DEBT CONVERSION: THE JAMAICAN EXPERIENCE

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INTRODUCTION

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This paper looks at Debt Conversion which was introduced as a debt management tool in Jamaica in July 1987. As it will not be possible to make an indepth analysis of the impact of debt conversion on the Jamaican economy at this time, the paper will look at the broad concepts of debt conversion and its use as a debt management tool, the experience of some developing countries in the use of this tool, and the factors which led to the Jamaican attempt at the debt for equity option. Finally, a brief assessment will be made of its impact on the Jamaican economy to date. It is the intention to do a follow-up study of the full impact of debt conversion on the Jamaican economy, at a later date.

The paper is divided into five sections. Section 1 deals with the concept of debt conversion and the use of debt conversion as a debt management tool. Section 2 looks at the experience of some developing countries in the use of debt conversion. Section 3 discusses the factors which led to the Jamaican attempt at the debt for equity option. Section 4 looks at Jamaica's experience in debt capitalization to date and Section 5 is a general summary and conclusion.

SECTION 1

DEBT CONVERSION - THE CONCEPT

There has been a number of proposals advanced for solving the problems of heavily indebted countries. These include rescheduling, the restricting of debt service to a percentage of export earnings, capping of interest rates and more recently debt conversion. There are three main types of debt conversion: debt-debt swaps, debt-peso swaps and debt-equity swaps. In practice, various combinations of these are used.

A debt-debt swap involves an exchange of debt among creditors independent of the debtor countries. This is done through the assignment of loans or by each party giving sub-participation to each other, without otherwise changing the terms of payments, and may involve external or internal creditors. The rationale for such action usually emanates from a desire to consolidate the creditors' exposure in countries where there is a long-term strategic interest. In a transaction involving external creditors a U.S. Bank may swap a Jamaican debt for a Trinidadian debt with a European Bank. In a transaction involving internal creditors, a U.S. Bank may swap a Jamaican debt for a Trinidadian debt with a Jamaican Bank. The Jamaican debtor would now have a Jamaican creditor while the Trinidadian debtor would have a U.S. creditor.

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A debt-peso swap is defined to be the purchase of a part of the national debt by the residents of a country, and peso is used synonymously with local currency. Under this arrangement residents are allowed to buy their own country's debt in the secondary market, using their funds abroad or foreign currency acquired in the parallel market. These foreign funds are paid into the creditor institution in exchange for local currency, which is valued at a higher rate, than the market exchange rate. In turn this is expected to be reinvested in local equity investment. The overall objectives of this scheme is to encourage the repatriation of illegal capital outflows as well as the reduction of the size of the national debt.

A debt-equity swap or debt capitalization involves the purchasing of a foreign debt in the secondary market. This is purchased at a discounted rate and is redeemed in local currency at or near face value. This method of debt management is aimed not only at reducing the stock of debt and the level of debt servicing but also at inducing the flow of new foreign investments. The transaction is effected in the following way:

(a) a creditor bank sells a hard currency loan to a corporation, often a multinational at a discount;

(b) the corporation presents the debt obligation to the Central Bank of the debtor country and receives local currency, at or near face value;

(c) in exchange, the corporation is required to make certain investments in the country, often export-oriented.

The parties to the the transaction will encounter certain advantages and disadvantages. The debtor country will have the advantage of decreasing its stock of debt and at the same time attract new investments. The creditor bank will have the restoration of a doubtful debt and the investor will receive low cost investment opportunities. The main disadvantage to the debtor country is the potential inflationary effect of an increase in the money supply. At the same time, the creditor banks will be obliged to revalue the entire loan portfolio and realise a net loss on the sale of the obligation, as the sale is transacted at a discounted rate. The main disadvantages to the investors are the restrictions placed on profit remittance and capital repatriation, the type of equity investment options available and the lack of exchange rate guarantees in a climate of changing exchange rates.

The use of debt conversion as a tool of debt management will depend to a great extent on the market for developing countries debt. A recent study[1] shows that the market for the three types of swaps has been growing rapidly but remains small in relation to the amount of LDC debt outstanding. Based on estimates, conversion of debt totalling approximately US$12 billion has already been realized since 1982. At the same time, however, estimates of Commercial Bank debt of the 15 Lesser Developed Countries (LDCs) in the Baker proposal amounts to approximately US$300 billion. The supply of debt for the three types of swaps tends to come mainly from European Banks and regional U.S. Banks.

SECTION 2

DEBT CONVERSION; SOME RECENT EXPERIENCES

Debt conversion has become increasingly popular over the past five years. Many developing countries, particularly the Latin American countries have utilized this tool of debt management as a means of trying to get out of the "debt trap" in which these countries have found themselves. This section looks at the attempts of Chile, Mexico, Brazil and the Phillipines in their use of debt conversion, as a means of solving their debt problems.

Since June 1985 and up to the end of January 1987, Chile with a stock of US$21 billion in foreign debt has converted approximately US$1.6 billion[2]. Chile's debt equity conversion scheme is said to be among the most liberal. Investors, both foreign and local, are able to buy external debt at a rate of about US$0.68 to the dollar. The proceeds can be channelled in various investments, to repay local currency debt or use as working capital. However, most of the times this is not done, due to the serious problem of "roundtripping". This involves Chileans bringing back illegal foreign exchange outflows, redeeming them at higher than market exchange rates, then exchanging it back into foreign exchange on the black market. This cannot be stopped. It can be restrained by carefully monitoring investments and by watching the exchange markets for evidence of "capital flight" and by not allowing the currency to become too overvalued.

Nevertheless, Chile's programme of converting foreign debt into equity has brought about numerous benefits. There has been a decrease in debt and interest flows, and the attraction of new technology along with other lucrative externalities associated with foreign investment. Naturally, there are certain restrictions. These include restrictions on the export of capital for ten years after the date of the investment, and related profits after four years. Profits accumulated during this four year period may be sent abroad commencing in the fifth year, in annual instalments which must not exceed 25 per cent of such accumulated profits. Profits earned in and after the fifth year may be freely remitted.

Mexico's debt conversion scheme allows funds to be used in a new project or expansion of an existing plant. It is said that the Mexican program is hampered by stringent guidelines. Capital raised in the scheme can often be spent only on Mexican goods and services. The money cannot be used as general working capital, nor for speculative investments, with the Central Bank maintaining a close watch. Mexico's stock of debt is approximately US$100.2 billion.

Brazil has converted approximately US$1.8 billion of its stock of approximately US$113.0 billion external debt into equity since 1983. In the middle of 1984, the swaps were limited to the original debt holders. Thus debt brought in the secondary market was ineligible for conversion. This led to a decline in activity in 1986.

The Phillipines' programme concentrates mainly on new investments and so far most of the money has been going into textiles. The scheme allows foreign and domestic investors to hold or purchase the country's foreign debt and redeem it through the central bank at the official exchange rate. Private and foreign debt is eligible for conversion. Equity investment in local companies may be resold after two years. Capital can be repatriated after three years if the investment was made in priority area, for example, export industry, food production or house construction. Capital can otherwise be repatriated after five years. A transaction fee of five to ten per cent on debt-equity conversion exists.

SECTION 3

THE GROWTH OF JAMAICA'S EXTERNAL DEBT

There are many factors which led to the establishment of the debt for equity programme in Jamaica, but before examining them, it is necessary to first look at the development of the external debt. Total external debt includes direct government debt, private and public sector debt guaranteed by the Government and foreign liabilities of the Bank of Jamaica. The non-guaranteed debt of the private sector is not included due to the unreliability of the information pertaining to this category of debt.

The debt crisis in Jamaica is related mainly to two structural problems. Jamaica has been unable to generate adequate savings to finance investment and hence heavy reliance is placed on external borrowing. Development in the sixties and early seventies revolved around the bauxite/alumina industry, tourism and the construction sectors of the economy. The shortfall in the production of bauxite and the capital intensive nature of tourism and construction resulted in an increased demand for foreign exchange. To complicate this, 1976-1980 was marked by private capital outflows. Outflows amounted to approximately US$323 million[3], while the deficit on the current account for the next five years totaled US$733 million[4]. Official borrowing had to be sought to help to cover the current account gap.

The second problem is related to the country's narrow and relatively inflexible economic structure. There are many capital and intermediate goods essential to development that cannot be produced by the domestic sector. Therefore a certain level of import is needed for economic growth. The level of imports required for economic growth grew at a faster rate that exports, thus causing a foreign exchange gap. This gap has been financed partially by official borrowing and depletion of reserves. The 1973 and 1979 oil price increases added fuel to an already burning problem since it further eroded Jamaica's ability to service the debt and thus widened the current account deficit.

Although revenue improved from 26.3 per cent of GDP in fiscal year 1976/79 to 29.4 per cent of GDP in 1979/80 and expenditure declined from 41.4 per cent of GDP to 38.4 per cent in 1979/80 resulting in smaller deficits in relation to GDP, the public debt grew, rising from 32 per cent in 1976 to 82 per cent of GDP in 1980[5].

The 1980s saw a change in the political directorate and consequently a new economic programme. This programme was supported by a substantial increase in foreign borrowing which was facilitated by the new IMF agreement. Needless to say, this impacted on the growth of the debt and its servicing. The public debt grew by approximately 93 per cent between 1980 and 1985 and the debt service ratio on an accrual basis (i.e. without refinancing) rise to 61 per cent from 24 per cent of goods and services in 1980[6]. This reflected accelerated borrowing as well as well as reduction in export earnings.

The structure of Jamaica's external debt in terms of categories of institutions to whom it is owed, shows the following breakdown for 1980, 1985, 1986 and 1987:

TABLE 1

CREDITORS BY INSTITUTIONAL CATEGORY

(1980, 1985, 1986, 1987)

US$ Million

	DEBTS OUTSTANDING							
	1980	%	1985	%	1986	%	1987	%
1. Commercial Banks	440	25	393	12	389	11	400	11
2. Official (Bilat.)	420	27	1417	42	1634	45	1800	51
3. Official (Multi.)	620	36	1313	39	1498	42	1300	37
4. Others	204	12	232	7	56	2	-	1
Total	1684 1734	100	3355	100	3577	100	3500	100

Source: Bank of Jamaica

At the end of 1985, Jamaica's stock of official debt stood at US$3.4 billion. Commercial banks accounted for 12 per cent of the total debt, bilateral loans 42 per cent, multilateral 39 per cent and other loans (suppliers credit, market loans) accounted for 7 per cent. This contrasted with the 1980 position when the bulk of the loans were from multilateral institutions (36 per cent) followed by bilateral lending (27 per cent) commercial banks (25 per cent) and other loans (12 per cent).

The stock of Jamaica's debt at the end of March 1987 amounted to US$3.5 billion or 133 per cent of GDP. Debt owed to multilateral institutions amounted to US$1.3 billion or 37 per cent of the total stock of debt and roughly 50 per cent of GDP. That owed to bilateral creditors amounted to US$1.8 billion or 51 per cent of the total stock of debt and to Commercial Banks, outstanding debts amounted to US$0.4 billion or 11 per cent of total debt outstanding. It is important to note that multilateral institutions (IMF, IBRD, IADB, etc.) do not reschedule or refinance their loans. This policy stance arises from charter obligations intended to help the institutions to build and maintain impeccable reputations in financial markets. From the point of view of debtor countries, the implication is that countries such as Jamaica which are significantly indebted to the multilateral agencies face a constraint in terms of the level of debt relief which can be obtained.

During 1980, the Government embarked on a Structural Adjustment Programme to reduce Jamaica's dependence on bauxite and alumina as the main foreign exchange and revenue earners. Emphasis has been placed on non-traditional exports and tourism to fill this foreign exchange gap. The recession which had significantly altered the demand for those two products led to a serious shortage of foreign exchange. As a consequence, it became necessary for Jamaica to try and ease its debt burden through rescheduling of bilateral and commercial bank loans. See Table 2 below:

Table 2

Rescheduled Debts 1981-1986

US$mn.

	Commercial Banks	Bilateral Agencies	Total
1981	40.1	95.7	135.8
1982	42.2	104.7	146.9
1983	58.8	142.7	201.5
1984	87.9	243.8	331.7
1985	95.6	185.0	280.6
1986	92.0	171.1	263.1

Source: Bank of Jamaica

In March of 1987, Jamaica was successful in securing the rescheduling of US$125 million of official debt on improved terms with the Paris Club. Compared to terms of 100 per cent of principal and 50 per cent of interest in previous reschedulings, Jamaica was able to negotiate for the rescheduling of 100 per cent of principal and 85 per cent of interest. More favourable results were obtained in respect of principal maturities when some US$375 million of Commercial Bank debt was rescheduled on terms comparable to those under the Paris Club Agreement. This resulted in the reduction of the debt service ratio on an accrual basis from 67 per cent to 39 per cent for fiscal year 1987/88.

As debt rescheduling provides only a breathing space in the form of short-term cash relief, it became necessary to look for a longer term solution. It was in light of this that debt conversion schemes were examined with a view to reduce the external stock of debt and debt service requirements as well as to provide inflows of new resources for investment.

The increased level of investment as a result of a debt conversion scheme is expected to be reflected over time in an improved current account balance, since the level of export earnings should increase. From a macro-economic perspective, benefits should be obtained in other areas as well. Using new foreign investment to supplement the level of domestic savings will increase the capital base of the economy. The growth of foreign exchange inflow should be accelerated as a result of investment being channelled into priority areas. This investment should also result in an increase in the productive capacity of the economy and in the generation of employment. Since debt conversion attracts new capital, a self-reinforcing cycle of investors' confidence is expected.

The ability of debt conversion to reduce debt service payments could alter both the magnitude and direction of the current account position. In fiscal year 1986/87, net interest payments amounted to US$305 million, compared to US$306 million in fiscal year 1985/86[7]. If such payments of interest could have been reduced, the current account position would have been significantly different and would have reflected a sizeable increase over the past two years, averaging US$150 million.

There has been recent improvements in the current account from a deficit of US$259.5 million or 11.7 per cent of GDP in fiscal year 1985/86 to a deficit of US$101.8 million or 3.9 per cent of GDP in fiscal year 1986/87. These improvements reflect both the substantial reduction in the merchandise trade deficit and the effects of the strong performance of the tourist sector on the services account. These gains, however, are offset by the growth in net capital outflows.

Debt conversions can impact positively on the current account position. The initial effect on the current account of a debt conversion is the reduction in interest payments as a result of the cancellation of the debt. Outflows through payments of dividends and remittances of profit would not be reflected immediately in the current account as regulations restrict repatriation of funds in the short-term.

SECTION 4

JAMAICA'S EXPERIENCE IN DEBT CAPITALIZATION

Jamaica, faced with a Commercial Bank debt of US$400 million, decided to use debt conversion as an additional debt management tool. The debt for equity option was chosen because it is deemed to be the most suitable one for Jamaica at this time.

In July of 1987, a five-year debt capitalization programme was launched in Jamaica. This programme, a first of its kind in the English-speaking Caribbean, is being managed by the Debt Capitalization Unit of the Bank of Jamaica, with assistance in the initial stages from a consulting firm, N.M. Rothschild. The programme offers an attractive source of funds for investments in two specifically targeted sectors, tourism and export manufacturing. Project approvals will be allowed on a case-by-case basis and will follow existing foreign investment guidelines (which encourage joint ventures) with a few restrictions on participating in specific sectors.

The programme aims at converting US$200 million, approximately one-half of the country's foreign Commercial Bank debt, over the next five years. Thus, while the country's foreign debt is being reduced, investment will also be stimulated. Priority areas of economic activity as designated by the Bank of Jamaica are:

1. The construction of hotels in Jamaica.
2. The production, manufacturing or processing of exports. Preference will be given to those

products involving the greatest addition of value in Jamaica itself.

3. Investment in activities in Jamaica's Free Zone.

4. Other activities generating employment in Jamaica.

The debt-swap programme is designed to operate in the following way. Firstly, the foreign investor must seek from the Jamaican authority approval status for investment projects. On obtaining this, the foreign debt is purchased at a discount from the Commercial Banks. The debt certificate is then presented to the Bank of Jamaica which issue local currency to purchase the investment. This is illustrated in the following chart.

MECHANICS OF DEBT CONVERSION*

(Simplified Hypothetical example using
a discount rate of 40%)

1

An investor buys Jamaican government debt from a Commercial Bank at a discount. The investor pays US$12 million for a debt with a US$20 million face value.

2

The investor presents the debt certificate to the Bank of Jamaica.

3

As agent of the Jamaican Government, the Bank of Jamaica issues local currency of (US$16 million, i.e. US$20 million less US$4 million in fees) J$88 million (i.e close to face value: US$16 million x J$5.50.

4

The investor then takes J$88 million and invests it directly in Jamaica.

*For a detailed mechanism see Appendix 1.

The programme is seen primarily as an investment instrument rather than a debt retirement mechanism and as such it is made as attractive as possible to investors. Although there is a required three-year holding period on dividend remittances and three to seven-year period for capital repatriation, this time is considerably shorter when compared to the programmes of other countries. Currently nationals are not allowed to participate in the programme. This is mainly due to the repercussions this can have on the economy as evidenced in other countries, for example, "roundtripping" in Chile.

An important factor in the debt equity programme is the concept of "additionality". This is the ability of debt-equity swaps to attract foreign equity investment that would not otherwise come into the country. The benefits to be derived from debt capitalization depend to a large extent on the degree of additionality. If, for example, a foreign multinational has already decided to invest a specific sum directly in Jamaica, and the Jamaican government then introduced a conversion scheme allowing that amount of investment to take place through a debt-equity swap, there would be no additionality. In contrast, if the multinational previously had no intention to invest, but the chance to invest through a swap change that decision, then the investment in the country would embody additionality.

Some concerns have been expressed about the appropriateness of introducing a debt-equity swap programme in Jamaica at this time. The Prime Minister in announcing the programme voiced the reality of the monetary implications which may result from the redemption of debt certificates. As a result of this, measures have been implemented to neutralize the effects. Since investment will be mainly in new areas, local currency to the investor will be apportioned according to the developmental needs of the project. Therefore the money supply will not be increased suddenly as result of a lump sum addition at any one time. This 'staggering' of local currency will be made known to the investor and agreed upon before the start of the programme.

The second concern is the likely pressures that the debt conversion scheme could have on the foreign exchange market. As the scheme is devised, the foreign investor is required to fund the foreign currency component of the investment with freely convertible foreign exchange or its equivalent in tangible assets. Jamaican dollars received from a debt conversion transaction may only be utilized to meet genuine local currency costs, and the investor will be prohibited from using the proceeds to enter the foreign exchange auction. Further restrictions on remittances of dividends and profits will also limit the outflow of foreign exchange.

Another concern in respect of the debt conversion programme is the effect on the pattern of ownership of domestic assets. A condition of the programme is that investments will only be in new areas beneficial to the economy. This will result in local expenditure and create employment, both in the development/ construction stage and later in the long-term productive stage.

The first transaction under the debt conversion programme has been approved. It involves Hanes Printables Incorporated of the U.S.A., which applied to fund construction of a factory in Hanover to do 807 assembly of men's women's and children's T-shirts for export to the U.S. The total value of the project is US$3 million (J$16.5 million), of which US$1.5 million (J$8.25 million) has been approved for funding by way of debt conversion with the balance being met from the introduction of foreign exchange or equivalent imports.

To date seven applications concerning debt for equity projects have been received but not yet finalized. It is anticipated that processing will be much quicker after the initial teething pains have been ironed out.

SECTION 5

CONCLUSION

"The debt conversion programme is designed to achieve principally the following policy objectives:

1. to stimulate and encourage equity investments in Jamaican enterprises by foreign investors,
2. to promote and target new investment into areas of high priority,
3. to reduce the external debt burden of Jamaica"[9].

This debt management tool undertaken by the Jamaican authorities is intended to realise the conversion of US$200 million in the next five years. Jamaica's debt problem will not be solved by copying corrective measures being used in other developing countries, because each country is unique and has its own unique solutions. However, Jamaica can learn from the the experiences of other countries and where applicable modify and adopt their solutions. The structure of Jamaica's debt is such that the bulk of the debt is owed to multilateral lending agencies and as such are not eligible for a debt swap arrangements, although current discussions have been centred around the fact that "the multinational banks should join with wealthy countries and Commercial Banks in creating a new lending programme that would enable middle income nations to grow out their indebtedness"[10].

Jamaica has successfully converted US$1.5 million of its debt so far. Nevertheless, it is hoped that this first project is not indicative of the type of projects Jamaica will attract in the future. Screwdriver type industries have a number of merits, for example, they increase the level of employment and can be a source of valuable foreign exchange earnings. On the other hand, there is no real technological development for the country, since projects of this nature do not require a high level of skills. Countries like Jamaica in their use of debt conversion need investment that will require the importation of highly developed technology and not just "cut, trim and stitch" projects which are already coming in through other investment channels.

Jamaica's debt management programme is targeted at new investments, and it is hoped that some amount of additionality will be obtained and foreign investors will not be taking advantage of capitalization to make investments they had already planned at the cheaper rate.

Debt conversion has been used as a tool for international debt management from as early as 1982, but when the amount of debt converted is compared to the stock of debt in each country, the figure is indeed minimal. Jamaica with a loan portfolio of US$400 million from the Commercial Banks has converted US$1.5 million of the projected US$200 million to be converted over five years.

The extent to which this programme can be successfully achieved will again depend on the market for Jamaica's debt. This is especially crucial since a survey of 109 nations done by Institutional Investors shows that Jamaica's credit rating has fallen. In September 1987, Jamaica was put in the 88th position with a rating of 14.5. This is two places below the position the country occupied in March 1987. This would mean a larger discount requirement on the part of the potential investor and could have implication for the marketability of the debt.

The success of the programme will also depend on the continuous monitoring which will be needed to ensure that the types of investments coming in will provide additionality as well as a reduction in the stock of debt. In addition, it is important for investments to be channelled into export-oriented industries. The authorities will need to have a vibrant marketing strategy, whereby applications are processed and expedited in the shortest time possible and everything is done to encourage the investor. The priorities given to these factors outlined above will determine the degree to which debt conversion may be used as an effective debt management tool.

APPENDIX 1

SUMMARY OF APPROVAL MECHANISM UNDER DEBT CONVERSION PROGRAMME

1. Investor submits investment profile to Jamaica National Investment Promotions Limited (JNIP).
2. Investor submits copy of investment profile and application for approval.
3. Debt capitalization Unit will liaise with JNIP and Exchange Control Department regarding the merits of the investment in particular its potential for export earnings and employment generation and its compatibility with Government's economic programme.
4. Debt Capitalization Unit will, based on three (3) above determine the portion of the Jamaica dollar costs which should be allowed for funding by way of debt conversion.
5. Thereafter approval will be issued to the investor stipulating the amount of:
   (a) the investment which will be funded by debt conversion;
   (b) the amount of fresh money to be injected;
   (c) Government's fee for the transaction.

   Restrictions applicable to the investment will also be set out in the approval.
6. On receipt of the approval the investor will formalize his arrangements for purchasing debt from the creditor banks and in accordance with Bank of Jamaica will determine a value date for

cancellation of the debt and issuance of local assets to the investor.

7. The investor and the recipient entity/company will sign an Exchange Agreement with Bank of Jamaica (acting on behalf of the Government of Jamaica).

8. On the agreed value date, Bank of Jamaica will issue a debt instrument to the recipient entity/company in exchange for issuance of shares from the recipient entity/company to the investor.

9. The recipient entity/company discounts the Jamaica dollar denominated debt instrument for face value with a private financial institution designated by Bank of Jamaica.

10. Investor and recipient entity/company submits post closing notification to the Debt Capitalization Unit.

11. The Exchange Control Department will issue Approved Status for the investment and this will be forwarded to the investor by the Debt Capitalization Unit.

12. The recipient entity/company must report semi-annually to the Debt Capitalization Unit on the use of Jamaica dollar proceeds of the debt conversion transaction. In addition, the investor and the recipient entity/company must make annual reports on declaration of dividends etc. supported by audited financial statements.

DEBT CAPITALIZATION UNIT

FOOTNOTES

1. See Debt Swaps: A Technique in Developing Country Finance.
2. See Chile's Pioneering role in the Debt/Equity Swaps Market edited by Francisco Gares Garrido.
3. Statistics Computed by the External Debt Management Department, Bank of Jamaica.
4. Ibid.
5. Ibid.
6. Ibid.
7. See Jamaica's Balance of Payments Reports for these years.
8. Ibid.
9. See Programme for the Conversion of Jamaica External Debt into Equity Investment, Bank of Jamaica.
10. See the proposal by the Prime Minister of Jamaica, Edward Seaga, to the World Bank and the I.M.F., October 1987.

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