatively small scale investments of 2-5 million US$.

According to available information, foreign banks have converted part of their Mexican portfolios for equity positions in the tourism sector, which was not the case in the automotive industry. If projects with foreign banks as investors could be considered completely additional, it would be very difficult to give a conclusion as to what extent DES investment of other foreign investors in tourism sector could be considered additional. There are indications that companies would decide to invest in famous Mexican resort projects even in the absence of the DES alternative.

Mexico's third most important sector for DES is the so-called maquiladora industry, accounting 17% of the total swaps concluded (cca 425 mil. US $). The maquiladora industry has been the fastest expanding manufacturing and foreign investment sector of the Mexican economy. Authorities have given approval for debt capitalization contracts for local expenditures in maquiladora plants, such as construction works and machinery purchases (Guide to Debt Equity Swaps, 1987, p.105). Since investments in the maquiladora industry generally do not carry high capital requirements (owing to the labour-intensive nature of this type of work), debt swaps in this sector tended to be small in amount and big in number of deals. Although US companies predominate as foreign investors, for example Texaco, Gillette and Chrysler, the Japanese presence is also strong (Toyota, Sony, Furukawa Electric, etc.).

Beside the automotive industry and maquiladora industry, which singificantly differ in their patterns, the government has also targeted some other industrial sectors for DES, such as segments in the chemical, pharmaceutical and electrical industries as well as in the filmmaking industry. Most of the projects in these areas involve relatively small investment, but it is estimated that they have accounted for about 5-10% of the total swaps concluded.

As seen from the above analysis, Mexico's DES programme provided opportunities for very different uses of DES transactions, from financial restructurings, including privatization of state companies, to new investments, including expansion of existing capacities or building up of completely new facilities. Many firms that tapped Mexico's DES programme with the financial restructuring objective used debt-equity proceeds to prepay foreign debt enrolled in the Foreign Exchange Risk Coverage Fund (Ficorca) programme. Prepaying Ficorca enabled firms to remove this foreign debt from their books and was therefore considered as a welcome opportunity to improve firms' debt/equity position. As far as privatization is concerned, only a few deals have been arranged. Two small state companies, Porcelanas Euromex (ceramic factory) and Pescados de Chiapas (fish processing firm) were both acquired by foreign investors (Guide to Debt Equity Swaps, 1987, p.106). In addition, in 1987, 24 application to move from minority to majority foreign investment were approved, as for example Komatsu, Daimler Benz, Caterpillar.

As a conclusion, the industrial sector participated with around 1.25 billion US $ or 50% in total swap transactions done in Mexico under the DES programme. The main characteristics are the following:

- concentration of industrial sector DESs in the automotive industry and maquiladora industry;
- investors have been almost exclusively foreign TNC, TNB have not been identified as investors in this particular sector;
- DESs have been used for all types of investments from buy-outs in the context of privatization (few cases) through debt restructurings (most of Ficorca programmes) to new investments, which have been particularly important in the automotive industry; most of these investment has been done by parent companies in their Mexican affiliates;
- DES projects in the industrial sector differ significantly in size. They range from small-scale projects, particularly in the maquiladora sector, to a number of huge projects in the automotive sector;
- there is no information on the fresh money component of projects in the industrial sector;
- having in mind that projects in the industrial sector are very export oriented where project costs have a crucial influence on investment decisions, it could be assumed that they have contributed to an additional flow of foreign capital into the country.

5.5. The Philippines

The Philippines' DES programme introduced in the middle of 1986 and revised in 1987 was one of the earliest programmes of this kind. According to available information, the programme started with substantial interest on the side of investors with most of the projects being approved in 1987. By the end of February 1988 there was a sharp fall-off in new applications as investors had more and more problems in acquiring the debt paper they needed prior to the stipulated deadline.

Table 9: The Philippines: Applications and Approvals of Debt-Equity Swap Transactions

Date	No of DES applications	Aggregate value of applications (mil. US$)	No of DES approved	Value of approved DES (mil.US$)	Schedule 2 No	Schedule 2 Value	Schedule 3 No	Schedule 3 Value
As of Dec. 1986	42	220	15	33	n.a.	n.a.	n.a.	n.a.
As of May 1987	98	364	60	92	53	n.a.	7	n.a.
As of Dec. 1987	309	1,493	135	456	124	431	11	25
As of July 1988	387	1,700	332	1,100	n.a.	990*	n.a.	110**

* cca 90% of the total
** cca 10% of the total

Source: - Debt-Equity Swap Handbook, Business International, February 1989, p.79-83.
- Rubin, Steven. Debt Equity Swaps in the Philippines. Multinational Business, No. 4, 1987, p.21.
- Suratgar. Debt Equity Conversions, 1988.

According to the above table, some 332 of 387 submitted transactions were approved (roughly 85%). It is estimated that in reality the rejection rate is higher, since in a number of cases potential investors are discouraged from applying for various reasons. Out of total approvals (332 in July 1988), 159 applications worth 485 million US $ have been implemented. This relatively low completion rate is a result of the limits imposed on the conversion of government paper (Debt-Equity Swap Handbook, 1989, p.79).

Of the 98 applications as of May 1987, 81 were filed by foreign investors and 17 by local investors. Among the foreign investor groups, US investors held the highest number of applications (24), followed by corporations registered in Hong Kong. Japanese and European investors as well as those from NICs constituted most of the remaining applications (Rubin, 1988, b, p.14). Most foreign investors have been TNCs. They have been using DES primarily as a mechanism to increase capital in their wholly owned subsidiaries, as a mechanism to fund an expansion of existing capacities or as a mechanism to fund the building of new a factory. The banks have been slower to take advantage of the DES programme on their own account. Their investments are focused in financial enterprises. Some of DES transactions with TNCs and TNBs are in the Annex Table 6.

Investments that qualify under Schedule 2 (around 90% of all DES transactions) are concentrated in export oriented manufacturing, accounting for almost half of all approvals under Schedule 2 (around 500 million US $). Within this sector, investments in semiconductors were the largest in dollar terms, while the largest number of approvals were granted to projects in the textile and garment industry. Other areas of considerable interest to investors are food processing and lumber and wood products (Debt-Equity Swap Handbook, 1989, p.83).

Agriculture has been the next target of investors, in terms of both the number of applications submitted and total dollar volume. Investments in agricultural production are also largely export oriented. Conservative investors, like banks, have been surveying the existing shrimp farms to determine if an investment is warranted. Less conservative investors have considered establishing new aquaculture operations.

The third sector is banking, where the number of applications and approvals has been rather small, despite efforts by the government to stimulate investment into this industry.

Under Schedule 3 most approvals have been granted for investments in the hotel industry, construction sector (housing), and pharmaceuticals.

The Philippines government is keen to allow foreign investors to use DES as a mechanism to fund investments in the country's privatization programme. All non-performing assets (NPAs) acquired under the privatization programme are classified as Schedule 2 investment. The Philippines has set up the Asset Privatization Trust (APT) for the purpose of selling NPAs to interested investors. A number of assets has been sold already. However, this has been only a small part of total book value of the assets in question which are expected to reach 5 billion US $ with a realizable value amounting to some 1 billion US $.

In the Philippines, conversion funds have been also established as an additional mechanism for DES. The most active worth 125 million US $ is the First Philippine Capital Fund LP (created by Shearson Lehman Hutton and IFC). The Fund has targeted Schedule 2 investment. Thus far 65 million US $ worth of shares in the Fund have been sold (Debt-Equity Swap Handbook, 1989, p.80).

On the basis of available information it could be concluded that projects in the industrial sector represent, in value terms, at least one half of approvals in the Philippines' DES programme. Industrial projects have been carried out primarily by foreign TNCs, but there is no evidence on TNBs as foreign investors in the industrial sector. There is no information on the fresh money component in total costs of investments done through DES transactions. As far as types of investment are concerned, it seems that most operations in industrial sectors has been aimed to purchase of equity existing firms and/or to expand existing subsidiary capacities. In this context, additionality of the programme is questionable. This is also the most significant argument against DES in government circles (in October 1987 new restrictions were imposed).

5.6. Uruguay

The country's DES programme was launched at the end of 1987. According to available information, 14 projects involving 86.3 million US $ of debt conversion were approved. However, only 11 projects were formally signed as of September 1988. They involve a total investment of 92.8 million US $ while the debt-equity portion of these projects is 52.1 million US $. This means that the debt-equity portion represents, on average, 56.1% of total investment, although the figures vary from project. None of the projects accepted used the maximum 80% perimitted for swap financing (Debt-Equity Swap Handbook, 1989, p.87).

Table 10: Uruguay - Debt-Equity Swap Transactions by Sectors, 1988

Sector	No of transactions	DES portion (mil. US$)	Fresh money (mil. US $)	Total (mil. US$)
Tourism	3	32.8	10.7	43.5
Forestry	2	6.6	19.9	26.5
Textiles	3	8.9	6.5	15.4
Agriculture	1	2.2	1.3	3.5
Commerce	1	1.0	1.5	2.5
Pharmaceuticals	1	0.6	0.8	1.4
TOTAL	11	52.1	40.7	92.8

Source: Debt-Equity Swap Handbook. Business International, February 1989, p.91.

Table 11: Uruguay - Main Patterns of Debt-Equity Swap Transactions, 1988

		Value	Objective
Tourism:	project No. 1	40.0	Construction of a new hotel
	project No. 2	1.76	" "
	project No.	1.76	" "
Forestry:	project No. 4	18.6	Pine tree plantation for wood production
	project No. 5	7.9	Eucalyptus plantation for wood production
Textiles:	project No. 6	7.1	Technological development
	project No. 7	6.7	" "
	project No. 8	1.6	" "
Agriculture:	project No. 9	3.5	Citrus plantation (export oriented)
Commerce:	project No. 10	2.5	Expansion of a shopping centre
Pharmaceuticals	project No. 11	1.4	Expansion of a local plant (subsidiary)

Source: Debt-Equity Swap Handbook. Business International, February 1989, p.91.

The above tables indicates that most of the projects (nine out of eleven) were below 8 million US $ and five of them even below 3 million US $. The data indicate that equity investments were made exclusively for establishing new entities (tourism) and for expanding existing corporations (all other sectors, including the industrial sector). The DES programme has not been used for buy-outs and financial restructurings so far.

Only projects in textiles and pharmaceuticals could be considered as investments in the industrial sector. The four projects accounted for 18% in total investment (16.8 million US $ out of 92.8 million US $) as well as in total debt-equity portion (9.5 million US $ out of 52.1 million US $), their average investment is 4.2 million US $, and all of them are aimed at expansion and/or technological development. As far as fresh money is concerned, it has participated with 44% in total project costs of industrial sector projects, which is just the same share as for all eleven projects signed until September 1988. There is no information available on who the investors are in the industrial sector's projects. The only one known is a pharmaceutical TNC Rhone-Poulenc, which has invested in its subsidiary in Uruguay.

5.7. Venezuela

Frequent changes in the Venezuelan DES programme which was introduced in April 1987 have been the result of low interest on the part of investors in the scheme. So far, the programme has not succeeded in either significantly cutting the country's external debt or encouraging foreign investment from abroad.

Table 12: Venezuela - Approved Debt Equity Swaps, 1987 and 1988

Project	Foreign partner	Sector	DES portion (mil.US$)	Fresh money (mil.US$)	Type of investment
-Shrimp-farming enterprise	National Bank of Washington (USA)	Agriculture	5.0	n.a.	New enterprise
-Animal-feed project	Pfizer Inc (USA)	Industry	5.3	n.a.	Expansion of production in local subsidiary
-Production of animal vaccines	Pfizer Inc (USA)	Industry	0.6	n.a.	Expansion of prod. in local subsidiary
-Production of emulsifiers	Hoescht (Germany)	Industry	5.5	n.a.	Investment in local subsidiary
-Production of aluminium wheels	Kelsey-Hayes (USA)	Industry	1.2	n.a.	New joint venture
-Cement production (Venezolana de Cementos)	Chase Manhattan Bank(USA)	Industry	41.0	n.a.	Acquisition of shares for investment to increase capacity
-Investment in local leasing company	Banque Indosuez(France)	Finance	0.7	n.a.	Cancellation of debt in exchange for shares
-Aluminium smelter	Austria Metall (Austria) and Pechiney (France)	Industry	280.0	300	New joint venture
-Steel-pellet plant	Kobe Steel (Japan)	Industry	40.0	75.0	Uppgrading of an old plant

Source: - Debt-Equity Swap Handbook, Business International, February 1989, p.97, 98.
- Business Latin America (various issues).

With the new DES programme endorsed in April 1989, it is expected that investors' enthusiasm will grow and debt swap activity will increase. Potential will be greatest for investments in export-oriented projects carried out as joint ventures with state-controlled industry, particularly in the aluminium sector and in petrochemicals. In these two areas, a number of projects in the DES pipeline, like the 1.3 billion US $ Aluyana aluminium smelter project where the participants are expected to be Italimpianti and Techint (Italy), Venezuelan state's CVG and VIF; another smelter investment with CVG, Alumax (USA) and Alusuisse (Switzerland) (Evans, 1988, p.44); 270 million US $ ammonia plant with Norsk Hydro, Pequiven, Polar group (Debt-Equity Swap Handbook, 1989, p.98).

An analysis of the nine projects approved by December 1988 (first seven under Decree 1521 and the last two under Decree 1988), prompts the following main conclusions:

- All but two projects approved have been in the industrial sector, thus the programme has been almost exclusively utilized for projects in this sector; measuring by value, 379 million US $ of debt swaps amounts of 0.6 - 5.5 million US $ while only three larger projects have been approved.
- Out of seven projects in the industrial sector three have been done by parent companies capitalizing their own debt in their Venezuelan affiliates. All three have used investments for expansion of production and were relatively small in size. Two investments one very small and the other extremely big, have been also by a TNCs, and were approved to take the form of new joint ventures, while the remaining two projects with Chase Manhattan Bank and Kobe Steel as foreign investors are aimed at new capacities and modernization.
- As far as fresh money is concerned, it is involved in both projects approved under Decree 1988 as requested, but there is no information regarding the fresh money component for other projects.
- The bank is involved as investor in only one industrial project approved by the authorities, although the volume of its investment is significantly higher than any other investment done through the DES programme under Decree 1521 in this sector.
- There is no available data on the extent to which the projects could be considered as sources of additional foreign investment. However, if investments by banks are considered as completely additional (total of three project in Venezuela; one in the industrial sector) and if investments approved under Decree 1988 could be considered at least as "partly" additional, than the programme has contributed to foreign investment in the country.

5.8. Costa Rica

The country's debt-swap option was opened in mid-1986. During the brief period in which the mechanism was available investors have shown considerable interest and a wide range of project proposals were submitted to the authorities for consideration. Due to raised concerns that the growing volume of DES would have negative monetary and fiscal implications and also due to the problem of round tripping the Central Bank suspended the option in December 1986.

In the short time during which the DES option was available, the authorities approved 32 projects with a total value 78.5 million US $. All transactions have also been actually done, the last one in April 1988. By using DES, Costa Rica succeeded in reducing its foreign debt by 123.2 million US $, i.e., almost 10% of its refinanced commercial debt (1.2 billion US $) and 3.4% of its total debt (3.6 billion US $) (Debt-Equity Swap Handbook, 1989, p.103).

Table 13: Costa Rica - Structure of Approved and Finalized Debt-Equity Swaps, 1986-1988

Activity	No	Amount converted (face value) (mil. US $)
- Export(agriculture,industry and marine products)	28	88.1
- Capitalization of local banks	1	3.9
- Shipbuilding(free zone)	1	8.8
- Import substitution	1	10.5
- National park conservation	1	5.4
Total	32	116.7

Source: Debt-Equity Swap Handbook, Business International, February 1989, p.105.

The Central Bank gave priority to projects that help country's balance of payments and/or create jobs (BLA, March 2, 1987, p.67). The table indicates that majority of projects were export oriented, primarily in the agriculture and fishing sectors. Other types of investments were in forestry development, pulp processing, leather and textile industry and apparel industry. Costa Rican debt swap have involved relatively small projects. Average value of the project was around 2.5 million US $. Although there is no information available, it is fairly safe to assume that DES in industrial sector have represented at least 50% of the total volume of these transactions and that substantial part of investment was allocated for new capacities and not for buy-outs and financial restructurings.

There is no available information on the fresh money inflow into the projects. As far as investors are concerned, the participation was open to both foreign firms and nationals, but most of the approved projects were done by nationals (BI DES, 1987, p.129).

5.9. Jamaica

Only 400 million US $ or 12% of Jamaican debt is eligible for DES. Jamaica views the programme primarily as an investment incentive rather than a debt cancellation mechanism.

In the period July 1987, when the programme was launched, to December 1988, 16 projects were approved by the Jamaican authorities. The total value of the projects is 115 million US $. It is expected that 85 million US $ will be financed through DES while the remaining 30 million US $ represents fresh money inflow. According to available data, only 4 of the 16 projects have actually been carried out (Debt-Equity Swap Handbook, 1989, p.118).

Table 14: Jamaica - Debt-Equity Swap Projects Carried Out, 1987-1988

Project	Foreign partner	Sector	DES portion (mil.US$)	Fresh money (mil.US$)	Comment
- Expansion of winter vegetable farm	Western Agri-Management	Agriculture	0.63	0.27	Export-oriented; 300-400 additional workers
- Expansion of garment factory	Hanes Printables	Industry	1.58	1.80	n.a.
- n.a.	Jockey International	Industry	0.50	0.63	n.a.
- n.a.	Noelle Industries	Industry	1.48	0.30	n.a.

Source: Various press accounts.

The table indicates that DES have involved relatively small amounts (small-scale projects) in labor-intensive activities (agriculture and the textile industry). All four projects are export oriented, carried out by TNCs, involve a fresh money component (15-55% of total project costs) and provide additional capacities to the Jamaican economy. It is not possible to offer any firm conclusions as to the extent which the DES programme contributed to the execution of the four projects, and to what extent the projects can be considered as additional.

Of the remaining 12 projects, at least two will be hotels (one is a 570-room facility at Mamee Bay, another is an expansion of the Sans Souci hotel from 80 rooms to 220 rooms). The Jamaican government has earmarked around 60 million US $ of Jamaica's debt specifically for conversions connected with the government's hotel privatization programme. The third project is a private sector free-trade zone to be built near Kingston (Debt-Equity Swap Handbook, 1989, p.118).

6. Conclusions

1. The study has proved that desk research does not provide sufficient information for making definite conclusions with regard to certain aspects of DESs in the industrial sector. Thus, some conclusions should be taken as preliminary or at any rate as working hypotheses for field research based on interviews of DES participants. There are at least three possible reasons for the somewhat biased results of the study: first, information on individual DESs (case studies, interviews, etc.) relates to a great extent to rather large transactions. Second, most information on DES transactions actually done is from the investors' point of view. Third, there was practically no possibility to cross-check some of the information which the research turned up.

2. The study found out that only 1.5% of highly indebted countries' total debt and 2.0% of their private debt was converted in DESs in the period 1984-1987. On the other hand, some 40% of total FDI in Latin America has been financed through DES in this period. This means that DES programmes should be considered primarily as an additional instrument for stimulating FDI rather than a mechanism for reducing the level of external debt.

3. In the nine countries analysed in this study (Argentina, Brazil, Chile, Mexico, the Philippines, Uruguay, Venezuela, Costa Rica, Jamaica), a total of 9,802 million US $ was converted (includes actually done as well as approved DESs) through DES programmes in the period 1985-1988.

   If only DES transactions in the industrial sector are taken into consideration, a total of 4,236 million US $ was achieved in seven countries (there is no data available for Costa Rica, Jamaica and Chile - Chapter 18), i.e. 57% of the total in these countries. With more than one half of the total DESs, the industrial sector has the leading position in these transactions. It has to be emphasized, however, that Chile's DESs in the industrial sector (Chapter 19) include transactions in natural resource sectors, which are of great importance in this country's DES programme.

   The relative importance of industrial swaps varies among the countries under study. On the lower end of the group are Uruguay and Chile (if only manufacturing is taken into consideration) with less than 20% in total DESs while in Venezuela the industrial sector accounted for as high as 98% of the total DES portion of investment. In Argentina, Brazil, Mexico and the Philippines this proportion ranges between 50% and 70%.

4. There is no empirical data on the importance of the industrial sector DESs as a segment of total volume of FDI flows. For Latin America, it is estimated that about 20% of these flows have been financed as DESs in the industrial sector in the period 1985-1988. It has to be underlined, however, that some industrial swaps have replaced other modes of financing investment that would have taken place anyway and they therfore do not represent additions to FDI.

5. The desk research as the only methodology applied in this study has not provided adequate information for making final conclusions on the additionality aspect of DESs in the industrial sector. It is therefore not possible to determine the extent to which DESs have increased the flow of FDI to industry in highly indebted countries. If the IFC study's conclusions (Bergsman, Edisis, 1988) on additionality are taken as a point of departure, the available fragmented data on additionality of industrial sector DESs provides grounds for the following tentative conclusions. First, there is a strong orientation of industrial sector DESs on export-oriented projects. According to the IFC study, investment of this kind, particularly in manufacturing, increase additionality to a greater extent than investment in domestic oriented projects. Second, natural resource projects, which are extremely important in Chile and also in some other countries, are considered to have low additionality, even if they are export oriented, since the quality of the resources is the main factor determing location. Third, if DES investments by banks are considered as wholly additional, then Chile has achieved the highest additional FDI from this type of foreign investors. Fourth, empirical evidence suggests that a significant number of big investments in the industrial sector made through DES could be classified as "partly" additional. This means that the DES transaction affects the timing and/or the amount of the investment.

6. In most of the countries under study (Argentina, Brazil, Chile, Mexico, the Philippines, Venezuela), industrial sector DES range from projects of small volume below 1 million US $ to projects over 20 and in some cases even over 100 million US $. All projects over 100 million US $ involve TNCs, all of them are in export-oriented industries (the automotive industry in Mexico, aluminium production in Venezuela, paper and pulp production in Chile and Brazil), and most of them could be classified as "partly" additional. Strong export orientation and prominence of TNCs are characteristic also for other industrial sector DESs, particularly for the larger ones.

   Although the above-mentioned mega projects are dominant in terms of amount, there is a high concentration, in terms of numbers, of industrial swaps on relatively small projects. A significant share of these projects is again export oriented. In Mexico for example, the whole maquiladora industry has been a popular target of DESs. Since these investments generally do not carry high capital requirements, owing to the labor intensive nature of this type of work, debt swaps in this sector tend to be small in amount. Similar are the characteristics of industrial DESs in smaller countries like Costa Rica and Jamaica.

   There is no information available about the importance of domestic market oriented projects within the total industrial sector DESs. It seems reasonable to assume that projects of this type are more concentrated in countries with a sizeable and growing market.

7. DESs in the industrial sector are eligible in programmes of all nine countries under study. As far as priority status is concerned, industry has explicit priority in only two countries (the Philippines and Venezuela). In six other countries priority is given to export oriented projects. Since a significant number of industrial sector DESs are export-oriented, they de facto have a priority status in these countries' DES programmes.

8. Both, corporate investors (predominantly TNCs) and banks are eligible as foreign investors in DES programmes of all the nine countries under study. However, there is significant difference about their actual involvement in industrial swaps. While TNCs have been very active in practically all countries, the activities of banks as investors in industrial sector DESs have varied from country to country. Available information suggests that although eligible, banks have not entered into industrial swaps with their own portfolio in Argentina, Chile (Chapter 18), Mexico, the Philippines and Jamaica, while they have been marginally present in Brazil and Venezuela (one project in each country). In contrast to the experiences of all these countries, there has been strong activity of transnational banks in industrial sector swaps in Chile (Chapter 19).

Local investors are eligible for DES transactions in Argentina, Chile (Chapter 18), Mexico, the Philippines, Uruguay, Costa Rica and, as of April 1989, also in Venezuela. In Brazil for example, locals participate in DESs through firms registered abroad. There is no information available about the amount and patterns of DES transacions carried out by local investors for most of the countries under study (Mexico, the Philippines, Uruguay) while the only information about Argentina and Costa Rica merely suggests that they are active. It is therefore not possible to make any conclusions about how successful these countries have been in attracting domestic flight capital back into the domestic country and in discouraging round tripping. It seems, however, that actual results are lagging behind debtor countries' expectations. Chile (Chapter 18) is the only country with a substantial amount of debt peso deals. There is no information on the sectoral breakdown of these transactions. Most transactions under this scheme have been used for refinancing with local banks as major investors (80% of the total).

9. Empirical evidence suggests that there is a substantial difference between the respective strategies of corporate investors and banks regarding the time horizons of their investments. The main objective of corporate investors entering into investment through DES is to reduce costs of the investment and to achieve higher yield in a relatively long term time perspective. On the other hand, banks have been using DESs as a mechanism to diversify and ultimately even to liquidate a part of their portfolio. In this context, banks are, in general, highly interested for equity investments which will provide opportunity for an exit after a relatively short time period.

10. The uses of industrial sector DESs include three major types: buy-outs, financial restructuring and investment into new capacity/ new company. There are significant differences among the countries under study regarding the eligibility of these types of transactions in DES programmes as well as regarding their actual use.

Buy-outs are explicitly forbiden in Argentina, while in some other countries (Brazil, Uruguay, Jamaica) these transactions are eligible but they have not been used in practice. In Chile and to a much lower extent in Mexico and the Philippines, buy-outs have been incorporated in the countries' privatization programmes. Banks have been active as buyers of shares of existing firms in Chile.

Chile and Mexico have used DESs for pure financial restructuring in the industrial sector. A large number of TNCs in these two countries have exchanged debt owed to others for equity investment in their local subsidiaries with the aim of their financial strengthening. In Mexico, almost 25% of the total value of DESs in 1986 and 1987 was used for financial restructuring (Bergsman, Edisis, 1988). In some other countries, Argentina and Brazil for example, pure financial restructurings are explicitly forbiden.

DES investments in new capacities/new companies are permitted in all nine countries under study, which indicates a strong preference of debtor countries for this type of DES transaction. At the same time, DESs of this type have also been the most active among the three identified uses of swaps. It is often combined with various firms of financial restructurings.

The study suggests that there are two major forms of DES investments in new capacities/new companies. First and by far the more important is project financing in affiliates. The aim of these investments is to expand and technically modernize subsidiary operations or to start with a completely new production line. This form of DESs has been the most important use of swaps in Argentina, Brazil, Chile, Mexico, the Philippines, Venezuela and Jamaica. The second form of DES investments in new capacities/new companies are joint ventures. Although substantially smaller in number, this form has been used in a number of large DES transactions, for example in Venezuela and Chile. In some of these transactions TNCs as major foreign investors have been accompanied by banks.

Table 15: Debt-Equity Swaps and the Industrial Sector - Summary Table I

Country	No.of approed projects under DES programmes	Total value of debt converted[1/] (mil.US$)	3 : 2 (mil. US $)	Fresh money component (mil.US$)	Total value of debt converted in ind.sector (mil.US$)	6 : 3 (%)	Period
1	2	3	4	5	6	7	8
Argentina	80	310	3.9	385	cca 220[2/]	cca 70[3/]	1988
Brazil	370	1,472	4.0	n.a.	843[4/]	57[4/]	1988
Chile(Ch.18)	n.a.	2,157	n.a.	n.a.	n.a.	n.a.	1985-1989/1
Chile(Ch.19)	194	1,630	8.4	n.a.	cca 990[5/]	61[5/]	1985-1988/9
Mexico	n.a.	2,500	14.7[6/]	n.a.	cca 1,250[7/]	cca 50	1986-1987
Philippines	332	1,100	3.3	n.a.	cca 550[8/]	cca 50	1986-1988/7
Uruguay	14	52	3.7	41	10	18	1988
Venezuela	9	379	42.1[9/]	375[10/]	373	98	1987-1988
Costa Rica	32	117	3.7	n.a.	n.a.	n.a.	1986-1988
Jamaica	16	85	5.3	30	n.a.	n.a.	1987-1988
TOTAL		9,802			4,236		

1/ Approximate figures, includes approved projects not yet closed.
2/ Computed from column 7 (cca 50%).
3/ Based on the structure of DES after the first three auctions.
4/ Includes mining.
5/ Includes manufacturing, natural resource sectors (mining, forestry, fishing) and half of mascellaneous.
6/ Only 1986.
7/ Computed from column 7 (cca 50%).
8/ Computed from column 7 (cca 50%).
9/ If the largest project (280 million US $) is excluded, the average, value of the project would be 12.4 million US $.
10/ Relates to only the two larger investment authorized under Decree 1988.

Source: - Chapters 4 and 5
- Annexes
- Annex Tables

Table 16: Debt-Equity Swaps and the Industrial Sector - Summary Table II

Country	Eligibility status of DES in ind. sector	Priority status of DES in ind. sector	DES investors in industrial sector Foreign TNCs	TNBs	Local	Type of DES investment in industrial sector buy-outs (privatization)	financial restructuring	new capacity/company
1	2	3	4	5	6	7	8	9
Argentina	Yes	P	e/3	e/1	e/3	ne[1/]	ne	e/3
Brazil	Yes	N	e/3	e/2	ne	e/1	ne	e/3
Chile(Ch.18)	Yes	n.a.	e/1	e/1	e/3	e/n.a.	e/3	e/n.a.
Chile(Ch.19)	Yes	P	e/3	e/3	ne	e/3	e/3	e/3
Mexico	Yes	EP	e/3	e/1	e/n.a.	e/2	e/3	e/3
Philippines	Yes	P	e/3	e/1	e/n.a.	e/2	e/2	e/3
Uruguay	Yes	P	e/2	ne	e/n.a.	e/1	n.a.	e/3
Venezuela	Yes	EP	e/3	e/2	ne	e/2	e/1	e/3
Costa Rica	Yes	P	e/n.a.	e/n.a.	e/3	n.a.	n.a.	e/3
Jamaica	Yes	P	e/3	e/1	ne	e/1	e/n.a.	e/3

1/ There are some indications that the government will allow some privatization transactions.

EP = explicit priority for industrial sector projects
P = priority given to export-oriented projects (industrial sector projects are not specifically mentioned)
NP = No priority

e = eligible; ne = non-eligible
1 = not active; 2 = active; 3 = very active
n.a. = not available

Source: - Chapters 4 and 5
- Annexes
Annex Tables

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A N N E X E S

ANNEX 1: Country by Country Survey of the Government's Share in the Secondary Market Discount and of Incentives to Investor

Argentina: Assessment and selection of the bids is carried out through a public auction process. In the tenders bids are qualified and given points based on the value of the conversion discount proposed. The discount is expressed as a percentage of the debt to be swapped. The Central Bank is authorized to set a minimum discount in the tenders. This discount is expressed as a percentage of the face value of the debt instrument to be converted (redemption price).

The Central Bank has managed to increase steadily the discount it applies to the redemption price of the debt over the five auctions held in 1988.

Table 1: Government's Share in the Secondary Market Discount and Incentive to Investor in Argentina (1988)

Auction	Market price	Redemption price	Average discount	Minimum discount	Government' share	Incentive to investor
January	32	63	37%	25%	54%	49%
March	27	46	54%	35%	74%	41%
June	28	42	58%	45%	81%	33%
September	21	34	66%	45%	84%	38%
December	24	28	72%	45%	95%	14%
AVERAGE	26	43	57%	39%	77%	40%

Source: The Debt-Equity Swap Handbook. Business International, February 1989, p.29 (for average discounts); Trade Finance. Euromoney-various issues (for market price); own calculations.

Brazil: Discount taken by the Central Bank on most swaps is set by auction bidding. Participants in the auctions submit the amount of their bid along with a proposed discount. When the volume of bidding exceeds the auction ceiling at a given discount, a new round of bidding begins at a higher discount. The Central Bank does not establish a minimum discount.

Table 2 (Annex 1): Government's Share in the Secondary Market Discount and Incentive to Investor in Brazil (1988)

Auction	Market price	Redemption price I	Redemption price II	Government's share I	Government's share II	Incentive to investor I	Incentive to investor II	Discount I	Discount II
March	46	73	89	50%	20%	37%	48%	27%	11%
April	50	68	85	60%	30%	26%	41%	32%	15%
May	51	78	99	45%	2%	35%	48%	22%	1%
June	53	86	84	25%	28%	38%	37%	14%	16%
July	54	73	89	59%	24%	26%	39%	27%	11%
August	51	70	91	61%	18%	27%	44%	30%	9%
September	46	66	94	63%	11%	20%	51%	34%	6%
October	46	62	83	70%	31%	26%	45%	38%	17%
November	39	50	72	82%	36%	22%	50%	50%	22%
December	42	51	82	85%	31%	18%	48%	49%	19%
AVERAGE	48	68	87	62%	25%	29%	45%	32%	13%

I = free area; winning bidders can apply their converted funds to projects anywhere in Brazil
II = incentive area; converted funds can be invested only in the states of the Amazon Basin, the Northeast, a northern region of the state of Minais Gerais (Jequitinhonha Valley) or in the state of Espirito Santo.

Source: The same as Table 1 of the Annex 1.

Chile: For DES transactions under Chapter 19, the discount is established through negotiation (case by case) between the investor and the Central Bank when original Central Bank debt is involved. If other debt is involved, the discount is negotiated between the investor and the original debtor. As of September 1988, discounts under Chapter 19 were in the range of 14-17% (The Debt-Equity Swap Handbook, 1989, p.62) thus the redemption price was in the range of 83-87%. Based on the average market price for Chilean debt in 1988 (58%), the government's share in a discount could be estimated at 36% while the investors' incentive was, on average, 32%.

Conversions based on Chapter 18 are conducted through auctions which held twice a month in 1988. Private commercial banks are presently buying back at discounts ranging from 10 - 15% as of September 1988 (The Debt-Equity Swap Handbook, 1989, p.62), therefore the distribution of a discount is the following: 29% incentive to investor and 71% government's share in a discount.

Mexico: The DES programme has a system of nine investment categories according to which the government sets a discount on the debt converted. For investments in the highest priority areas (category 0) the government will convert the debt at full face value. However, if the investment falls in the lowest category (category 8), the government will apply a discount of 25% of the face value of the debt. This categorization has been done in the form of general guidelines, not precise indicators. Swap proposals have frequently fallen into more than one category. This has given to the officials fairly broad discretionary power to offer higher or lower conversion discounts depending on the relative desirability of the project. Investments are conducted on a case-by-case basis.

According to available information, average redemption price at the beginning of 1987 was 85% and in November 1987, before the suspension of the programme, 65-70% (Debt-Equity Swap Handbook, 1989, p.71).

Table 3: Government's Share in the Secondary Market Discount and Incentive to Investor in Mexico (1987)

	Market price	Redemption price	Government's share	Incentive to investor
January 1987	56	85	34%	34%
November 1987	53	68	68%	22%

Source: Own calculations.

The Philippines: In October 1987 the government changed conversion fees or discounts. Previously, a fee of 5% of the face value (which practically means that the redemption price was 95%) applied to investments under Schedule 2 (preferred investments), and 10% was charged for projects under Schedule 3 (less-preferred investments). Now, preferred investments have fees ranging from zero, if a bank finances 50% of a conversion with new money, to 20% if no new money is used. On Schedule 3 investments, there is a zero fee if 30% of conversion is financed by new money. If no money is used, the fee is 24%.

Table 4: Conversion Fees Assessed in the Philippines

	Minimum percentage of fresh money funding	Fee (% of face value of debt)
Schedule 2	50	0.0
(preferred investments)	40	6.7
	30	11.5
	20	15.1
	10	18.0
	0	20.0
Schedule 3	60	0.0
(less preferred investments)	50	8.0
	40	13.5
	30	17.5
	20	20.0
	10	22.5
	0	24.0

Source: Debt-Equity Swap Handbook. Business International, February 1989, p.83.

The Philippines Central Bank reviews each proposal on a case by case basis. Unfortunately, there is no statistical data indicating an average conversion fee or a discount for investments carried out in the Philippines through DES transactions.

Uruguay: Regulations stipulate that the Central Bank discount on the redemption of the foreign debt paper is a minimum of 12% of face value. Investors submit their projects with proposed discounts to the Planning and Budget Office where their eligibility is determined based on the government's investment priorities. If a project qualifies, it is sent to the Central Bank for approval or rejection. The only 14 debt equity proposals approved in Uruguay (in May 1988) offered discounts ranging from 12-19% (Debt-Equity Swap Handbook, 1989, p.89). This means that redemption price was 81-88%. Taking into account market price for Uruguay debt (58% in January 1989), government's share in a discount was between 29% and 45% while investors' incentives ranged from 28% to 34%.

Venezuela: A special committee established to review and approve debt-conversion transactions decides upon the final terms of any deal, including the redemption rate (percentage of face value that will be paid out to the investor) and whether redemption will be made in cash or in local currency debt instruments. As of January 1989, the redemption rate was still 100% of face value. Although this provision was extremely beneficial for investors (they get whole secondary market discount) and indicates the government's desire to utilize the DES programme primarily as an incentive to attract FDI rather than as a means to decrease its own obligations by taking advantage of the market discounts for Venezuealan debt, the scheme was unattractive for investors due to exchange rate disadvantages: the programme stipulated the use of the official rate, which is very unfavourable compared to the current free market exchange rate (official rate B 14.5 : 1 US $; free-market exchange rate B 40 : 1 US $; at the end of 1988).

In April 1989 the scheme was drastically changed (see Annex 3 for details). An auction system was introduced and all swaps became eligible to be converted at free market rate.

Costa Rica: Although the country has never had a formal DES programme, in 1986 it did provide a mechanism allowing investors to finance their projects through DES. All the projects submitted to the Central Bank have been approved or rejected on a case by case basis.

The guidelines for Costa Rica's DES established a maximum redemption rate for each category of investment according to its priority.

Group A: up to 75% of nominal value
Group B: up to 60% of nominal value
Group C: up to 45% of nominal value

In practice the following results have been achieved:

Table 5: Government Share in the Secondary Market Discount and Incentive to Investor in Costa Rica (1986)

Activity	Market price	Redemption price	Government's share	Incentive to investor
Export oriented projects*	45	67	60%	33%
Capitalization of banks	45	67	60%	33%
Shipbuilding	45	56	80%	20%
Import substitution	45	55	82%	18%
National park conservation	45	76	44%	41%

* 28 out of 32 projects approved and finalized in Costa Rica were export-oriented projects.

Source: Debt-Equity Swap Handbook. Business International, 1989, p.105; own calculations

Jamaica: The programme guidelines state that the conversion discount applied by the Bank of Jamaica will not exceed 10%, with the actual rate depending on "the nature of the investment". The average discount on the four deals done to date (in 1988) has been 5% (Debt-Equity Swap Handbook, 1989, p.117). Taking into account the market price for Jamaican debt - 50% (mid 1988), the governments' share in a discount was 10% and the incentive to the investor 47%.

acquisition of capital stock positions in new or existing firms; on the other hand, the programme specifically banned the following uses: payments for goods and services of non-national origin; payments for impacts of inputs or capital goods; intercompany loan repayment; provision of working capital.

There is a clear ranking of investment in terms of priority in the Mexican programme. Priorities are given to investments used for the sale of selected state enterprises and new investments or capital widening which promote exports and generate foreign exchange, which result in goods that replace imports, which involve advance technology, which produce goods with higher domestic content, and/or which create new jobs and require employee training, research and development.

The Mexican programme has nine priority categories with discount in the debt converted:

Table 1: Discounts for Converted Loans According to Priorities in Mexico

Category	Discount (%)	Conditions
0	0	The partial or full purchase of state companies.
1	5	New companies, expansions, or product lines with export production of 80% or more. Full or partial purchase by foreign capital of Mexican companies. New companies specialized in advanced technology, featuring high degrees of domestic content, or substituting imports. Small business investments (as defined by the National Foreign Investment Commission's General Resolution No. 15).
2	8	New companies,expansions, new product lines or new advanced technology,enterprises in priority sectors that generate forex and employment,enterprises in zones of industrial decentralization, enterprises exporting a minimum of 50% of new production.
3	12	Enterprises exporting a minimum of 30% of new production. Companies with advanced development projects involving high technology. Investments in Mexican companies with minority or no foreign capital.
4	13	Investments in companies with balance of payments deficits. Self sufficiency in foreign exchange. New company, expansions, or new product lines oriented partially towards export markets. Domestic content levels below industry norms.

Category	Discount (%)	Conditions
5	14	New companies or investments in new product lines intended to reduce a company's trade deficit. Reduction of debt with domestic suppliers. A low degree of domestic content medium technology.
6	15	Partial capitalization or partial prepayment to Ficorca or state bank's"national credit societies" Medium technology No foreign exchange generated.
7	16	Debt payment to Ficorca or state banks.
8	25	No foreign exchange income produced. Projects not fulfilling conditions outlined in previous categories.

Source: Rubin, Steven. Guide to Debt to Equity Swaps. The Economist, September 1987, p.122-123.

The Philippines: Under the Philippino programme, most sectors are eligible, but investment is restricted to the purchase of equity in existing firms in the form of shares or an ownership interest. The authorities are guided, in their decision to approve DES, by the extent to which the investment meets the following criteria: at least 80% of production is for exports; a new export product is involved; the export product is not subject of foreign quota; employment is generated; the productive process is labour intensive; location is in the regions that are not heavily industrialized.

The programme specifically encourages investment (by more favourable treatment with respect to repatriation, remittance and conversion fee) in the following priority areas: (Schedule 2) - preferred investment; production of goods for export; services contracted outside the country where revenue is in foreign currency; agricultural production and related sectors; health care facilities; construction or maintenance of low and middle-income housing facilities; construction and maintenance of educational facilities; activities listed in the Investment Priorities Plan; banking; acquisition of non-performing government assets under the privatization programme. All other investments are considered nonpriority (Schedule 3).

Uruguay: Investment can be made for establishing or expanding a company in Uruguay as well as to purchase shares in local companies. Fund may be used for the acquisition of new equipment, construction of industrial plants and for other assets needed to increase or improve the production of goods and services. Priority is given to export-oriented and tourism projects, but there are no strict sectoral or geographical restrictions.

Venezuela: The programme specifies that conversion can be authorized if the proceeds are invested in import substituting or export promoting industries or in industries in one of the following 11 priority sectors: agriculture; agroindustry; construction and maintenance of infrastructure; tourism; construction of low-cost housing; rendering of transportation services;

production of capital goods; manufacture of chemicals and petrochemicals; electronics and informatics; biotechnology; and aluminium production. In addition, swap funds can also be used to invest in enterprises in danger of being closed down. Investments in other sectors may also be approved by the authorities. It is more than obvious that the programme covers a wide range of priority areas.

As far as the uses of swap funds are concerned, they can be invested in existing or in new companies. Under Venezuelan law, certain sectors are reserved for local investors; in these sectors (for example, telecommunications) companies must be 80% locally owned; in the others foreign participation is limited to 49%. Under Venezuelan banking law, new foreign investment in the financial sector is prohibited.

Costa Rica: According to the programme, all projects eligible for DES investment are categorized according to priority (different redemption prices):

Group A (highest priority): export oriented projects, banana production and investment in free trade zones.

Group B (intermediate priority): import-substitution projects and capitalization of local financial institutions.

Group C (lowest priority): Investment in Central Bank securities.

Jamaica: According to the guidelines, investment undertaken through DES can take the form of shares in any Jamaican public or private sector companies. Priority is given to projects in free trade zones as well as to tourism and export-oriented projects.

ANNEX 3: New Venezuelan Debt Equity Swap Programme (April 1989)

The Venezuelan DES programme was launched in April 1987 with the Decree 1521. With bolivars trading on the open market at 40 to the US $ and the programme's rate fixed at 14.5 US $ (official rate), the DES programme was unattractive for potential investors, in spite of some other incentives, like 100% redemption price, no fresh money, required, etc. Potential investors were of the opinion that incentives offered by Venezuelan authorities under Decree 1521 on the one hand were removed by the deterrents on the other.

Due to very meagre interest on the part of investors in the DES programme, Venezuelan authorities decided to provide some additional incentives for export oriented projects (Decree 1988 from February 1988). Under this Decree, firms making investments in new industrial projects in selected sectors - metallurgy, chemicals, metalmechanics, pulp and paper, petrochemicals, mining and hotels - that export at least 80% of production were permitted to retain abroad the foreign exchange earnings not required to cover local operating costs. For projects between 20 and 100 million US $, 50% of the total investment was allowed to be derived from swap transactions. For projects over 100 million US $, the eligible portion was raised to 80% (BLA, February 15, 1988, p.56).

In October 1988, officials amended Decree 1988 with Decree 2485. Under the new scheme, swappers are allowed to convert currency at the free market rate. In exchange for this incentive, the Decree lowered the percentage of the project's cost that may be financed through swaps (40% for projects below 100 million US $ and 60% for projects over 100 million US $).

In April 1989 Venezuela has come out with a completely new DES programme, thus signaling a commitment to attract fresh investment capital. The new programme replaces Decree 1521 of April 1987. The programme has the following innovations (BLA, April 3, 1989, p.97, 98):

- the programme is open to foreign investors and previously excluded Venezuelan investors;
- it introduces the auction system, like that of Argentina and Brazil;
- the Central Bank has to receive all the applications as well as a bids. The bank is free to accept or reject the bid on the basis of the proposed discount and the overall merits of the investment (previously the redemption rate was 100%);
- all swaps are converted at the free market rate (previously at the fixed rate, which was significantly below the market rate; use of the free market rate was extended only to projects under Decree 2485);
- the priority sectors cited in the plan are virtually identical to those contained in the earlier plan with two categories added mining and metallurgy;
- the commission may authorize swaps for the purpose of buying shares on the stock market of companies in priority sectors;
- as far as restrictions on profit remittances and capital repatriation, they remained the same as in the old programme.

ANNEX TABLES

Annex Table 1: Benefits and Costs of Debt-Equity Swaps to Participants

Participants	Strategic Benefits	Operational Benefits	Costs
Countries	Reduce debt in hard currencies and service costs.	Improve balance of payments and reduce strain on export earnings.	Sovereignty at stake.
	Encourage foreign investment and repatriation of capital.	Encourage exports through use of investors' resources.	Lose control of state owned companies.
	Regain ability to borrow again in hard currencies at competitive rates.	Concentrate investments in selected industries.	Capital inflow increases inflationary pressures.
	Improve economic climate and utilization of resources and opportunities.	Reduce interest payments on existing loans.	Official recognition of unfavourable international rating, if discount is large. Unfair precedent for established companies not benefiting from new DES.
Banks	Change composition of loan portfolio.	Reduce exposure to default/ currency risks.	Potential downgrade of bank's entire loan portfolio.
	Reassess risk/return assumptions on loans.	Confront the problem: reduce management time on dubious loans and invest it in more rewarding activities.	Increase reserves at the expense of dividends/investments for growth.
	Focus lending strategy toward healthier and more promising opportunities.	Avoid increased lending as part of "rescue" packages.	Heavy cash losses due to loan discounting.
	Increase bank's short-term liquidity.		Establish undesirable precedent for other loans to same/other customers.

Participants	Strategic Benefits	Operational Benefits	Costs
Investors	Convenient/unique source of low-cost financing. Expedite stalled and new projects fitting with global competitive strategy. Increase barganing power and recognition of strengths by host government.	Lower cost than traditional investments. Achieve strategy at a lower cost and facilitate market entry. Gain access to activities/ resources previously banned.	Increase exposure to foreign,political,and economic risks. Adjust policies and administrative systems to those of partners in case they are needed for successful operations in new environment. Adaptation of investor's organization to country's legal, political,cultural, and ethical frameworks.

Source: Ganitsky, Joseph and Lema Gerardo. Foreign Investment through Debt-Equity Swaps. Sloan Management Review, Winter 1988, p.24.

Annex Table 2: Eligible Participants in Debt-Equity Swap Programmes

Argentina:	The programme is open to both domestic and foreign companies and banks. Up to now only non-financial companies have participated in the scheme, as it requires investment in new facilities.
Brazil:	The programme is open to foreign banks, TNC and non-residents. In practice, Brazilian residents might be behind some corporations based abroad.
Chile:	Chapter 19 is restricted to use by foreigner (TNC, banks) and non-resident nationals, except for investing in conversion funds. In Chapter 18, both nationals and foreigners are eligible to participate; the programme is utilized mainly by nationals.
Mexico:	The programme allowed foreign and national companies and banks to participate in DES transactions.
Philippines:	The programme is available to foreign and national companies and banks.
Uruguay:	The programme is open to foreign and national companies and banks. Banks are not permitted to make investments outside of the financial sector.
Venezuela:	The programme of April 1989 is open to foreign and local companies and banks.
Costa Rica:	The programme was available to foreign and national banks and companies.
Jamaica:	The programme is open to foreign banks, companies and non-residents.

Source: - Rubin, Steven. Guide to Debt Equity Swaps. Economist, September 1987.
- Debt-Equity Swap Handbook. Business International, February 1989.
- Various press accounts.

Annex Table 3: Restriction on Profit Remittance and Capital Repatriation

Country	Restrictions on profit remittance	Restrictions on capital repatriation
Argentina	Banned for 4 years (under normal foreign investment law 3 years)	Banned for 10 years (under normal foreign law no limits)
Brazil	No specific limit;may be remitted according to existing law	Banned for 12 years
Chile (Chapter 19)	Banned for 4 years,with no more than 25% of the first four years' profits remitted beginning in the fifth year	Banned for 10 years
Chile (Chapter 18)	Not entitled to future remittance right	Not entitled to future repatriation right
Mexico	As soon as profits realized	Banned for 12 years
Philippines	As soon as profits realized in priority sectors;banned for 4 years in other sectors	Banned for 3 years in priority sectors;banned for 5 years in other sectors
Uruguay	As soon as profits realized	Period not less than original debt
Venezuela	10% per annum of the dollar amount of the registered capital for the first three years;thenafter 20% of capital plus LIBOR equivalent	Banned for 5 years;thenafter not more than 12.5% per annum of the initial investment
Costa Rica	As soon as profits realized	Period not less than original debt
Jamaica	Banned for 3 years	Banned for 3 years for priority projects; banned for 7 years for other projects

Source: - Rubin, Steven. Guide to Debt Equity Swaps. Economist, September 1987.
- Debt-Equity Swap Handbook. Business International, February 1989.
- Various press accounts.

Annex Table 5: Major Brokerage Houses in Brazil's Auctions, 1988

Brokerage house	Associated with	Total converted(mil.US$)	Share of all conversions(%)	No of projects
FNC	Citibank (USA)	250.1	17.0	35
Multiplic	Lloyd	167.5	11.4	19
Guilder	NNB Bank (Dutch)	158.4	10.8	81
Unibanco	Unibanco (local)	138.9	9.4	19
Garantia	Garantia (local)	98.5	6.7	25
Tochpe	Bankers Trust (USA)	70.4	4.8	20
JPM	Morgan Guaranty (USA)	68.8	4.7	11
Bozano	Bozano (local)	60.1	4.1	11
Total (9)		1,012.7	68.9	221
Grand Total		1,465.7	100.0	370

Source: Debt-Equity Swap Handbook. Business International, February 1989, p.52.

Annex Table 6: The Philippines - Some Lebt-Equity Swaps

Project	Foreign partner	Sector	DES portion (mil. US$)	Type of investment
-Semiconductor production	Texas Instruments (USA)	Industry	23.9	Expansion of production in local subsidiary
-Cattle feed production	Kawasaki Steel Corp. (Japan)	Industry	1.2	Acquisition of shares
-Hotel	Japan Air	Tourism	1.0	Acquisition of shares
-Expansion of coconut oil plant	Kao Corp. (Japan)	Agriculture	0.4	Expansion of production in local subsidiary
-Shampoo factory	"	Industry	6.2	New factory
-Investment in a local bank	Bank of Boston (USA)	Finance	19.0	Acquisition of shares
-Investment in a local bank	Bank of Nova Scotia (USA)	Finance	...	Acquistion of shares
-Semiconductor production	... (US,UK)	Industry	4.3	New company
-Production of floppy disk drivers	n.a.	Industry	1.2	Acquisition of shares
-Motorcycle programme	Honda (Japan)	Industry	3.2	" "
-Flashlights production	(Matsushuta (Japan)	Industry	0.3	" "
-Pharmaceutical products	Abbot Lab(USA)	Industry	6.1	Expansion of production in local subsidiary

Source: Various press accounts.