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The Feasibility of Debt-Equity Swaps in Russia

Thomas M. Reiter

University of Michigan Law School

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STUDENT NOTES

THE FEASIBILITY OF DEBT-EQUITY SWAPS IN RUSSIA

*Thomas M. Reiter**

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* Georgetown University, B.S.F.S. (1987); University of Michigan Law School, J.D. (1994).

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INTRODUCTION

In recent years, dramatic political and economic events in Russia have focused the world's attention on Russia's desperate need for foreign investment. The tremendous economic dislocations caused by the precipitous decline in Russia's trade with Eastern Europe and the dismantling of Russia's command economy have led to the near collapse of the Russian economy. Meanwhile, domestic and foreign investors hesitate to commit vital investment capital to Russia until fundamental legal and political issues have been resolved. Official bilateral and multilateral aid programs promote foreign investment in Russia, but most such programs have limited resources and have concentrated only on promising sectors such as oil and gas. Ultimately, only private investors will be capable of unleashing Russia's vast economic potential.

The injection of significant amounts of private capital into Russia is complicated by Russia's massive debt overhang. The Soviet Union's impeccable debt service record did not survive the Soviet Union itself, and Russia has fallen into arrears on principal and interest payments to commercial and official creditors alike. The Paris Club of official creditors and the London Club of commercial creditors have recently completed rescheduling agreements to ease Russia's debt service requirements. Despite the reschedulings, many Western commercial banks balk at financing any but the most lucrative investment opportunities, even with official guarantees. Financing a project in Russia that does not generate hard currency receipts is virtually impossible.

The debt-equity swap may provide a partial solution. Developed in the mid-1980s as a response to the Latin American debt crisis, a debt-equity swap is a process in which public or private debt of a developing country borrower is converted into equity in an enterprise in the debtor country. A debt-equity swap should not be considered a single, homogeneous, set-piece transaction, but rather a series of transactions that result in the cancellation of a debtor country's foreign debt in return for equity in the debtor country's enterprises. Each debt-equity swap program is unique, as they must be tailored to the goals and circumstances of the particular debtor country. Numerous variations on the debt-equity swap concept have also been developed.¹

This Note examines the origins, development, and mechanics of debt-equity swap programs in Latin America before discussing the various goals and policy considerations involved in formulating debt-equity swap programs. Next, the Note describes Russia's debt situation and sketches the outlines of a debt-equity swap program that will reduce Russia's foreign debt while stimulating foreign direct investment.

I. THE DEBT CRISIS AND THE DEVELOPMENT OF THE DEBT-EQUITY SWAP²

A. *The Debt Crisis*

In August, 1982, Mexico inaugurated the developing country debt

1. These include debt-for-nature, debt-for-development, debt-for-education, debt-for-trade, etc.

2. For works providing good information on this topic as a whole, see generally 1 THE WORLD BANK, WORLD DEBT TABLES 1992-1993: EXTERNAL FINANCE FOR DEVELOPING COUNTRIES (1992) [hereinafter WORLD DEBT TABLES]; UNCERTAIN FUTURE: COMMERCIAL BANKS AND THE THIRD WORLD (Richard E. Feinberg & Valeriana Kallab eds., 1984) [hereinafter UNCERTAIN FUTURE]; Peider Kőnz, *The Third World Debt Crisis*, 12 HASTINGS INT'L & COMP. L. REV. 527 (1989).

crisis by declaring a moratorium on external debt servicing.³ For the rest of the decade, developing countries around the world struggled to service their external debt to commercial banks and official creditors. Investment levels and economic growth stagnated as flows of private capital into developing countries virtually ceased. Some developing countries are now regaining access to international capital markets, perhaps signalling an end to the worst of the debt crisis.⁴ Nonetheless, the debt crisis had ruinous economic effects on the developing world and sparked vigorous debate on the best methods of managing the developing world's debt problems.

The roots of the debt crisis lie in the oil price shocks of 1973–1974.⁵ Commercial banks sought productive outlets for the glut of “petrodollars” deposited by newly rich, oil-exporting countries.⁶ This increase in international liquidity and a simultaneous economic recession in the developed world led to unusually low or even negative real interest rates, which made external borrowing an attractive and inexpensive means for developing countries to obtain necessary financing to cover the increased cost of oil and other imports without submitting to the extensive conditions required by multilateral development banks.⁷ Rising commodity prices and export volumes seemed to offer developing countries a means of repaying the external loans.⁸ Under these conditions, the heavy borrowing levels seemed sustainable, and commercial banks began competing among themselves to offer the most attractive terms to developing country borrowers.⁹

3. WORLD DEBT TABLES, *supra* note 2, at 41.

4. *Id.*

5. *Id.*

6. *Id.*; see Richard E. Feinberg, *Restoring Confidence in International Credit Markets, in UNCERTAIN FUTURE*, *supra* note 2, at 3, 6.

7. See Feinberg, *supra* note 6, at 6–7.

8. WORLD DEBT TABLES, *supra* note 2, at 42.

9. *Id.* at 41–42. External debt of developing countries increased from less than \$100 billion in 1972 to over \$500 billion by 1981. (Developing country debt to commercial banks grew from \$4 billion in 1970 to \$127 billion in 1980. *The Brady Initiative*, WORLD BANK INFO BRIEFS (The World Bank, Wash., D.C.), #C.02.8-92.). Although this six-fold increase now seems imprudent, at the time it seemed sustainable. Developing countries' export prices increased by 70% in the 1970s, resulting in debt-to-export ratios that increased only from 150% in 1970 to 175% in 1980. Moreover, the debtors' rate of economic growth exceeded the real interest rate of their debt, allowing them to borrow more without increasing their relative debt burden. See *New Ways to Grow: A Survey of Third World Finance*, ECONOMIST, Sept. 25, 1993, at 64, survey at 8 [hereinafter *Survey: Third World Finance*]. By 1981, however, the six-fold increase in debt greatly exceeded the doubling of Gross Domestic Products (GDPs) and export volumes. WORLD DEBT TABLES, *supra* note 2, at 41. Debt-to-export ratios continued to increase, reaching 250% by 1981, and climbing to 350% before peaking in 1985, when rescheduling and declining interest rates reduced the region's debt-export ratios to 40% by the end of the year. Bank for International Settlements, *Recent Developments in the External Pay-*

Such favorable borrowing conditions did not last, however, and by the end of the 1970s rising real interest rates¹⁰ and falling commodity prices and export volumes¹¹ had forced several countries to reschedule their external debt.¹² Nevertheless, commercial banks continued to increase lending to developing countries, offering them lower margins and longer maturities.¹³ One unsympathetic observer called the result a history of "stupid loans by stupid bankers to stupid countries."¹⁴

Eventually, however, the developing countries' debt servicing problems and alarming international economic indicators prompted commercial banks to downgrade their credit ratings and virtually shut off new lending to developing countries.¹⁵ Banks regarded the debt servicing arrears as a solvency crisis, not as a temporary liquidity crisis for developing countries caused by global recession, a sharp drop in export earnings, and rising real interest rates. The developing countries were viewed as incapable of repaying their outstanding debt, and commercial banks scrambled to reduce their exposure. Developing countries' lack of access to new loans deprived them of their chief means of servicing outstanding debt, thus precipitating the debt crisis. In August 1982, Mexico declared its moratorium on debt repayment. Within two years, commercial banks were negotiating with more than thirty countries that had fallen into arrears on debts amounting to half of all developing country debt.¹⁶

The massive capital outflows to service outstanding debt and the loss of new financing and investment had devastating effects on developing country economies. The 1980s have been called "a lost decade for development,"¹⁷ as the lack of access to international capital markets throttled economic growth and reduced standards of living in many

ments and Financing of Selected Latin American Countries, INT'L BANKING & FIN. MARKET DEVELOPMENTS, Nov. 1992, at 16, 16-18.

10. The developed countries tightened their monetary policies after the second oil shock in 1979-80, causing world-wide long-term rates to increase by three percent between 1979 and 1982, with even greater increases in short term rates. WORLD DEBT TABLES, *supra*, note 2, at 44. Rising interest rates caused interest payments to consume increasing proportions of new borrowing, reaching one-third of new disbursements by 1981. *Id.* at 45.

11. Export volumes dropped by 4.2% between 1979-80 and 1981-82. *Id.* at 45.

12. In 1976, Zaire, Argentina, and Peru began renegotiating their debt; in 1979, they were joined by Gabon, Sierra Leone, Sudan, Togo, Turkey, and Jamaica. *Id.* at 44.

13. Half of precrisis commercial lending to developing countries arose in the last three years before the onset of the debt crises in 1982. *Id.*

14. Feinberg, *supra* note 6, at 6 (quoting unnamed banker).

15. In 1980-81, \$38 billion in long-term capital flowed into the region annually, while the cumulative total for the next four years was only \$20 billion. Annual levels of capital inflows declined even further in the late 1980s. Massive increases in capital flight exacerbated the problem. Bank for International Settlements, *supra* note 9, at 18.

16. WORLD DEBT TABLES, *supra* note 2, at 46.

17. *Id.*

heavily indebted countries (HICs).¹⁸ Ill-advised domestic economic policies often exacerbated the problems brought on by the debt crisis.¹⁹ Unstable economic conditions induced many local nationals to take their money abroad, and levels of capital flight reached perhaps two-thirds of external debt stock by 1990.²⁰ Disgruntled debtor country citizens demanded a reduction or an end to debt servicing, but their governments feared the consequences of default.

B. Dealing with the Debt Crisis

The possibility of widespread defaults on developing country loans threatened the international banking system itself. Exposed lenders soon sought official help in dealing with the debt crisis.²¹ Initial attempts to resolve the debt crisis involved granting debtor countries short-term liquidity relief by refinancing interest payments as they came due. This limited relief proved inadequate, however, and more substantial debt-relief mechanisms evolved.

The Baker Plan was the first major debt-relief initiative. Launched in 1985, the Baker Plan sought to stimulate new bank lending to developing countries by promoting macroeconomic policy changes such as trade liberalization, privatization, and increased foreign investment.²² Although the Baker Plan met with limited success, it failed to reduce significantly outstanding debt or to attract new commercial bank lending.

Debtor countries' inability to attract new loans led to the introduction of various market-based debt relief programs, including debt buy-backs,²³ debt-for-debt swaps,²⁴ and debt-equity swaps. In 1987-1988, a menu

18. Lack of foreign capital forced many HICs to slash imports and public spending. For instance, middle-income HICs saw import volumes drop by 15% and investment rates by 20% between 1982 and 1985. *Id.* In seventeen middle-income HIC's between 1980 and 1987, investment and imports fell more than five percent per year, while per capita consumption fell almost two percent a year. THE WORLD BANK/ INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT, WORLD DEVELOPMENT REPORT 1988, at 30 (1988) [hereinafter, WORLD BANK REPORT 1988]. Declining consumption levels had an immediate economic impact on the living standards of local nationals, while the lack of investment reduced prospects for future growth.

19. In addition, many developing countries were forced to assume local private sector debts to appease international creditors or to relieve financially-strapped domestic private firms, thus adding to fiscal pressures. WORLD DEBT TABLES, *supra* note 2, at 47.

20. *Id.* at 49. Between 1976 and 1984, estimates put capital flight from Latin America at levels roughly equal to its increase in external debt. *Survey: Third World Finance, supra* note 9, at 8.

21. WORLD DEBT TABLES, *supra* note 2, at 49-51.

22. *Id.* at 51; *A Glossary of Debt Terms*, WORLD BANK INFO. BRIEFS (The World Bank, Wash., D.C.), #C.03.8-92; *The Brady Initiative, supra* note 9.

23. A debtor country buying back its own debt at a discount.

24. Banks swap debt instruments denominated in foreign currencies for local currency obligations.

approach to debt reduction emerged, as Argentina, Brazil, and Mexico allowed individual commercial banks to choose debt reduction instruments that suited their preferences.²⁵

These measures also failed to resolve the debt issue, and in 1989, U.S. Secretary of the Treasury Brady proposed a more comprehensive solution that combined new roles for multilateral financial institutions with new money flows and outright debt relief.²⁶ The Brady Plan provided both debt reduction and liquidity relief to eligible debtor countries.²⁷ The Plan's two premises were that voluntary commercial bank lending would not resume until debt had been reduced to manageable levels, but, at the same time, that debt could not be reduced without new money flows. Under the Brady Plan, multilateral financial institutions provided necessary new financing for debtor countries and facilitated restructuring negotiations that allowed debtor countries to retire debt at a discount by offering commercial bank creditors a menu of market-based debt reduction schemes, including the conversion of foreign debt into debtor country government bonds or equity in local companies.²⁸ The Brady Plan thus created pools of liquid, homogeneous debt instruments which allowed bankers to disregard traditional country risk concerns. One banker explained that "[p]re-Brady debt still trades on a discounted basis . . . Post-Brady trades on yield."²⁹ The Brady Plan has been successful to a certain degree because it recognized that the outstanding debt was not worth its face value, provided cash flow relief to debtor countries and security to creditor banks, and encouraged debtor countries to improve investment regimes to attract foreign and flight capital.³⁰

By the end of 1992, Costa Rica, Mexico, the Philippines, Uruguay, Venezuela, and Nigeria had negotiated Brady Plan debt reductions. When tentative agreements with Argentina and Brazil are finalized, the Brady Plan will have succeeded in restructuring about half of all outstanding

25. WORLD DEBT TABLES, *supra* note 2, at 52.

26. Könz, *supra* note 2, at 535. Brady Plan programs often involve the forgiveness of between 25% and 50% of debt. Francesca Carnevale, *Banking on a Future in Debt*, TRADE FIN., Feb. 1992, at 28, 31.

27. To qualify for participation in the Brady Plan, a debtor country needed a major problem with debt overhang, a program of progressive economic reforms, and prospects for strong economic growth. *The Brady Initiative*, *supra* note 9.

28. The menu approach is desirable because different tax and regulatory regimes in creditor bank countries require different approaches to writing off bad debt. Menu options typically include new money bonds, par and discount bonds, debt buy-backs, temporary interest rate reduction bonds, debt-equity conversion privileges, recapture clauses based on commodity prices or GDP, and bonds with phased enhancements. WORLD DEBT TABLES, *supra* note 2, at 52.

29. Carnevale, *supra* note 26, at 30.

30. David C. Mulford, *The Americas: Moving Beyond the Latin Debt Crisis*, WALL ST. J., Aug. 21, 1992, at A7.

developing country commercial bank debt.³¹ The introduction of various debt reduction policies has allowed debtor countries to reduce their exposure by more than \$60 billion from 1986 through 1991, as compared to \$1 billion in 1984 through 1985.³²

While the Brady Plan proved quite successful in dealing with the problems of those countries indebted to commercial banks, many low-income HICs never had access to commercial lenders and owed debt primarily to official creditors.³³ Official lending to these countries on concessional terms continued unabated until the late 1980s, when their faltering command economies and plunging export receipts forced many of them into arrears. Relief attempts have taken the form of new financing, debt forgiveness, and debt rescheduling. Since 1989, when debt levels were recognized as unsustainable, \$10.9 billion in official development assistance debt to low-income HICs has been cancelled.³⁴ Most negotiations with official creditors have been conducted under the auspices of the so-called Paris Club.

The Paris Club is the name given to ad hoc meetings of creditor governments that arrange for the renegotiation of debt owed to or guaranteed by official creditors.³⁵ Although neither the International Bank for Reconstruction and Development (World Bank) nor the International Monetary Fund (IMF) belong to the Paris Club, the IMF plays an important role in debt rescheduling negotiations because neither official creditors nor commercial banks will reschedule debt unless the debtor country has instituted an IMF-approved economic stabilization program.³⁶ Established in 1956, the Paris Club was not very active until the late-1970s, when oil-importing countries requested rescheduling. Originally, Paris Club reschedulings were intended as a means of allowing debtor countries to avoid "imminent default"³⁷ by providing short-term liquidity relief for long-term debt. The onset of the debt crisis in 1982 required a new approach, however, and the Paris Club responded with new terms³⁸

31. WORLD DEBT TABLES, *supra* note 2, at 55. By the end of 1992, only Columbia and Peru had not rescheduled their foreign debt. Bank for International Settlements, *supra* note 9, at 23.

32. Bank for International Settlements, *supra* note 9, at 23.

33. See WORLD DEBT TABLES, *supra* note 2, at 56.

34. *Id.* at 57.

35. The Paris Club has no charter, bylaws, or permanent membership, and relies heavily on precedent and consensus during debt negotiations. *Id.* at 73.

36. *A Glossary of Debt Terms*, *supra* note 22, at 1.

37. WORLD DEBT TABLES, *supra* note 2, at 57.

38. See *id.* at 57. The Paris Club introduced the Toronto terms in 1988. Originally intended only for a few low-income African nations, the Toronto terms had been granted to 20 developing countries by September 30, 1991. The Houston terms followed in September 1990, with enhanced Toronto terms established in December 1991. See *id.* at 76-79.

that have resulted in major changes to Paris Club agreements.³⁹ In early 1991, the Paris Club designated Poland and Egypt as "exceptional cases" and rescheduled all of their foreign debt on highly concessional terms that amounted to a fifty percent reduction in the real value of the debt.⁴⁰

The Paris Club now also includes provisions allowing for various debt swaps, including debt-equity swaps.⁴¹ These provisions are voluntary in that they are to be accepted and elaborated upon in bilateral agreements. There is no cap on the amount of intergovernmental or official development assistance (ODA) loans that can be converted via swaps, but the Paris Club imposed a swap ceiling of ten percent on each creditor country's outstanding non-ODA debt to preserve equal treatment of creditors.⁴²

In 1990, the United States announced a unilateral approach to reducing debt owed to the U.S. government by Latin American and Caribbean countries. The "Enterprise for the Americas Initiative" (EAI)⁴³ was meant to promote economic growth by encouraging trade, investment, and debt reduction in Latin American and Caribbean countries which had implemented economic stabilization programs and restructured their commercial debt.⁴⁴ The EAI allowed the U.S. president to forgive portions of certain official debt in return for new obligations from the debtor country to repay the remaining principal in dollars and to pay interest in local currency into a fund established to support conservation and development projects in the debtor country.⁴⁵ The president was also authorized to sell or cancel debt to facilitate debt-for-nature or debt-for-equity exchanges.⁴⁶

Attempts to resolve the debt crisis have not been limited to debt restructuring and rescheduling initiatives; extensive efforts have also been made to increase the debtor countries' ability to pay by promoting sound economic policies. Before providing new loans or agreeing to reschedule, commercial banks and official creditors generally require developing countries to comply with IMF-mandated austerity programs. In many debtor countries, problems imposed by high debt service payments were exacerbated by large budget deficits, foreign exchange and trade controls,

39. For example, extended (20 to 25 year) maturities, flexible amortization schedules, and outright debt forgiveness are now allowed in some circumstances. *Id.* at 77-78.

40. *Id.* at 77.

41. *Id.* at 79.

42. *Id.*

43. 22 U.S.C.A. §§ 2430-2430h (West Supp. 1993)

44. See J. Eugene Gibson & William J. Schrenk, *The Enterprise for the Americas Initiative: A Second Generation of Debt-for-Nature Exchanges*, 25 GEO. WASH. J. INT'L L. & ECON. 1, 16 (1992).

45. See *id.* at 17.

46. *Id.* at 17-18; 7 U.S.C. § 1738p (Supp. IV. 1992).

price controls on basic commodities, and government-directed investment or subsidies into unproductive sectors of the economy. Deficit-fuelled inflation⁴⁷ and pervasive government intervention in the economy place artificial constraints on economic growth. The IMF's solution is to slash government spending and intervention in the economy to spur greater efficiency by reliance on the free market.

The IMF austerity measures often have short-term deleterious effects on debtor country living standards, and are often the subject of bitter complaints by citizens of the debtor country. The World Bank notes that "[l]ower living standards are unavoidable when the previous level has been artificially raised by unsustainable policies."⁴⁸ Critics, however, charge that some aspects of the austerity programs prolong economic recession instead of promoting growth.⁴⁹

Recently, renewed investment flows and access to international capital markets since 1989 have led some to declare the end of the debt crisis.⁵⁰ The controversial economic reforms instituted since the mid 1980s have in fact produced encouraging signs of economic growth.⁵¹ Smaller debt service payments have made available additional resources for productive investment, and new financial resources have enabled debtor countries to reduce inflation by slashing deficit spending.

Latin American debtor countries are farthest along the road to recovery. Most new financing in Latin America is in the form of bond and equity flows. Blue-chip Latin American companies are issuing bonds on international capital markets and stock markets in the region are

47. Inflation in middle-income HICs was six times higher in 1982-91 than in 1973-81, and twice as high as the average for other developing countries. World Debt Tables, *supra* note 2, at 47-49.

48. WORLD BANK REPORT 1988, *supra* note 18, at 60.

49. Neva Seidman Makgetla, *External Influences on Third World Debt*, 12 HASTINGS INT'L & COMP. L. REV. 591, 610-11 (1989).

50. In 1991, the total flow of long-term capital to the developing world was \$205 billion, compared with \$157 billion in 1981. Of the 1991 total, only 17% represented commercial bank lending, which accounted for about half of predebt crisis capital flows. Bonds, equities, and foreign direct investment accounted for 25% of capital inflows in 1991, compared to less than 10% in 1981. Bonds and equity flows increased from \$20 billion in 1991 to \$35 billion in 1992. *From Bank to Market: Capital Flows to the Third World*, ECONOMIST, Apr. 24, 1993, at 86.

51. The debt-to-exports ratio of middle-income countries has declined to pre-1981 levels. Inflation has fallen by two-thirds, and investment in the region reached \$40 billion in 1991, an eight-fold increase over 1989. Mulford, *supra* note 30, at A7; Nonguaranteed commercial bank debt to developing countries peaked in 1982 at \$89 billion, but fell to \$26.4 billion by 1986 as banks sought to exit the market and reschedulings "nationalized" large portions of developing country debt. UNITED NATIONS CENTRE ON TRANSNATIONAL CORPORATIONS, DEBT EQUITY CONVERSIONS — A GUIDE FOR DECISION-MAKERS 8 (1990) [hereinafter U.N. GUIDE].

booming.⁵² A good project in Mexico, Chile, or Venezuela can now be financed, unlike a few years ago.⁵³

There are three major differences between the developing countries' precrisis external financing and recent financing patterns. First, only certain developing countries have regained access to international financial markets. Second, bank loans now constitute a smaller share of external financing; and third, more of the capital is directed to the private sector rather than governments or state-owned enterprises.⁵⁴

Only those developing countries that have successfully tackled their debt servicing problems, and introduced economic reforms that promote economic stability and the private sector, have been successful in attracting new capital flows; the poorest countries have not yet regained access to international capital.

The composition of the capital flows has also changed, with foreign direct investment (FDI) and equity supplanting bank loans. In the past, developing countries often discouraged foreign direct investment because it was accompanied by the direct participation of foreign management. Now it is often encouraged for the same reason. Although worldwide FDI has declined in the past two years, it has actually increased in the developing world.⁵⁵

Investment in bonds, equities, and other securities has increased even faster, growing from less than \$10 billion in 1989 to \$37 billion in 1992. Portfolio investment has been a convenient vehicle for the return of flight capital. In addition, international finance is being channeled in greater amounts to the private sector, which can make more efficient use of the capital.⁵⁶

Despite these encouraging signs, it is still premature to say that the debt crisis is over. Many developing countries still face considerable difficulties in servicing their debt and attracting new capital.⁵⁷ Moreover,

52. The Buenos Aires stock market rose fourteen-fold in the first three weeks of August 1991, before dropping by one-half over a weekend. Thomas Kamm, *Latin America Escapes the Jaws of Debt; Region's Return to the Market Draws Flood of Foreign Capital*, WALL ST. J., Aug. 29, 1991, at A7. Foreign investment into Mexican stocks grew from \$4.2 billion in 1991 to \$27 billion in 1992. Anthony DePalma, *Fortunes are Cast in Mexican Stocks*, N.Y. TIMES, Apr. 12, 1993, at D1, D4. Between 1989 and 1992 gross flows of equity finance to Latin America expanded by more than tenfold, from \$434 million to \$5.6 billion. *From Bank to Market*, *supra* note 50, at 86.

53. Kamm, *supra* note 52, at A7.

54. *Survey: Third World Finance*, *supra* note 9, at 15.

55. Between 1989 and 1992, global FDI fell from \$234 billion to \$150 billion; in the same period, FDI in developing countries grew from \$29 billion to \$40 billion. In 1991, Mexico, China, Malaysia, Argentina, and Thailand accounted for about one-half of the total. In 1991, Malaysia received enough FDI to finance almost one-fifth of all domestic investment. *Id.* at 16.

56. *Id.* at 20.

57. By the end of 1991, the United Nations estimated service arrears for Latin America

a new debt crisis looms over Eastern Europe, where unstable political and economic conditions vastly complicate attempts to promote debt relief and foreign investment.

C. *Emergence of the Secondary Debt Market*

During the debt crisis, the inability of many developing countries to service their loans induced many creditors to remove the bad debt from their books by selling their public and private sector debt at a discount determined by the perceived risk of nonpayment under the terms of the loan. A secondary debt market soon emerged to facilitate the increasing volume of debt transactions.⁵⁸

The first transactions involved debt swaps at face value among banks that wished to align their debt portfolios with their risk assessments or regional expertise.⁵⁹ As the debt crisis continued, many regional banks decided to stop lending to developing countries altogether and to use the secondary market to dispose of the developing country debt that remained on their books.

As the debt crisis continued, four factors contributed to the development of a secondary market: (1) the growing willingness of banks to sell or swap their debt despite significant discounts; (2) the consolidation of debtor countries' debt into more homogeneous debt instruments; (3) a simplification of debt transfer procedures and the resultant decline in transaction costs; and (4) the introduction of debt conversion schemes in various countries.⁶⁰

Major international banks are the principal debt brokers in secondary market transactions. These banks have retained most of their debt, but earn lucrative commissions by arranging secondary market transactions for third parties. Most debt is still supplied by the regional banks, which have largely chosen to clear out their developing country portfolios. Debt transactions have taken many forms,⁶¹ but since the emergence of debt-equity swap programs in 1986, most of the demand comes from investors

and the Caribbean at \$25 billion. BUSINESS INTERNATIONAL CORPORATION, *THE DEBT-EQUITY SWAP HANDBOOK, Debt-Equity Swap Update (Nov. 1991)*, at 1 (1992)[hereinafter SWAP GUIDE]. Total foreign debt to that area was \$432 billion at end of 1990, expected to rise three percent with interest and new financing. *Id.*

58. The secondary market has no central exchange or regulation, and is composed primarily of a loose network of debt brokers.

59. E.g., European banks trading Latin American debt for the East European debt of a U.S. commercial bank. WORLD DEBT TABLES, *supra* note 2, at 109.

60. U.N. GUIDE, *supra* note 51, at 18.

61. Debt-equity swaps and debt capitalizations, debt securitization, debt buyback, debt-for-goods swaps, debt-for-nature swaps, and other informal conversion instruments. WORLD DEBT TABLES, *supra* note 2, at 109.

such as multinational corporations, banks, and investment funds, as well as developing countries purchasing their own debt at a discount.

Prices for debt on the secondary debt market vary widely according to the debtor country involved and the banks' perception of how likely they are to be repaid.⁶² Although a myriad of factors determine the secondary market price of a country's debt, the three chief factors are the debt-servicing status of the debtor country, the success of a country's debt-equity swap program, and the level of creditor banks' loss provisioning reserves.⁶³ Each country's debt usually consists of several different types of instruments, with different maturities, coupons, indentures, and rescheduling terms. "Stripped prices" must be utilized to convert the value of dissimilar debt instruments into a standardized debt instrument that can be compared to debt in other countries or with different characteristics.⁶⁴

The secondary market is very thin and rich in arbitrage possibilities.⁶⁵ Actual transaction prices often differ markedly from quoted prices, particularly for debt in low demand. The long-term trend for secondary market prices for developing country debt has been downward,⁶⁶ with the increased demand for developing country debt offset by the banks' greater willingness to offload their nonperforming developing country debt.

The sliding secondary market price of debt has been accompanied by

62. Representative prices are listed below as fractions of face value.

Country	April 1988	April 1989	April 1990
Argentina	29%	17-19%	12-13%
Brazil	51.5%	38-39%	24-25%
Chile	59%	57-59%	66-67%
Mexico	52%	42-43%	41-42%
Peru	8%	4-7%	5-7%

U.N. GUIDE, *supra* note 51, at 21; SWAP GUIDE, *supra* note 57, *Debt-Equity Swap Update* (Mar. 1992), at 3.

63. SWAP GUIDE, *supra* note 57, *Overview* at 6.

64. See WORLD DEBT TABLES, *supra* note 2, at 111.

65. Prices can rise by as much as one percentage point on the basis of a single swap as small as \$50-80 million. SWAP GUIDE, *supra* note 57, *Overview* at 5.

66. The accumulated value of developing country debt dropped from 66.7% of face value in January 1987, to 47.3% of face value in January 1988, to 37.6% of face value in April 1989. *Id.*

a huge surge in volume, which increased from only \$4 billion in 1985 to approximately \$100 billion in 1991.⁶⁷

D. *The Origins of the Debt-Equity Swap*

This rapid growth in secondary market transaction volumes was both a cause and effect of the adoption of debt-equity swap programs in various debtor countries. Debt-equity swaps increased the demand for secondary market debt by bringing multinational corporations to the secondary markets; meanwhile, a viable secondary market was necessary to fully develop debt-equity swap programs because it made it feasible to assemble packages of the requisite debt and eased tax and accounting concerns by allowing proper valuation of debt.⁶⁸

With a secondary market in place to facilitate debt transactions, debt-equity swaps became an increasingly attractive debt reduction mechanism, as they secured benefits for debtor countries, creditor banks, and international investors.⁶⁹ Debtor countries were able to reduce sovereign debt while stimulating investment flows that had been shut off by a lack of access to international financing. In debtor countries with privatization programs, debt-equity swaps could boost private sector interest in state-owned enterprises. The creditor banks could sell nonperforming debt for cash, albeit at a steep discount, and some banks stood to earn lucrative commissions for arranging swap transactions. Finally, by buying debt at a steep discount on the secondary market and redeeming it at face value in local currency, investors could realize substantial savings in financing investments in debtor countries.

1) The Players

In most debt-equity swap programs, there are five key participants: (1) debtor country authorities; (2) creditor banks; (3) foreign investors; (4) financial intermediaries (debt brokers); and (5) multilateral organizations.⁷⁰

Generally, debt-equity swap programs are devised by the debtor country's Ministry of Finance or Economy, and are administered through these ministries and the Central Bank, usually with the involvement of several other federal and state level ministries. To facilitate their debt-equity swap program, the Philippines established a special agency with

67. WORLD DEBT TABLES, *supra* note 2, at 110. Other sources estimate volume as increasing from \$10 billion in 1987 to \$200 billion in 1991. Mulford, *supra* note 30, at A7.

68. U.N. GUIDE, *supra* note 51, at 19-20.

69. *See id.* at 8.

70. *Id.* at 22-29.

representatives of all the ministries necessary to approve a proposed investment.⁷¹ Different countries establish different levels of regulatory supervision of their programs, although most programs grant debtor country officials some degree of "veto" power over unacceptable investment applications. Debtor country officials typically fine-tune their swap programs frequently, either in response to monetary pressures or in an effort to channel investment into priority sectors or regions. In many debtor countries, the debt-equity swap program is closely associated with one or two senior officials and would be vulnerable were they removed.

The major international commercial banks are also major players in debt-equity transactions. The syndication of developing country debt resulted in debtor countries having dozens, or even hundreds, of creditors, many with different strategic goals.⁷² Banks seek to align their debt portfolios according to their risks preferences or corporate objectives: Some banks want developing country debt off of their books regardless of the loss; others want to diversify their risks by holding debt of several different developing countries; yet others seek to consolidate their portfolios by converting all of their debt into that of the developing country that they consider most promising.

Regional banks have generally been most eager to sell their developing country debt on the secondary market so that they can recover some of their losses on nonperforming loans.⁷³ The international commercial banks generally held on to their developing country debt, but have started conducting debt-equity swaps on their own account now that they have amassed adequate loan-loss reserves.⁷⁴ Leading international banks such as Citicorp, Manufacturers Hanover, Chase Manhattan, J.P. Morgan, and Bankers Trust control steadily increasing percentages of developing country debt as smaller banks move out of the market.⁷⁵

The debt provided to the secondary market by the regional banks is purchased by various forms of foreign investors. Multinational corporations account for as much as ninety percent of debt-equity swap volume.⁷⁶ Multinational corporations like debt-equity swaps because it is often difficult for them to raise funds in local markets, and because the secondary market discount can save them between twenty-five percent and fifty-five percent

71. See Andrew Hilton, *Debt-equity Swaps*, C.T.C. REP., Autumn 1990, at 9.

72. Mexico is reported to have had at least 50 creditor banks in 1982; Brazil had 450. U.N. GUIDE, *supra* note 51, at 23.

73. *Id.* at 44.

74. SWAP GUIDE, *supra* note 57, *Overview* at 2.

75. U.N. GUIDE, *supra* note 51, at 25.

76. See SWAP GUIDE, *supra* note 57, *Overview* at 2.

of the cost of the investment.⁷⁷ Multinational corporations use debt-equity swaps to finance joint ventures and new projects or to expand existing operations. Privatization projects and investment into the tourism and automobile sectors have been popular swap targets.⁷⁸ Smaller first-time foreign investors have been increasing their participation as debt-equity swaps become more routine and the transaction costs fall. Investment funds have been a popular means of using debt-equity swaps to channel foreign equity investment into developing country capital markets.

Creditor banks participate in debt-equity swaps to a lesser extent than large corporations.⁷⁹ While most banks are wary of risky equity stakes in local enterprises, they have been more willing to use debt-equity swaps to increase their presence in the financial sector of debtor countries.⁸⁰

Although many of the leading commercial banks noted above have held on to most of their own debt, they have established debt trading teams to serve as "debt brokers" to handle debt-equity transactions on their own account and especially for third-party clients.⁸¹ International investment banks and small specialist firms have also emerged as financial intermediaries despite the lack of developing country debt on their own books. The debt trading teams of U.S. banks have played the largest role as debt brokers, but European banks also play a major role.⁸² Some debt-equity swap programs mandate the participation of local financial intermediaries in debt-equity transactions; regardless of formal requirements, many debt brokers have established close relations with local financial institutions through equity stakes or agreements.

The major function of debt brokers is to go to the secondary market to assemble the requisite package of debt for the intended investment. Financial intermediaries also typically perform services such as preparing the contracts, dealing with debtor country authorities, and submitting the necessary applications. Debt-equity swaps are very complex and fees by the financial intermediaries impose high transaction costs.

77. *See id.*

78. U.N. GUIDE, *supra* note 51, at 27.

79. SWAP GUIDE, *supra* note 57, *Overview* at 2.

80. U.N. GUIDE, *supra* note 51, at 27.

81. U.S. banking regulations create distinctions between banks trading their own debt and handling debt transactions for third-party clients. Banks fear participating in swaps on their own account because it could "contaminate" the remainder of their debt portfolio by forcing banks to mark the rest of the debt on their books down to the fair market value as determined in the transaction.

82. The Dutch bank *Nederlandische Middenstandbank* was probably the largest debt swapper in Latin America in the late-1980s. U.N. GUIDE, *supra* note 51, at 27.

Debt brokers are chosen largely on the basis of price,⁸³ although their banking relationship with the investor also plays a large role in the selection; debt-equity swaps are often conducted on the basis of "a phone call, a handshake and an understanding."⁸⁴ Financial intermediaries generally either charge a fixed fee for the debt with no additional charges, or require a percentage spread of the face value of the debt purchased. The fixed price option is more popular with investors because it allows more certainty in predicting costs. In addition to payments to debt brokers, fees must often be paid to central banks and agent banks.⁸⁵

Multilateral organizations are involved in debt-equity programs as analysts, advisors, and active investors. Organizations such as the IMF are interested primarily in analyzing the macroeconomic impact of debt-equity swaps on developing countries, while the World Bank has funded studies of swap programs and provided technical assistance for administering the programs. The International Finance Corporation (IFC), the private sector arm of the World Bank, has been an active participant in conventional swap transactions and has been especially active in setting up debt-equity swap investment funds, where the local currency obtained in the swaps is invested in local stock markets.⁸⁶ Most multinational organizations support the inclusion of debt-equity swaps on a "menu" of debt restructuring options.

The full-scale development of the secondary debt market and the endorsement of debt-equity swaps by multilateral institutions have been critical in the development of the debt-equity swap. Informal intracompany debt-equity swaps⁸⁷ are not new, but only well-conceived official programs can bring about meaningful debt reduction while attracting significant amounts of foreign capital.

2) Origins of the Debt-Equity Swap

The idea of using a formal program to convert sovereign debt into private sector equity may have first arisen during negotiations restructuring Turkish debt in the mid 1970s, but Brazil was the first country to implement a program on a useful scale in the late 1970s. Nonetheless, interest in debt-

83. Competition has forced margins down from four to five percent to less than two percent. SWAP GUIDE, *supra* note 57, *Overview* at 5.

84. *Id.* at 4.

85. U.N. GUIDE, *supra* note 51, at 29-30.

86. The IFC promoted a \$65 million First Philippine Capital Fund and a smaller Chilean fund. *Id.* at 28.

87. An intracompany debt swap is a transaction in which a company forgives a foreign subsidiary's intracompany debt in return for a greater equity stake in the subsidiary.

equity swaps remained low until Chile introduced its effective debt-equity swap program in 1986.

The success of the Chilean program sparked further interest in debt-equity swaps, and other debtor countries launched programs. Mexico, the Philippines, Ecuador, Jamaica, Venezuela, and Nigeria initiated programs, while Argentina and Brazil revamped their procedures.⁸⁸ The individual programs of Chile, Brazil, Argentina, and Mexico will be analyzed in Part III.

Although it is difficult to quantify debt-equity transactions because of the variety of formal and informal programs, estimates are that major debtor countries converted about \$15 billion between 1985 and 1989, representing about three percent of their total commercial debt.⁸⁹ The volume of debt-equity transactions is cyclical and depends to a large extent on the movement of international interest rates, the state of the world economy, and the status of debtor countries in Brady Plan or debt restructuring negotiations.

II. INSIDE THE DEBT-EQUITY SWAP

Champions of debt-equity swaps regard them as almost magical in their ability to transform bad debt into economic growth (and fat fees). Debt-equity swaps truly benefit everyone. Businesses obtain discounted financing. Banks get rid of nonperforming debt.⁹⁰ Debtor countries reduce debt while attracting foreign investment.⁹¹

Debt-equity swaps have many detractors, however, especially in debtor countries. Although many criticize debt-equity swaps for their macroeconomic impact on debtor countries, the most potent attacks come from those who condemn the swaps as a form of neocolonialism where multinational banks and corporations assume control over developing country economies.

The truth lies somewhere in the middle. Before devising a swap program, a policymaker needs a firm grasp of the economic and political realities in the particular debtor country and must understand its goals and priorities for economic development. Only this knowledge will allow the

88. U.N. GUIDE, *supra* note 51, at 11-12.

89. *Id.* at 12. There are alternate estimates on the volume of debt-equity transactions. One set of figures estimates debt-equity swaps at \$497 million in 1985, rising to almost \$9.5 billion in 1990 before dropping to less than \$2 billion in 1991. WORLD DEBT TABLES, *supra* note 2, at 110. Another set of world-wide debt-equity swap figures shows \$773 million in swaps in 1984, increasing to \$8.8 billion by 1988. STIJN CLAESSENS ET AL., POLICY, RESEARCH, AND EXTERNAL AFFAIRS, THE WORLD BANK, NO. 16, MARKET-BASED DEBT REDUCTION FOR DEVELOPING COUNTRIES 51 (1990); U.N. GUIDE, *supra* note 51, at 13.

90. U.N. GUIDE, *supra* note 51, at 44.

91. *Id.* at 35-39.

provisions of the swap program to be carefully tailored to achieve the country's plan for economic development.

A. The Mechanics of a Debt-Equity Swap

A typical debt-equity swap seems simple, but debt-equity swaps are actually extremely complex arrangements with very high transaction costs. There are three general types of debt-equity swaps:⁹² (1) swaps in which a private entity's debt is traded for an equity stake in that enterprise; (2) swaps in which sovereign debt is traded for equity in a private sector enterprise; and (3) swaps in which sovereign debt is converted into equity in a public enterprise undergoing privatization.

The simplest form of debt-equity swap is the intracompany version whereby a company forgives the internal debt of a foreign subsidiary in return for a greater equity stake. In these transactions, no debt package has to be assembled and restrictive legal documentation can be kept to a minimum as the parent investor controls the subsidiary.

In a more common form of debt-equity swap, a company seeks to swap a portion of the debtor country's sovereign or private external debt for an equity stake in a private company. The company would hire a debt broker to assemble a package of the country's debt large enough to finance its investment project. These hard-currency debts are then redeemed for local currency or local currency denominated bonds issued by the debtor country's central bank. Central banks often redeem this debt at about eighty percent of face value, leaving the twenty percent redemption discount as an added benefit for the debtor country government.⁹³ The bonds or local currency are then used to finance a preapproved investment project in the debtor country.

Such a transaction does not seem complicated, but beneath the surface lies a series of intricate problems. The difficulties begin when a debtor country issues new decrees or legislation authorizing a debt-equity swap program (the regulations). These regulations are generally very complex because the debtor country must choose between several conflicting goals,

92. Derek Asiedu-Akrofi, *A Comparative Analysis of Debt-Equity Swap Programs in Five Major Debtor Countries*, 12 HASTINGS INT'L & COMP. L. REV. 537, 540 (1989).

93.

Secondary market price of debt	Incentive to investor	Redemption price granted to investor by debtor government	Debtor government share of discount	Fact value of debt
Secondary Market Discount				

typically seeking to reduce debt, to attract foreign investors, and to promote economic development.

Investors are well-advised to speak with responsible host country officials and good lawyers very early in the process of initiating an investment through a debt-equity swap. The investor must first determine whether the project fits within the scope of a country's swap program. Projects that promote exports, create jobs, or bring in high technology are particularly likely to be acceptable to the debtor country. Next, the investor must submit a project application that typically requires information about the investor's other business projects in the debtor country, the specific debt to be swapped and through whom, the exact use of the swap funds, and the proposed project schedule. Final approval is attained through an auction for swap rights or a review of each proposal by debtor country officials.⁹⁴ To promote serious investment activity, debtor countries often impose restrictions on repatriation of capital and remittance of dividends. Some also limit the percentage of the project that may be financed via debt-equity swap and require new money for the remainder.

Assembling debt packages is another tricky aspect of debt-equity swaps. The debt broker retained by the investor acquires the requisite amount of debt through a complex series of transactions. Debt often changes hands several times before being secured by the investor. If the project requires a stream of investment rather than one lump sum, investors will often purchase and swap the debt in stages as a hedge against depreciation of swapped local currency or to avoid driving up the price of the debt to prohibitive levels. Cumulative brokers' margins reduce the debt's discount on the secondary market.⁹⁵

94. SWAP GUIDE, *supra* note 57, *Overview* at 3.

95. A typical debt-equity swap transaction would proceed as follows:

- 1) Corporation A instructs Bank B to assemble \$30 million (face value) worth of eligible debt of Country C to finance in investment in Country C through C's debt-equity conversion program. Bank B charges 2% of the market value of the debt.
- 2) Bank B assembles the debt at the average price of 45% of face value for a total of \$13.5 million. Bank B earns \$270,000 in fees for the transaction.
- 3) If Country C allocated debt-equity conversion rights via auctions, Bank B would take Corporation A's debt to the program auction to bid for the right to convert the debt. A typical auction would require Bank B to bid up to 25% of the value of the debt, meaning that Corporation A is willing to give up 25% of the face value as a "discount" to the debtor government. Corporation A will thus receive \$22.5 million in local currency, rather than the \$30 million face value. Fees to the agent bank and local broker could total another \$630,000 for such a transaction, while the central bank might take off another 5% discount fee, reducing the local currency received to perhaps \$21 million. For its \$13.5 million initial investment augmented by almost \$1 million in fees, Corporation A thus receives \$21 million in local currency.

Once the debt is assembled by the broker its title must be transferred to the investor. The timing of the transfer is crucial, and investors seek to purchase the debt as late as possible to minimize "walk-away" costs if the deal should fall through. Debt purchase contracts usually provide that the investor will be relieved of the commitment to buy the debt if the project does not go ahead.

Contractual provisions in the syndicated loan agreements are a major obstacle to the establishment of a formal debt-equity swap program.⁹⁶ In particular, the debtor country might need waivers of mandatory prepayment and "sharing" clauses that are intended to prevent the preferential treatment of one creditor at the expense of the others. Recently, loan documents have been drafted to avoid these difficulties by stipulating that these clauses are only activated if prepayment is made in a foreign currency.⁹⁷ Restrictions on permissible assignees may preclude assignment of the debt to anyone but banks or other financial institutions, because debtor countries initially sought to keep their debt in the hands of banks that might be more easily persuaded to provide "new" money.⁹⁸ One alternative is to provide a blanket authorization for assignment to nonfinancial institutions when the assignment is part of a debt-equity swap.⁹⁹ Legal opinions are necessary to determine the impact of these clauses.

B. Other Debt Conversion Schemes

Enthusiasm for the potential of the basic debt-equity swap has been tempered by recognition of its limitations. Numerous debt conversion schemes have adapted the basic debt swap framework to achieve other ends.¹⁰⁰

Two economists at the Massachusetts Institute of Technology have developed a debt conversion program to cover interest payments.¹⁰¹ Following the conclusion of a restructuring agreement, the Modigliani-Dornbusch approach provides that creditors will accept all interest payments in the form of local currency paid into special accounts.¹⁰² The creditor

96. *See id.* at 30.

97. *Id.*

98. *Id.*

99. *Id.*

100. *See id.* at 14-17.

101. *See Franco Modigliani & Rudiger Dornbusch, Easing the Mexican Interest Burden, WALL ST. J., Jan. 3, 1989, at A12.*

102. Another variation more acceptable to banks would be to require hard currency for that portion of interest payments representing London Interbank minus the current rate of interest, with the remainder paid into the local currency accounts. Victor L. Urquidi, *A Proposal to Create a System for Part-payment in Local Currency of Interest on External Debt*, in JOINT ECON. COMM.,

then has the right to invest these funds into local firms and to receive local-currency denominated dividends, which will be eligible for conversion into foreign currency after a certain period.¹⁰³ A variation would be for these local currency payments to be pooled into investment funds administered by multinational organizations such as the IFC for investment in export sectors.¹⁰⁴ One attractive feature of this approach is that it can be implemented on a stand-alone basis or in conjunction with more comprehensive Brady Plan or debt-equity swap programs. Such a program could also be structured to facilitate the development of the debtor country's financial sector.

Another debt conversion program provides that creditors accept repayment for interest or principal in the form of in-kind exports which the creditor then sells abroad. The chief obstacle to these "debt-for-trade" schemes lies in the *pari passu* and sharing clauses in syndicated loan agreements. Such a program has been introduced only in Peru, where First Interstate Bank orchestrated an agreement between a consortium of Peru's twenty main creditors. Most transactions accomplished to date have involved short-term, unsyndicated debt.¹⁰⁵

Debt-for-nature programs have played a small role in reducing debt but have potential to make a significant impact on preserving the natural resources of debtor countries.¹⁰⁶ The simplest form of debt-for-nature swaps involve the cancellation of foreign debt in return for debtor country governmental commitments to implement specified environmental policies. Another form of debt-for-nature swap replaces foreign debt with local currency denominated bonds that are used to finance environmental activities in the debtor country. Typically, an international environmental organization

100TH CONG., 1ST SESS., ECONOMIC DEVELOPMENT IN LATIN AMERICA AND THE DEBT PROBLEM: SELECTED ESSAYS 105, 108 (Joint Comm. Print 1987).

103. One commentator recommends that the real rate of interest be covered by foreign currency payments, while the remainder is paid in local currency into "restricted" bank accounts that would earn local currency interest at the inflation rate or would be hedged. *Id.* at 105-09.

104. U.N. GUIDE, *supra* note 51, at 14.

105. The program requires banks to pay two dollars for every three dollars worth of export goods. The discount goes to retire short term debt.

106. See generally, Priya Alagiri, *Give Us Sovereignty or Give Us Debt: Debtor Countries' Perspective on Debt-For-Nature Swaps*, 41 AM.U.L.REV. 485 (1992); Gibson & Schrenk, *supra* note 44, at 1; Laurie P. Greener, *Debt-For-Nature Swaps in Latin American Countries: The Enforcement Dilemma*, 7 CONN. J. INT'L L. 123 (1991); Jean Terranova, *Enterprise For The Americas Initiative Act: A Pragmatic Response to Debt and Environmental Crises*, 15 SUFFOLK TRANSNAT'L L.J. 153 (1991); Nancy Knupfer, *Debt-For-Nature Swaps: Innovation or Intrusion?*, 4 N.Y. INT'L L. REV. 86 (1991); Rosanne Model, *Debt-For-Nature Swaps: Environmental Investments Using Taxpayer Funds Without Adequate Remedies For Expropriation*, 15 U. MIAMI L. REV. 1195 (1991); Nina M. Dillon, *The Feasibility of Debt-For-Nature Swaps*, 16 N.C. J. INT'L L. & COM. REG. 127 (1991); Allegra G. Biggs, *Nibbling Away at the Debt Crisis: Debt-For-Nature Swaps*, 10 ANN. REV. BANKING L. 429 (1991); Molly J. Moline, *Debt-For-Nature Exchanges: Attempting to Deal Simultaneously With Two Global Problems*, 22 L. & POL'Y INT'L BUS. 133 (1991).

buys the debt to be forgiven on the secondary market and donates it to a local nongovernmental organization that takes part in planning and executing the environmental plan. Bolivia and Costa Rica completed the first such swaps in 1987, with Brazil, the Dominican Republic, Ecuador, Madagascar, Mexico, the Philippines, and Zambia all subsequently introducing programs.¹⁰⁷ These agreements have remained very small scale, and are criticized as being unenforceable and as representing a new form of "eco-imperialism."

Debt-for-development programs are similar to debt-for-nature schemes in many respects.¹⁰⁸ International aid organizations such as United Nations spend millions of dollars funding aid and development programs in developing countries. A debt-for-development swap cancels debt bought for a discount on the secondary market in return for redemption in local currency at near face value. International aid organizations utilize these local currency funds to expand their operations in the debtor country while reducing the country's debt servicing.¹⁰⁹ Debt-for-development schemes are limited by the same tax, accounting, and regulatory issues as debt-for-nature programs.¹¹⁰

The same mechanism has been used to swap foreign debt for local currency to be used to provide educational opportunities for students of debtor and creditor countries. Harvard University and Ecuador instituted a debt-for-education program in which Harvard cancelled debt purchased on the secondary market in return for the establishment of a local currency endowment in Ecuador that funded scholarships for Ecuadorian students studying at Harvard. Funds were also set aside for fellowships for Harvard students to study in Ecuador.¹¹¹

Jacques Attali, President of the European Bank for Reconstruction and Development, has issued a bold proposal to reduce the debt of the former

107. Gibson & Schrenk, *supra* note 44, at 4-8. In the first debt-for-nature swap, Conservation International, a U.S. environmental group, bought \$650,000 worth of Bolivian debt for \$100,000 and converted it into local currency in return for a covenant by the Bolivian government to set aside four million acres of rain forest as a nature preserve. The more sophisticated Costa Rican plan redeems debt at 75% of face value in local currency which is deposited into a special environmental fund in Costa Rica.

Tax, accounting, and regulatory concerns in creditor countries have limited the attractiveness of donating debt for such swaps. U.N. Guide, *supra* 51, at 15-16.

108. Eve Burton, *Debt-For-Development: A New Opportunity for Non-Profits, Commercial Banks, and Developing States*, 31 HARV. INT'L L.J. 233 (1990).

109. Midland Bank executed one of the few completed debt-for-development transactions when it donated Sudanese debt with a face value of \$800,000 to the United Nations Children's Fund, which the Sudanese government converted into local currency for use in development programs in drought-stricken areas. U.N. GUIDE, *supra* note 51, at 16.

110. Gibson & Schrenk, *supra* note 44, at 55-63.

111. Jennifer F. Zaiser, *Swapping Debt For Education: Harvard and Ecuador Provide a Model for Relief*, 12 BOSTON COLL. THIRD WORLD L.J. 157 (1992).

Soviet Union (FSU) in return for the dismantling of the region's nuclear warheads. This "debt-for-nukes" proposal has been called "the ultimate debt-for-nature swap."¹¹²

C. Legal, Tax, Accounting, and Regulatory Considerations

The legal, tax, accounting, and regulatory regimes of creditor countries play major roles in debt-equity swaps and will be mentioned briefly here.¹¹³

The complexity of debt-equity swaps requires careful drafting of the legal documentation.¹¹⁴ Legal fees can mount quickly however, and experienced debt swappers often impose expense caps on their legal teams.

Tax treatment of debt-equity swaps in creditor and debtor countries will often determine the success or failure of a swap program. Usually tax treatment in the debtor country is favorable or at least neutral, because one of the objectives of the program is to attract investment. Creditor country tax laws thus assume particular importance. One crucial tax issue in debt-equity swaps is the method of taxing the gain received by the investor (the difference between the price paid for the debt and the value of the local currency received).¹¹⁵ Other tax issues involve taxation policies for capital gains and dividends. The different tax regimes in the various creditor countries account for much of the enthusiasm for debt reduction menus.

Accounting considerations also play a major role in debt-equity swaps. U.S. accounting rules do not require nonperforming debt to be marked down on a bank's books unless portions of it are bought or sold.¹¹⁶ For the bank

112. *EBRD Could Play A Pivotal Role in Promoting Debt Relief Via Swaps*, EBRD WATCH, Mar. 23, 1992, at 1.

113. SWAP GUIDE, *supra* note 57, *Key Legal, Tax and Accounting Considerations for Debt-Equity Swaps*, at 1-11; Stuart M. Berkson and Bruce A. Cohen, *The Tax Implications of Debt-For-Equity Swaps*, 12 HASTINGS INT'L & COMP. L. REV. 575-90 (1989); Gibson & Schrenk, *supra* note 44, at 25; Leslie A. Sowle, *International Debt For Equity Swaps: Does Revenue Ruling 87-1224 Make Sense?*, 83 N.W. UNIV. L. REV. 1079 (1989); Andrew C. Quale, Jr., *New Approaches to the Management and Disposition by Banks of Their LDC Debt: Legal and Accounting Considerations*, PLI Order No. B4-6827 (Apr. 21, 1988) 596 PLI/Corp 325.

114. The numerous technical drafting issues will not be addressed in detail here. See Swap Guide, *supra* note 57, *Key Legal, Tax and Accounting Considerations for Debt-Equity Swaps* at 1-3.

115. The Internal Revenue Service issued Revenue Ruling 87-124 in November 1987 to clarify the tax treatment for debt-equity swaps undertaken by U.S. companies and banks. Ruling 87-124 taxes debt-equity swaps to the extent that the fair market value of the local currency obtained exceeds the amount the investor pays for the debt. The key, obviously, lies in the determination of value of the local currency obtained, a task often very difficult due to currency exchange or repatriation restrictions; it is very important that all factors affecting the value of a currency, including inflation and general economic conditions, be reflected in the computed fair market value. Debt swappers criticize 87-124, arguing that the fair market value of the local currency obtained does not exceed the price paid; the U.S. company does not realize a gain on the swap and thus should not be taxed. *Id.* at 4-5.

116. There is little incentive for a bank to buy or sell \$100 of Brazilian debt for \$50 if the

disposing of its debt, the transaction is fairly simple: debt is sold for a discount from the face value which is reflected on the books by a loss on the transaction. The accounting is trickier for the investor, because the value must be either the amount paid to buy the debt or the amount of local currency received for the debt.¹¹⁷ Market values provided by the secondary markets provide limited relief to tax lawyers.

U.S. bank regulations, especially the Federal Reserve Board's Regulation K on International Banking Operations, also impose significant constraints on debt-equity swaps.¹¹⁸ Regulation K now allows banks to acquire up to one-hundred percent of privatizing public sector companies pursuant to a debt-equity swap program, or up to forty percent of a private sector enterprise. This is an increase from the maximum twenty percent equity ownership allowed under the old rules.¹¹⁹ The modifications to Regulation K allow banks to swap sovereign debt for private or public sector equity investments in the debtor countries considered eligible by the Federal Reserve Board.

D. *Evaluating the Effects of a Debt-Equity Swap Program*

Although debt-equity swaps offer many benefits to debtor countries, critics of debt swap programs raise legitimate concerns about the effects of these programs on the host country. Ultimately, advantages of a debt-equity swap program outweigh the disadvantages only if the regulations have been carefully tailored to suit the conditions of the debtor country.

1) Criticisms

Detractors often criticize three potential negative effects of debt-equity swaps. First, debt-equity swap programs tend to exert inflationary pressure on the host country economy by expanding its monetary base. Debtor country authorities must issue millions of dollars worth of local currency to be exchanged for the foreign debt; many debtor country central banks

rest of the bank's loans to Brazil will also have to be marked down to that price. William Ollard, *The Debt Swappers*, EUROMONEY, Aug. 1986, at 67, 74.

117. SWAP GUIDE, *supra* note 57, *Key Legal, Tax and Accounting Considerations for Debt-Equity Swaps* at 8. The Financial Accounting Standards Board has established a standard that revolves around the "allocation of the purchase price to fair values," which requires proper structuring of the transaction to maximize accounting and tax benefits. *Id.* at 10.

118. Regulation K governs the foreign investment activity of U.S. banking institutions, and was modified in 1987 and again in February 1988 to allow for more flexibility to U.S. banks in investing in equity ownership in nonfinancial companies. *Id.* at 3.

119. If banks acquire more than 25% of a private nonfinancial company, current rules require another shareholder to have a greater share to share the operational responsibility and risk. *Id.* at 4.

procure the local currency by printing it. Second, debt-equity swap programs are criticized as subsidizing foreign investments that would have been made even without the program. Third, debt-equity swaps are blamed contributing to capital flight, as local investors take their foreign currency holdings offshore to become eligible for the swap program. Debtor country nationals also participate in "round-tripping," where they take the local currency proceeds of a debt-equity swap, convert them back into foreign currency on the black market, buy more debt on the secondary market, and so on.

These concerns are significant but can be addressed by a properly conceived and implemented debt-swap program. A more fundamental question is whether debtor countries should participate in debt-equity swaps at all. In the long run, debt-equity swap programs could prove more expensive for a debtor country than just repaying the debt itself; by exchanging bad debt for good equity, debtor countries transform a finite debt obligation into an "open-ended foreign exchange drain."¹²⁰ Moreover, why should debtor countries convert debt instruments that will probably never be repaid into foreign ownership and control over the "commanding heights" of the local economy?¹²¹ Debt-equity swaps can also reduce flows of investment in the form of cash into the debtor country.¹²² Finally, debt-equity swaps make debt restructurings more difficult for the debtor countries by providing an "exit vehicle" for creditor banks that are not enthusiastic about extending new loans.

2) Benefits

Advocates of debt-equity swaps maintain that a properly structured program can minimize the drawbacks mentioned above and also provide other benefits that could not be attained through debt restructuring.¹²³ The relatively small size of most debt-equity swap programs limits the inflationary impact of debt swaps. Moreover, inflationary pressures can

120. Hilton, *supra* note 71, at 11.

121. One former Argentine official explained his preference for a restructuring agreement over debt-equity swaps by asking why he should choose to pay now, rather than in fifteen years, as allowed after restructuring negotiations. Stephanie Cooke, *Salvaging Debt-Equity Swaps*, INSTITUTIONAL INVESTOR, Sept. 1989, at 149. A former Chilean central bank official opposed swaps because the depressed state of the Chilean economy lowered equity prices and enabled creditor banks to exchange bad debt for good equity; in Chile, post-tax profit rates for the companies chosen for debt-equity swaps were higher than interest rates. *Interview with Ricardo Ffrench-Davis*, C.T.C. REP., Spring 1987, at 35.

122. In Chile, direct foreign investment increased under the debt-equity swap program, but the increase was entirely composed of debt conversions, and the amount of actual cash invested declined sharply. This drop in cash FDI was greater than the reduction in interest payments, before even taking into account the potential outflow of dividend payments. *Interview with Ricardo Ffrench-Davis*, *supra* note 121, at 33.

123. U.N. GUIDE, *supra* note 51, at 35-39.

be reduced further by imposing ceilings on the amount of debt eligible for conversion within a given time frame.¹²⁴ Programs can be devised to promote “additional”¹²⁵ investment by using eligibility restrictions or other means. Similarly, “round-tripping” can be reduced by paying the debt conversion proceeds into special accounts.¹²⁶

More importantly, debt-equity swaps can bring many advantages beyond the liquidity relief and debt reduction available after restructuring negotiations.¹²⁷ Debt-equity swaps attract “additional” investment by granting investors an upfront discount or subsidy. It is important to note that this subsidy is not paid by the debtor country itself, but by the original creditor that sells its debt for a steep discount on the secondary market.¹²⁸ These investments provide a valuable spark for economic growth, especially in countries that otherwise find it difficult to attract foreign investors. Foreign interest in taking equity stakes often “snowballs,” leading to increased investment of a more direct nature. A successful debt-equity swap program also has substantial “second order” benefits such as increasing tax revenues, employment, and foreign exchange reserves, and showing foreign and domestic investors that the debtor country is committed to developing a favorable business climate. Foreign investors can also prove a source of valuable skills and technology to improve the productivity of the local workforce. In particular, debt-equity swap programs can give a real boost to the local financial sector and capital markets.

Debt-equity swaps provide the financing necessary to expand the private sector and are well-suited for use in conjunction with a privatization program.¹²⁹ First, the debt swap program serves as a valuable market-based mechanism for channeling investment into the private sector or privatization efforts.¹³⁰ Second, debt-equity programs built around a privatization program largely eliminate any inflationary impact, because the foreign investor receives government-owned shares in privatizing companies instead of local currency.¹³¹ Finally, debt-equity swaps are advantageous because they

124. U.N. GUIDE, *supra* note 51, at 43.

125. Additional in the sense that these investments would not have been made without the debt-equity swap program.

126. *See, e.g.,* Asiedu-Akrofi, *supra* note 92, at 555 (a discussion of the Mexican requirement of special accounts in their debt-equity swap program.)

127. Besides providing benefits in their own right, the offer of debt-equity swaps can often be a useful card for getting better terms at debt restructuring talks. Cooke, *supra* note 121, at 149.

128. *Interview with Susan L. Segal*, C.T.C. REP., Spring 1987, at 32.

129. U.N. GUIDE, *supra* note 51, at 35–39.

130. *Id.*

131. SWAP GUIDE, *supra* note 57, *Debt-Equity Swap Update (Nov. 1991)*, at 3.

replace a fixed debt repayment stream with dividend streams that will rise and fall with the economic conditions in the debtor country.¹³² The equity will prove altogether worthless if the investment project is unsuccessful.

In light of the relative advantages and disadvantages of debt-equity swaps, it seems that they can play a useful but limited role in facilitating debt reduction and economic growth.¹³³ The ideal program would attract additional investment in export sectors and would increase the private sector's access to long-term capital by developing the local capital market. It cannot be overemphasized that the program must be very carefully tailored to the individual country's needs; the regulations will determine whether debt swaps' drawbacks will be minimized or exaggerated. Debtor countries are well-advised to seek expert assistance from multilateral organizations such as the IFC in devising their swap programs. Vague, poorly drafted regulations that fail to adequately define eligible types of investment or that impose onerous currency limitations to prevent "round-tripping" can cripple a swap program.

Beyond the swap regulations themselves, it is critical that any debt-equity program be part of a general improvement of the investment climate. Without a stable business environment, debt-equity swaps will not attract foreign investors or flight capital. As countries recognize the vital role of private investors in spurring economic development, they can look to debt-equity swaps to finance privatization programs (which do not have inflationary impact), infrastructure projects (for which financing is otherwise hard to find), and hard-currency generating projects in the export or tourism sectors.

Candid assessment of the political situation in the debtor country is crucial when formulating a debt-equity swap program. Popular reaction against granting investment privileges to foreigners may prove a serious obstacle. The political impact of a program can be minimized by restricting it to enterprises in special economic zones, or by placing certain sectors of the economy off-limits. Swaps must become apolitical and routine and must not become a contentious political issue in the debtor country.

Even the most successful debt-equity swap program cannot be maintained indefinitely. Debt-equity swap programs tend to operate in cycles. Programs that attract too much investment will either drive up the secondary market price to the point that debt swaps are no longer attractive

132. U.N. GUIDE, *supra* note 51, at 35, 37-38.

133. Antoine Basile, *The Role of Debt-Equity Conversions in Attracting FDI*, C.T.C. REP., Autumn 1989, at 58. With its debt-equity swap program, Chile reduced its foreign debt by \$1.2 billion out of combined commercial bank debt of \$16 billion, or 6% of Chile's foreign debt. *Interview with Susan L. Segal*, *supra* note 128, at 32.

or spark restrictive changes to the swap programs themselves.¹³⁴ The secondary market discount on developing country debt also shrinks to the point of nonattractiveness as general economic conditions improve in debtor countries and the prospect of regular servicing improves. Eventually, investors will increasingly rely on conventional foreign investment programs instead of the debt-equity mechanism. This signals the imminent return of the debtor country to the international financial fold.

Ultimately, debt-equity swaps can never provide more than a partial solution to a country's debt problems because there are limited attractive investment targets in any particular debtor country, and because many of the most indebted countries owe money as official debt that is not typically eligible for debt-swap programs.

The previous discussion outlines the possible positive and negative outcomes of a debt-equity swap program, but does not consider how to maximize the benefits; the devil is in making the difficult value and policy decisions necessary to make the program successful.

E. Policy Questions in Establishing a Debt-Equity Swap Program

To draw up their debt-equity program, debtor country authorities must address a series of policy questions regarding the objectives, scope, and procedures of the program. Once the program is designed, it must be implemented; special challenges await those hoping to implement swap programs in countries with "weak leadership, corrupt bureaucracies, almost nonexistent capital markets and faltering economies."¹³⁵

The following policy considerations must be addressed when formulating a debt-equity swap program. First, the debtor country authorities must

134. Note the cyclical nature of debt-equity swap volumes between 1985 and 1990:

DEBT-EQUITY SWAPS 1985-1990 (\$ Millions)

Country:	1985	1986	1987	1988	1989	1990
Argentina	467	—	—	1,354	514	5,796
Brazil	530	206	300	5,115	4,724	483
Chile	332	981	1,950	2,762	2,778	1,103
Mexico	—	363	1,786	2,919	2,546	652
Venezuela	—	—	—	47	656	405

THE WORLD BANK, WORLD BANK INFO. BRIEFS (The World Bank, Wash. D.C.), #C.04.8-92, at 2.

135. Cooke, *supra* note 121, at 149.

establish the goals of the program. At least four different primary objectives are possible:¹³⁶ (1) a reduction of external debt; (2) the promotion of additional investment; (3) the promotion of development in certain sectors or regions; and (4) the repatriation of flight capital. Although these objectives are not mutually exclusive, neither are they fully compatible. Trade-offs must be made as the debtor country proceeds toward the realization of one objective or another. For instance, a program that emphasizes debt reduction needs a large volume of debt swap activity and must encourage all investment, whether or not it is additional. Debtor country authorities will seek to capture a large portion of the secondary market discount for the government but will maintain lax screening and approval procedures. However, authorities that want to structure their program to encourage additional investment must institute a much more selective screening process to ensure that the investment would not be made without the swap program. This will reduce conversion volume and thus the amount of debt reduced.

Once the authorities have selected their program's primary objective, they must decide on the form the program is to take. Should the program be built around a formal, transparent program with established procedures, or should it be informal, with debt-equity swaps negotiated on a case-by-case basis in the absence of any specific authorizing legislation?¹³⁷

Whichever form of program is chosen, four sets of questions must be addressed: (1) eligibility criteria; (2) conversion procedures; (3) financial concerns; and (4) control issues.¹³⁸

1) Eligibility Criteria¹³⁹

Who will be eligible to participate in the swap program? Limiting participation to foreigners will reduce the repatriation of flight capital and will have an adverse long-term effect on the debtor country's balance of payments, because local investors would be less likely to transfer income streams abroad in the future. However, the political repercussions of allowing local citizen participation are particularly troublesome when it allows widespread laundering of illegal profits. Limiting eligibility to foreigners will provoke angry calls for equal privileges for locals, but

136. JOHN D. SCHILLING ET AL., *DEBT EQUITY CONVERSION ANALYSIS: A CASE STUDY OF THE PHILIPPINE PROGRAM*, at 3-4 (1990).

137. An informal program is often considered better when significant political opposition to debt-equity swaps can be expected and authorities want to maintain a very low profile. Hilton, *supra* note 71, at 9.

138. U.N. GUIDE, *supra* note 51, at 106-10.

139. Hilton, *supra* note 71, at 9.

allowing domestic investors to participate will eventually prove politically difficult, as illicit foreign currency hoards are in essence laundered into equity in blue-chip local enterprises through the official debt swap program.

What kind of swap will be allowed? Although most countries allow virtually any form of swap, some programs only allow swaps by the original creditor or between a foreign corporation and a local subsidiary.

What kind of debt should be eligible? The authorities can authorize conversions of limited amounts of government debt, all private or public sector debt, or somewhere in between. Their choice largely depends on the amount of debt that the country wants to see converted and on the potential economic and political impact of the program. Most countries restrict eligible debt to long-term debt already covered by one rescheduling agreement (regardless of who originally held the debt) and exclude short-term debt or trade credit. However, some countries, such as Nigeria, permit conversion of short term trade-related debt.¹⁴⁰ Mexico's program from 1985–1987 was among the most restrictive; only debt that had been rescheduled and that had been originally issued by a bank that had recently agreed to provide new loans could be converted.

What kind of investment will be eligible?¹⁴¹ Choices concerning investment eligibility criteria are particularly important and depend upon the primary objective of the swap program. Some countries impose essentially no restrictions except for their defense and communications sectors,¹⁴² while others limit investment to the export or import substitution sectors. Others give graduated incentives to investors according to investment priorities established by the debtor government, based upon key industrial sectors or depressed regions.¹⁴³

Another issue is whether investment in stock funds (i.e., secondary investment on local stock markets) is eligible; this will increase activity on local capital markets but may also divert capital from higher priority direct investment.

2) The Conversion Procedure

Administration of the swap program. The Central Bank and Finance Ministry generally administer debt-equity swap programs, but usually several different ministries become involved in dealing with the range of issues presented by debt-equity swaps. Some mechanism is necessary to avoid

140. *Id.*

141. *Id.*

142. *Id.* at 10.

143. Tourism and privatization are favorite target sectors; target regions are typically either free economic zones or underdeveloped regions.

ministerial deadlock. The Philippines established an interdepartmental agency with representatives from all relevant ministries to allow a "one-stop" swap application and approval process.¹⁴⁴

Allocation of debt conversion rights. In most official programs, debt conversion rights are allocated through formal auctions. At the auctions, investors bid by offering the government an increasingly larger local currency "discount" on the foreign debt being converted. The winner is the investor that agrees to give up the largest portion of the local currency proceeds to the debtor country government. The size of the discount investors are willing to bid depends upon the price of the debt on the secondary market and the appeal of the investment opportunity. In addition to the auction discounts, investors must often pay fees to the debtor government or local financial intermediaries.¹⁴⁵ The authorities must also resolve several other questions.¹⁴⁶ Who will run the auctions? Can investors bid directly, or must they bid through local financial intermediaries? Will the authorities wield a veto in screening procedures that determine who is eligible to participate in the auction?

Other programs, particularly informal programs, allocate debt conversion rights by individual review and negotiation of each proposed investment between the investor and the authorities, with the rights going to the investors with the proposals best suited to the current priorities of the swap program. This approach is often criticized for its lack of transparency and potential for corruption and other vices, but it has the advantage of minimizing the potential political problems of a transparent, nondiscretionary program.

Argentina's swap program uses both systems, with a preliminary case-by-case screening followed by formal auctions.¹⁴⁷ Other countries administer two sets of auctions, for investment in normal and priority regions.

Disbursal Procedures. Disbursal procedures often prove to be the most difficult facet of a debt-equity swap program. The Central Bank cannot simply hand the investor the local currency proceeds of the swap because of concerns about inflationary pressures and round-tripping. Mexico's program in 1985-1987 deposited swap proceeds in a government-administered account that could not be drawn upon without proper invoices evidencing valid expenses of the investment project.¹⁴⁸ Other programs issue

144. Hilton, *supra* note 71, at 10.

145. *Id.*

146. *Id.*

147. *Id.*

148. *Id.* at 11.

local-currency denominated bonds with staggered maturities. Privatization programs simplify the process, by allowing the government to issue privatization vouchers in lieu of cash.

3) Financial Issues

Exchange Rate. A basic swap uses an exchange rate close to the official rate. In an auction system, investors bid by increasing the discount based on the official rate. In case-by-case negotiations, an investor negotiates the exchange rate to be used. Debtor countries must recognize that at some point, an unfavorable exchange rate will offset any advantages from the swap and foreign investors will refuse to participate.

Fees. Programs vary in their fee structure, but almost all investors will have to pay a fee to their debt broker for assembling the debt package. Debtor countries often impose central bank fees or require that investors be represented by local financial intermediaries during the swap auctions or applications.

Variable priority-determined financial incentives. Sometimes authorities try to channel investment into special priority sectors or regions by offering a graduated scale of financial incentives. Brazil presents investors with two different sets of incentives: one for investment in normal regions, and a more attractive set for investment in priority regions. Mexico has a complex schedule of financial incentives based upon the priority of investment sector.

Matching funds requirement. Almost all debt-equity swap programs provide only local currency for the converted debt. Any necessary imported equipment or supplies requires an injection of new cash; most debt-equity swap programs thus have a *de facto* new money requirement.¹⁴⁹ A few debtor countries impose matching fund requirements that mandate a certain amount of foreign currency exchanged at the official exchange rate for every dollar converted via swaps. Such requirements are quite unpopular with investors, particularly banks, and diminish the attractiveness of the debt swap program.

Tax regime. Tax treatment is yet another complex issue. It is debatable whether debt swappers should enjoy additional benefits in the form of tax incentives not provided to conventional investors and local nationals. The taxation of dividends and capital gains must also be addressed. The issue is complicated by the tax consequences of a debt-equity swap in the investor's country.

Restrictions on remittance of dividends and repatriation of capital. Almost all programs place restrictions on the remittance of dividends and

149. *Id.* at 10.

the repatriation of capital. Generally, such restrictions should correspond to the returns permitted by the terms of the underlying debt.

4) Controlling Macro Concerns

Inflationary effects. Inflationary effects are often cited as one of the chief drawbacks of debt-equity swap programs. Debt-equity swap programs add to the domestic money supply by converting foreign debt into local currency, thus increasing the money supply and causing inflation. One solution is to "sterilize" the inflationary impact by issuing local currency bonds instead of cash for the swapped debt. This policy often results in higher local interest rates and a diversion of capital from domestic investment opportunities. Another solution is to place a cap on the amount of debt to be converted either by setting auction quotas or by monitoring on-going swap transactions. Privatization vouchers are another option.

Inflationary concerns are real, but often exaggerated.¹⁵⁰ First, the relatively small size of most debt-equity swap programs would limit the effect on the monetary supply. Second, most countries in the position to implement debt-equity swaps already have monthly inflation rates in double digits; the marginal inflationary effects of a debt-equity swap program would be minimal.¹⁵¹

Political Concerns. Political concerns are often determinative. The slightest appearance of government subsidies for foreign investors or foreign domination of key sectors of the economy can prove a very divisive political issue. There are several ways to limit the political opposition to a swap program.¹⁵² It is possible to restrict the size, scope, and "profile" of the program. Also, the debtor country can use the IMF or Western banks as scapegoats. Opening the program to local investors as well as foreigners will also help reduce opposition, as will increasing public awareness of the jobs that foreign investment can provide. Finally, foreigners may be restricted to minority holdings in some or all sectors of the economy. The best approach might involve combining several of these measures.

III. FOUR DEBT-EQUITY SWAP PROGRAMS

Many countries have introduced debt-equity swap programs in the wake of Chile's success. Not all countries' debt-equity swaps have proved as successful as Chile's; moreover, each scheme is different. The profiles below are intended to illustrate the approaches that various countries have taken in designing debt-equity swap programs.

150. For example, Chile, which has the largest debt-equity program of any country, has seen its inflation rate fall throughout the existence of its program. *Id.* at 11.

151. *Id.*

152. *Id.*

A. Chile

Chile's debt-equity swap program is often regarded the most successful and significant swap program because of the volume of debt converted, the level of interest exhibited by foreign investors, and the general lack of political opposition that it evoked in Chile. The primary objective of the Chilean program was to reduce foreign debt, so the program allowed many types of debt conversion, not just debt-equity swaps. By late 1989, Chile's debt conversion program had converted \$8.1 billion in debt, with over \$5 billion in debt-equity swaps.¹⁵³

Chile adopted debt-equity swaps in response to the severe economic problems that accompanied the debt crisis. Although Chile's external debt stood at less than \$5 billion in 1976, it had jumped to \$17 billion by 1982. With the onset of the debt crisis in 1982, Chile's GDP dropped by 14.1%, and private investment dropped by more than fifty percent.¹⁵⁴ Although most Chilean debt was initially held by the private sector, by 1986 the Chilean government had agreed to assume direct or indirect responsibility for eighty percent of Chile's external debt, up from thirty-eight percent in 1982.¹⁵⁵

Chile introduced its pioneering debt-equity swap program in May 1985 as Chapters 18 and 19 of the foreign exchange regulations.¹⁵⁶ Chapter 18 converts foreign debt into domestic debt and is intended primarily for Chilean nationals, although foreign investors may also use it. Chapter 19 converts foreign debt into domestic equity and is only open to foreigners.¹⁵⁷ Decree Law 600 (DL 600), the basic foreign investment law, also authorizes debt-equity swaps.

Chile's debt-equity swap program prioritizes the export and import-substitution sectors and privatization projects. All investors had to use a local bank to convert the foreign debt into domestic currency.

Chile chose to allow local investor participation in its swap program through Chapter 18. Chapter 18 investors did not have to reveal the source of their funds, which could be converted into local currency without restrictions on its use, but they were not provided access to official foreign

153. U.N. Guide, *supra* note 51, at 10.

154. MARY L. WILLIAMSON, DEBT CONVERSION IN LATIN AMERICA: PANACEA OR PANDEMIC? 11-13 (Overseas Development Council Policy Essay No. 2, Richard E. Feinberg ed., 1991).

155. *Id.* at 12-14.

156. SWAP GUIDE, *supra* note 57, *Country Chapters: Chile* at 1.

157. In 1986, Chapter 19 swaps accounted for perhaps 40% of completed transactions; the remaining 60% were Chapter 18 swaps undertaken by Chilean nationals repatriating flight capital. Steve H. Hanke, *The Anatomy of a Successful Debt Swap*, in PRIVATIZATION AND DEVELOPMENT 161, 166-7 (Steven H. Hanke ed., 1987).

exchange reserves for capital repatriation or remittance of dividends.¹⁵⁸ To limit the inflationary effects of the swaps, the Central Bank imposed ceilings on the amount of debt that could be converted at the monthly auctions.¹⁵⁹

Originally, Chapter 18 funds could only be used for equity investment or debt reduction. Later, they could also be used for almost any type of investment. Most swaps have been used to refinance foreign debt into local debt with better terms.¹⁶⁰ To reduce the number of nationals using offshore corporations to invest through Chapter 19, Chilean authorities eventually added Annex 4 to Chapter 18 to allow nationals to invest in local firms with the same review procedures as in Chapter 19.

The terms of Chapter 19, which allows foreign equity investment via debt cancellation, are generally more attractive than Chapter 18.¹⁶¹ Chapter 19 provides for access to foreign exchange at the official rate for future repatriation of foreign currency but is not open to resident nationals. Chilean authorities review each investment proposal under Chapter 19 and generally ration approvals to serve monetary ends or to target priority investment sectors. Central bank approval under Chapter 19 is discretionary, with the central bank retaining the right to reject applications without explanation. The applications were screened to ensure investor eligibility and to

158. WILLIAMSON, *supra* note 154, at 19.

159. Asiedu-Akrofi, *supra* note 92, at 542. Chapter 18 local investors are assumed to be buying dollars on the unofficial market, and the quotas are imposed in part to prevent a wide divergence between official and unofficial exchange rates; Central Bank measures helped keep the margin down to less than 2.4% in August 1990. See SWAP GUIDE, *supra* note 57, *Country Chapters: Chile* at 2.

160. SWAP GUIDE, *supra* note 57, *Country Chapters: Chile* at 5. Such a transaction would work in the following manner: A Chilean investor would have a debt broker locate eligible Chilean debt selling for perhaps 67% of face value. The broker would then submit a sealed bid for a "ration coupon" to the central bank, indicating the discount that the investor is willing to grant to the central bank in return for the right to convert the external debt into domestic debt. These ration coupons allowed Chilean monetary authorities to "sterilize" the monetary impact of debt-equity swaps by setting a monthly quota (ration coupons) for the amount of permitted swaps. If the investor's sealed bid were accepted by the central bank, the investor would then proceed to purchase the foreign debt instrument which is then converted into a peso-denominated debt instrument that is indexed to Chilean inflation. This domestic debt instrument would then be placed in the local capital market for sale, where it would typically fetch 92% of par value, which would finally be delivered to the Chilean investor after the debt broker had received another four percent in fees. Hanke, *supra* note 157, at 166-67. Thus, the central bank captured an eight percent discount, and domestic financial markets captured another four percent. Under the program, Chilean banks earned more than twenty-five percent of their profits from fees and commissions generated by debt-equity swaps. U.N. GUIDE, *supra* note 51, at 82-84.

161. From 1985-1990, more than \$3.5 billion in Chilean debt was converted into equity investment through Chapter 19, representing about one third of Chile's external debt reduction. Screening procedures were meant to eliminate "round-tripping" and promote additionality. The applicable regulations were largely developed during negotiations concerning the first Chapter 19 investment in June 1985; the regulations were elaborated as other investment applications were submitted. See JOHN M. KLINE, FOREIGN INVESTMENT STRATEGIES IN RESTRUCTURING ECONOMIES: LEARNING FROM CORPORATE EXPERIENCES IN CHILE 28-30 (1992).

determine the economic benefit of particular projects.¹⁶² Despite the extent of the authorities' discretion over the review process, participants found central bank officials reasonably fair and objective. The officials were usually willing to pass their concerns on to investors to negotiate a more acceptable deal.¹⁶³ Although Chile's program had no formal "new money" requirement, authorities often recommended that investors fund part of the investment with cash when they deemed the project "non-additional".¹⁶⁴ As the program progressed, the central bank restricted the use of swap funds for buy-outs while allowing the use of equity to expand a plant's capacity.¹⁶⁵ Chile did not impose a ceiling on the amount of debt that could be converted.¹⁶⁶ After four years, investors were allowed to remit twenty-five percent of profits, while capital could not be repatriated for at least ten years. Changes introduced in 1991 allowed immediate remittance of profits and repatriation of capital after three years if the investor paid an "exit fee."¹⁶⁷

When the program was established, investors could use Chapter 19 proceeds for virtually any type of investment.¹⁶⁸ Gradually, Chilean authorities restricted authorized swaps to direct investment into priority sectors such as exports or import substitution, particularly telecommunications, tourism, and banking.¹⁶⁹

DL 600, Chile's general direct foreign investment law, allows for a firm's debt to be converted into equity in that firm. Investors utilizing DL 600 swaps did not pick up the secondary market discount, but were allowed to remit dividends immediately and repatriate capital within three years. These swap provisions can only be used to add to an existing investment and must be approved by the Foreign Investment Committee instead of the central bank.¹⁷⁰

162. Central bank authorities generally considered four factors when evaluating the economic desirability of an investment: (1) the economic sector of the proposed investment; (2) the investor's contribution of "new money" to the project; (3) the extent to which the investment involves the introduction of new production capacity versus buy-out of existing firm, privatization, etc.; and (4) the investment's likely effect on Chile's current account balance. WILLIAMSON, *supra* note 154, at 22.

163. *Id.* at 21. Part of the negotiations was the kind of discount that the investor was willing to grant the Chilean government.

164. *Id.* at 23.

165. *Id.* at 24.

166. SWAP GUIDE, *supra* note 57, *Country Chapters: Chile* at 1.

167. *Id.*

168. *Id.* at 4.

169. In 1987, Chapter 19 was amended to allow for the use of Chapter 19 money in special investment funds. Until the regulations changed to prohibit investments in such funds, they proved to be popular with foreign banks.

170. Only \$273 million had been converted under DL 600 by the end of 1989. SWAP GUIDE, *supra* note 57, *Country Chapters: Chile* at 1. Between 1985 and 1989, only three percent of

Informal debt conversions also played a major role in the Chilean debt-swap program.¹⁷¹ These transactions were conducted directly between Chilean debtors and their foreign creditors, without central bank involvement.¹⁷²

Chile's program has been very successful at reducing foreign debt and attracting foreign investment. By the end of 1989, the Chilean program had converted more than \$8 billion out of \$14.5 billion in eligible debt.¹⁷³ The program has been credited with renewing flows of foreign direct investment to Chile and accounted for more than sixty percent of new investments registered between 1985–1988.¹⁷⁴ The swaps financed projects in a variety of sectors; thirty-eight percent of swaps involved manufacturing projects, twenty-five percent agriculture and fishing, eleven percent were in the financial sector, and nineteen percent were in commercial projects. The debt-equity swap program can also be credited with contributing to a more diversified export base by encouraging investment into nontraditional export sectors, although Chile's improving general economic conditions probably played the major role in Chile's success in increasing exports.¹⁷⁵

The program slowed, however, as its success depleted stocks of eligible debt and exhausted the attractive investment opportunities presented by the first wave of privatization. Swap transactions in Chile dropped from \$1.3 billion in 1989 to \$412 million in 1990 to \$20 million in 1991. The shortage of debt drove up the secondary market price and increased winning discount bids at the Central Bank debt auction to between twenty-five and twenty-seven percent.¹⁷⁶ As demand for Chilean debt increased, Chilean authorities also placed increasing restrictions on debt transactions intended to channel debt-equity into priority areas.¹⁷⁷

Two characteristics of the Chilean program should be noted. First, participants in the open market, not the central bank, performed debt

debt-equity swaps took the form of D.L. 600 investments. WILLIAMSON, *supra* note 154, at 25.

171. Through mid-1990, almost one-third of recorded debt-equity swaps were conducted on an informal basis. WILLIAMSON, *supra* note 154, at 26.

172. *Id.* at 27.

173. \$2.54 billion under Chapter 18, \$3.16 billion under Chapter 19, and the remainder under DL 600 transactions and Chilean government debt buy-backs. SWAP GUIDE, *supra* note 57, *Country Chapters: Chile* at 1. The program was a success almost immediately, converting \$121 million under Chapter 19 alone in first nine months of operation. Ollard, *supra* note 116, at 71. A former Deputy Manager of the Central Bank of Chile claims that the official conversion figures are misleading and discounts many of the supposed benefits of Chile's program. *Interview with Ricardo Ffrench-Davis*, *supra* note 121, at 33.

174. U.N. GUIDE, *supra* note 51, at 83.

175. WILLIAMSON, *supra* note 154, at 39.

176. SWAP GUIDE, *supra* note 57, *Country Chapters: Chile* at 10.

177. KLINE, *supra* note 161, at 32-33.

valuation and conversion. The central bank limited its role to controlling the monetary impact by setting the required discount for the ration coupons and determining which of the sealed bids met this price. Second, Chile has a well-developed, liquid capital market in which long-term debt instruments are actively traded and which is large enough to allow the central bank to "sterilize" a large volume of swaps.¹⁷⁸

Despite its apparent success, Chile's program has been criticized on several grounds. The most fundamental criticism is that the swaps did not serve the best interests of Chile as a whole, but instead benefitted international and domestic banks and Chilean speculators.¹⁷⁹ Opposition to Chapter 19 swaps focused on three interrelated issues: First, investment through debt-equity swaps brought little "new" money into Chile. The second issue focused on such swaps' lack of additionality. The third issue was that foreign investors seemed to have an advantage over local investors, especially when the transaction involved a buy-out of a privatizing firm instead of a new investment. Such investors received a double-barrelled discount on Chilean equity: First from the discount achieved in the swap itself, and second, from the cheap equity caused by the severe economic recession in Chile.¹⁸⁰

B. Brazil

Brazilian debt-equity swaps date from at least 1978, although interest remained weak until the onset of the debt crisis in 1982, when declining direct foreign investment inflows induced Brazilian authorities to increase interest in debt-equity swaps by introducing tax incentives.¹⁸¹ Swaps were criticized as reducing foreign direct investment into Brazil, and in 1984 the tax credit was abolished and swaps were restricted to those debts held by original creditors.¹⁸² These restrictions greatly reduced foreign interest in the Brazilian swap program, and a new approach was instituted in 1988 with the enactment of Resolution 1460. The chief objective of the new program was reduction of foreign debt, not attracting foreign investment; the flexibility of the program allowed Brazil to convert more than \$2.7 billion in debt in 1988 alone.¹⁸³

178. Hanke, *supra* note 157, at 166-67.

179. U.N. GUIDE, *supra* note 51, at 84-85.

180. WILLIAMSON, *supra* note 154, at 24.

181. The program converted only \$40-50 million between 1978 and 1981. U.N. GUIDE, *supra* note 51, at 9, 74.

182. *Id.* at 9.

183. *Id.* at 74. \$24 billion was eligible for auction conversion at the beginning of the program. *Id.* at 76.

The program was designed to capture the maximum discount at the conversion auctions, and placed minimal restrictions on investment activities. There was no screening procedure for proposed projects, and investment into swap funds was allowed. Capital could not be repatriated for twelve years, but the program imposed no special restrictions on remittance of dividends. The authorities imposed a ceiling of \$150 million on the monthly auctions, and required half of that total for investment in priority underdeveloped regions. By the last auction in 1988, these and other measures allowed Brazil to increase the discount captured for the government from 19.58% to 36.98%.¹⁸⁴ Informal debt-equity swaps and swaps under the more restrictive Circulars 1125 and 1303 also continued to play a role.

Brazil's debt-equity swap programs reveal the dangers of ill-conceived regulations. The restrictions in the early programs caused flows of direct foreign investment to plunge.¹⁸⁵ The 1988 program remedied this problem by yielding to creditors' pressure to relax the rules and administration of the program; direct foreign investment returned to traditional levels, but was accompanied by evidence of "round-tripping" and paper swaps.¹⁸⁶

Critics also blamed Brazil's program for a surge in inflation.¹⁸⁷ Half of the increase in Brazil's money supply was attributed to the "round-tripping" swaps, which also led to an ever wider gap between official and black market exchange rates.¹⁸⁸ Meanwhile, banks accused the Brazilian Central Bank officials administering the swap auctions of corruption.¹⁸⁹ Only after nine months of hyperinflation and allegations of corruption did the Finance Ministry suspend further debt swaps. Brazil's debt-equity swap program resulted in the removal of cash from the country and subsidies for foreign investment that would have been made even without the program.¹⁹⁰

Brazil's experience with swaps imparts three general lessons for other debtor countries.¹⁹¹ First, serious problems result when political factors preclude a stable regulatory and procedural regime for the swap program,

184. *Id.* at 78.

185. *Id.* at 74.

186. *Id.* at 77. Much of Brazil's 1988 debt conversion was converted for "round-tripping," whereby arbitrageurs and banks bought Brazilian debt on the secondary market, swapped it for crusados under an informal conversion program in Brazil, and then sold the crusados for black market dollars to be taken back out of the country. The fact that direct foreign investment returned to traditional levels under this program indicates that the program attracted little additional investment. *Id.* at 79.

187. Cooke, *supra* note 121, at 150.

188. *Id.*

189. *Id.*

190. *Id.*

191. U.N. GUIDE, *supra* note 51, at 79.

because constant changes to the program dissuade potential investors. Second, any program that focuses on reducing foreign debt by capturing the largest discount in the debt auctions will result in too much nonadditional investment and round-tripping, because the authorities give up control over the use of the local currency as the price for the larger discount. Finally, it is very difficult to establish viable debt swap investment funds, even in what was perhaps the biggest stock market in the developing world.

C. Mexico

Debt-equity swaps began in Mexico in the immediate aftermath of the 1982 debt crisis, when multinational corporations began capitalizing debts to subsidiaries without a formal program. After Chile, Mexico was the first Latin American nation to institute a formal debt-equity swap program in July 1986.

Mexico's first debt-equity program was highly structured, with the primary objective of channeling of investment to priority sectors.¹⁹² Mexico offered a variable rate of discount on redeemed debt, based on an elaborate set of priorities devised by the Mexican authorities.¹⁹³ To increase the attractiveness of the program, Mexico did not require any matching funds and did not place restrictions on the remittance of dividends other than requiring that they did not exceed the interest payments that they replaced for the first five years. One major restriction was that foreign investors were generally limited to a forty-nine percent stake in Mexican companies. Mexico tried to limit speculative practices by placing the swap proceeds in a special account and allowing disbursements only after the presentation of proper invoices for investment-related expenses. The program proved very popular, but Mexico cancelled the program in late 1987 for fear of inflationary effects after converting \$2.6 billion worth of debt.¹⁹⁴

Mexico's program was interesting in two other respects. During negotiations for a new money agreement with Mexico's creditors, several banks proved reluctant to provide new loans; Mexico threatened to exclude

192. Mexico was largely successful in this, as illustrated by the sectoral distribution of debt-equity swaps: Tourism, 30%; automotive, 16%; capital goods, 12%; and export zone assembly operations, 11%. *Id.* at 72.

193. For example, investors in high-priority sectors such as privatization or high-technology exports received 100% of the peso value of the cancelled debt, while investors in lower priority sectors received a smaller percentage, down to 75% for low priority investments. Asiedu-Akrofi, *supra* note 92, at 555-56.

194. SWAP GUIDE, *supra* note 57, *Country Chapters: Mexico* at 1. Critics of the program asserted that every \$100 million of converted debt increased inflation by three to five percent. Aseidu-Akrofi, *supra* note 92, at 559-60.

these banks from converting their debt or from participating in any manner in the next debt swap program. Another interesting aspect was the lack of opposition to the program from Mexico's highly nationalistic labor unions and politicians. Mexican authorities successfully presented the program as a mechanism for reducing debt, not increasing foreign investment.¹⁹⁵

Negotiations with creditors led to the reintroduction of a smaller program in early 1990, with a cap of \$3.5 billion in its forty-two month lifespan.¹⁹⁶ To limit the monetary impact of the swap program, Mexico limited the eligible investment to privatization and infrastructure projects. In addition, the program was to be instituted in a series of auctions to allow Mexican authorities the opportunity to adjust the regulations for each new auction. The rules did ease in some respects, however, as foreign investors are now allowed to own 100% of equity in many sectors.¹⁹⁷ Mexico has also implemented an innovative approval system. If a project is small (under \$100 million), funded from abroad, outside a major metropolitan center, expected to keep imports and exports in at least a balance for the first three years, provides job training and permanent jobs, and meets environmental standards, then it does not need governmental authorization. Otherwise, it needs approval by the Foreign Investment Commission.¹⁹⁸ The minimum discount is set at 35%, and there are no restrictions on remittance of profits except for some privatization investments.¹⁹⁹

D. Argentina

Argentina's original debt-equity swap program extended from October 1987 to March 1989, when further swaps were suspended due to currency fluctuations and monetary concerns.²⁰⁰ Reduction of foreign debt seemed to be the primary objective of the program, and the Central Bank succeeded in achieving a steadily increasing discount in swap auctions.²⁰¹ The Argentine program did not impose regional or sectoral priorities on investors, but most projects involved export-generating enterprises in the

195. Asiedu-Akrofi, *supra* note 92, at 556, 559-60.

196. SWAP GUIDE, *supra* note 57, *Country Chapters: Mexico* at 1.

197. Ollard, *supra* note 116, at 69.

198. SWAP GUIDE, *supra* note 57, *Country Chapters: Mexico* at 2.

199. *Id.* at 4.

200. Argentina first attempt at debt-equity swaps began in late 1984, with a program that converted debt into promissory notes that could be swapped for equity. This program converted \$500 million during the year it was in existence. The 1987 program retired \$2 billion in foreign debt and brought in \$390 million in new money. SWAP GUIDE, *supra* note 57, *Country Chapters: Argentina* at 1.

201. In the first auction, the minimum discount of 25% was easily met, with winning bids of 36.69%; the minimum discount was repeatedly set higher, until average discounts reached 77.3% in March 1989. SWAP GUIDE, *supra* note 57, *Country Chapters: Argentina* at 1.

Buenos Aires area. In contrast to Brazil and Chile, Argentina limited eligible investments to new projects that would result in increased production, as opposed to buy-outs or restructurings that merely transferred existing assets²⁰² Argentina also imposed a matching fund requirement to ensure that investors bring in new capital.²⁰³ Argentine companies and individuals were also allowed to participate in the program, helping repatriate flight capital.²⁰⁴ Finally, remittance of dividends was allowed after four years, and capital could be repatriated after ten years.²⁰⁵

Argentina's lack of well-developed, long-term capital markets and unstable inflationary situation precluded the use of long-term bonds to sterilize the capital inflows, so the authorities imposed annual conversion ceilings of \$300 million to \$400 million and allowed swaps in conjunction with the ongoing privatization program.

The program seemed to generate quality investment in the form of new productive capacity before its suspension in early 1989. One criticism of the program, however, was that it was structured to capture the largest possible discount for the Central Bank, but did not allow the authorities to grant conversion rights to truly additional investment. Almost a third of the swaps under the program were directed at investment into agro-industries, where Argentina's comparative advantage would seem to indicate that these swaps merely served to replace normal flows of direct foreign investment.²⁰⁶ By trying to capture the largest possible share of the discount on the secondary market, Argentine authorities authorized virtually all investments and virtually lost control over which projects would actually obtain debt conversion rights. Within the pool of approved investments, the projects that could afford to offer the winning bids were often those that would have been made even without the swap program.²⁰⁷ Another criticism of the Argentine program involved the size of the completed debt-equity swaps. Unlike in Mexico and Chile, most of the swaps in Argentina involved relatively small projects.²⁰⁸ Although foreign investors did not find many large projects in Argentina worth investing in, the auction

202. This feature of the program and the matching fund requirement reduced the participation of international banks, which prefer to swap into a passive equity stake rather than a more active investment posture.

203. Only 70% of an investment could be funded via swaps, with 30% required in new money. SWAP GUIDE, *supra* note 57, *Country Chapters: Argentina* at 2.

204. Ollard, *supra* note 116, at 73.

205. SWAP GUIDE, *supra* note 57, *Country Chapters: Argentina* at 6.

206. U.N. GUIDE, *supra* note 51, at 87-88. In contrast, Chile allowed very little swap activity in its areas of comparative advantage, such as mining, and normal foreign investment flows remained strong.

207. *See id.* at 89.

208. *Id.* at 88.

mechanism also slightly favored small and medium-sized enterprises by imposing a ceiling on auctioned debt that was too low to allow megaprojects.²⁰⁹

Argentina's debt-equity program was revived in the summer of 1990 in conjunction with a new privatization program.²¹⁰ Entel, the Argentine telephone company, was the first company privatized. Sixty percent of the company was sold through debt-equity swaps, with shares going to those bidding the highest face value of Argentine debt.²¹¹ The base price was \$3.5 billion, but investors bid the total up to \$5 billion in debt (purchased for \$1 billion on the secondary market) and an additional \$600 million in new investment. The Argentine airline, Aerolineas Argentinas, was also privatized, with eighty-five percent of the shares going for \$2 billion in debt (purchased for \$400 million). Argentina thus reduced its foreign debt by \$7 billion, or twenty percent of outstanding commercial bank debt, through the sale of only two state-owned companies.²¹²

Since Economics Minister Domingo Cavallo introduced Argentina's privatization program, it has cancelled out \$7.6 billion in debt; by the completion of the program, Argentina will have sold off a list of sixty Argentine enterprises and reduced foreign debt by \$10 billion.²¹³ The federal government has also seen tax revenues increase by sixty percent and has reduced the flow of these tax revenues to the provinces. Cavallo hopes that the private sector will increase productivity and tax revenues enough to improve Argentina's economic position.²¹⁴ Besides increasing Argentina's tax revenues, the privatization has allowed the government to reduce expensive budget subsidies to inefficient state firms. The Argentine authorities helped increase the popularity of the program by diverting some of the proceeds to increase employee pension funds.²¹⁵

E. *Lessons from Latin American Debt-Equity Swap Programs*

Latin America's experience with debt-equity swaps provides valuable lessons for those considering a debt-swap program in other countries.

209. *Id.* at 86.

210. SWAP GUIDE, *supra* note 57, *Country Chapters: Argentina, Debt-Equity Swap Update (August 1990)*.

211. This procedure was intended at least in part to avoid the practical and political difficulties of valuating the assets of the privatizing enterprises. WOONKI SUNG & ROSARIA TROIA, DEVELOPMENTS IN DEBT CONVERSION PROGRAMS AND CONVERSION ACTIVITIES 35 (World Bank Technical Paper No. 170, 1992).

212. *Id.*; WILLIAMSON, *supra* note 154, at 56.

213. Danielle Robinson, *Argentina Banks on the Market*, EUROMONEY, Sept. 1992, at 143.

214. *Id.*

215. *Id.*

Besides illustrating the general features common to most debt-equity swap programs, the Latin American experience demonstrates how to reinforce the positive aspects of a debt-equity swap program. Most debt-equity swap programs are similar in their goals, investor incentives, and ultimate consequences.²¹⁶

1) Goals

First, achieving rapid debt reduction through an early rush of deals is usually unwise in debt-equity programs because the debtor country is merely attracting nonadditional investment at the cost of incurring large long-term foreign exchange liabilities.

Second, debt-equity swaps are most important to countries seeking to win back the confidence of creditors and investors in order to regain access to international capital markets. However, debtor countries must be careful not to implement a swap program before the necessary degree of economic stabilization has occurred and should ensure that the debt conversions are limited to sustainable volumes. Efforts to improve relations with creditors and investors could be hampered by an excessive emphasis on increasing the benefits accruing to the host country.

Third, debt-equity swaps can play a major role in a privatization program. Such transactions are non-inflationary and may ease some political problems of privatization by allowing foreign investors to pay a higher local currency price for the enterprise. Governments can help by reducing the secondary market discount that they retain for themselves. For example, Mexico redeemed debt at full face value for privatization investments. Other countries forbid privatization swap transactions or prohibit investors from acquiring majority stakes through swaps.²¹⁷

2) Investor Incentives

a) Debtor governments can enhance the additionality of the new investments by promoting export and nontraditional sectors and by limiting the use of swaps to finance buy-outs of existing enterprises or limiting investment into sectors where the country has a competitive advantage.

b) Debt-equity swaps offer particularly attractive investment incentives because they can be large and are up-front discounts, unlike most financial

216. WILLIAMSON, *supra* note 154, at 65.

217. Some debtor countries prohibit or restrict swap transactions in privatization programs because they are loath to give up major stakes in state-owned enterprises to foreigners at the discounted fire-sale prices attainable in many debt-equity swap programs. JOEL BERGSMAN & WAYNE EDISIS, *DEBT-EQUITY SWAPS AND FOREIGN DIRECT INVESTMENT IN LATIN AMERICA*, 16 (1988).

incentives, which are either delayed or dependant on uncertain future events.²¹⁸ Debt-equity swaps are particularly attractive for multinational corporations because the swap grants them the equivalent of an up-front cash grant which reduces the amount the investor places at risk and lowers the required rate of return.

c) Debt swap programs are more likely to encourage export-oriented investment, while investment aimed at domestic markets tends to be based upon strategic considerations and will be made with or without the debt swap program (i.e., such investment is "nonadditional"). Investment decisions on projects aimed at the domestic market are chiefly determined by strategic market considerations, and companies will only invest for "sound business reasons" despite incentives offered by swap programs. In addition, up-front incentives have greater effect on export-oriented manufacturing (as opposed to resource extraction) projects because costs are generally more important to export projects as competition in world markets generally does not allow investors to pass on high costs to consumers.

d) The effects of swap programs on banks are quite different from their effects on multinationals. Almost all debt swaps by banks are additional, in that banks would not otherwise make equity investments.²¹⁹

e) Reasonable restrictions on the amount and timing of dividends and repatriation of capital should not seriously reduce the attractiveness of the program. Most investors that choose to participate in the program are in the country for the long haul. Moreover, such restrictions will improve the country's short-term balance of payments and divert some nonadditional investment back into conventional investment channels.²²⁰

3) Consequences

a) Countries without well-developed, long-term capital markets must be especially wary of the inflationary effects of swaps. They must sterilize the inflationary impact of debt conversions by setting conversion ceilings and tying them in to privatization programs. Mexico, Brazil, and Argentina are all examples of large economies that were unable to implement large-scale debt conversion programs because their underdeveloped capital markets proved unable to absorb the long-term bonds necessary to sterilize the monetary impact of the swaps.²²¹

218. *Id.* at 5.

219. *Id.*

220. *Id.* at 25.

221. WILLIAMSON, *supra* note 154, at 61.

b) Debt swaps facilitate the development of the private sector in the debtor country by channelling investment capital into productive use in the private sector, by generating fees for the local financial sector, and by instilling confidence in the overall investment climate.

c) Successful debt-equity swap programs are "self-terminating" in that investors drive up the price of the debt on the secondary market and bid up the discount granted to the debtor government as the stock of debt available on the secondary market is reduced. Investors lose interest in the program when rising secondary market prices and growing debtor government discounts converge, thus eliminating the investor's financial incentives.

d) Attempts to channel investment into priority sector risk evoking corruption and favoritism during the selection process. Moreover, government intervention in the screening process might frustrate efforts to maximize the benefits of free enterprise in the debtor country.

e) Debt conversions that allow domestic investors to participate on roughly the same footing as foreigners will draw back flight capital and reduce the swaps' future foreign exchange costs.

f) Debt-equity swaps, in addition to reducing debt, will either cost the government foreign exchange (if the investment was not additional) or require an increase in domestic currency (if the investment was additional), but not both. If the swap investment is not additional, the swap program will not have inflationary effects. In other words, a swap program leads to inflationary impacts only to the extent that investments made under the plan would not have happened without the swap program.²²²

g) In countries with underdeveloped capital markets and a shortage of long-term financing for industrial expansion, swaps can provide an excellent source of long-term finance. Local companies can either approach creditor banks, or may use their own hard currency reserves to purchase debt on the secondary market. In countries with more developed capital markets, such as Chile, a more common transaction is one in which the creditor bank will offer to finance most of the investment of a suitable foreign company in the debtor country if it can find a suitable enterprise.²²³

h) Initial observers expected that developing countries would only be able to absorb a limited number of swap transactions before all of the country's interesting investment possibilities were sold. Experience has shown however, that a proper swap program will create new productive capacity, not just transfer ownership. In fact, an attractive swap program in an investment-friendly economic environment will generally attract more investors than the debtor government may want, at least until the depletion

222. BERGSMAN & EDISIS, *supra* note 217, at 6.

223. *Id.* at 17.

of debt stock drives up secondary market prices.²²⁴

i) Additionality increases with the duration of the swap program as investors become aware of the benefits and possibilities of the swap program.

j) Swaps executed through buy-outs or financial restructuring are generally followed rather quickly by improvements or additions to productive capacity or management.²²⁵

k) Debtor countries should allow the participation of domestic investors because to prohibit their participation arouses resentment and political opposition to economic privileges granted to foreigners. Moreover, investments by domestic investors are less likely to generate future foreign exchange outflows.²²⁶ Debt swaps might provide domestic industry with access to long-term financing that might otherwise be unavailable due to underdeveloped capital markets. Allowing domestic participation will also facilitate the repatriation of flight capital.²²⁷ Finally, domestic investors will ultimately find a way to participate regardless of restrictions, through offshore corporations or other means.²²⁸

F. Means of Achieving Program Goals

An IFC study evaluated Latin American debt swap programs to determine the best means to achieve three possible debt swap objectives: (1) increasing additional investment; (2) channeling investment into high-priority sectors or regions; and (3) reducing the debt burden to the maximum extent by securing a larger share of the secondary market discount for the debtor government.²²⁹ The IFC's conclusions are discussed below.²³⁰

1) Increasing Additionality²³¹

a) Countries should keep incentive levels high for all eligible investors, but should prescreen for obviously nonadditional investments,²³² because

224. *Id.*

225. *Id.* at v-vii.

226. SCHILLING, *supra* note 136, at 4.

227. *Id.*

228. BERGSMAN & EDISIS, *supra* note 217, at 24.

229. *Id.* at vii.

230. *Id.* at 23-25.

231. "Additionality" is a tricky concept to define, particularly considering that even if one investor might not have made the investment without a debt-equity swap, another investor might have. The IFC study uses additionality to mean that the particular investor would not have made the investment without the swap program. Moreover, sometimes swap programs might not have induced the investor to make the investment, but may have influenced the timing or amount. This can be referred to as "partial" additionality.

232. Some governments try to increase additionality by conducting negotiations with

some degree of screening potential investments is worthwhile to prevent round-tripping and to increase additionality. Screening investments for priority regions or sectors can also be worthwhile, especially to encourage export-oriented investment. Authorities should not attempt, however, to screen investments according to their merits, except to weed out egregiously illegitimate or exploitative projects because the authorities lack the time and the experience to conduct full-blown qualitative evaluation.²³³ Screening should be restricted to the extent possible to reduce the impact of corruption and red-tape.²³⁴ Some swap programs tend to restrict the use of swaps for buy-outs and restructurings on the grounds that they do not involve substantive improvement in productive capacities. Screening out buy-outs and financial restructurings will probably prove counterproductive, given their potential for follow-on investment. Research has shown that buy-outs and restructurings often lead to improved management or simply allow the firm to consider future investments and improve its balance sheet.²³⁵ Moreover, most of these transactions are additional and are noninflationary if the central bank has assumed private debt.²³⁶

b) Countries should maintain continuity in the program for a long period. The projects during the first several months of the program will have been planned before its inception and thus cannot be considered additional. However, the additionality of later investments will rise as investors start seeking investment opportunities to take advantage of the swap program.²³⁷

c) Countries should consider restricting the swap program to export investments or at least subjecting proposals for export projects to less stringent screening.

individual investors instead of by allocating conversion rights through auctions. This is probably a fallacy because governments can always prescreen for obviously nonadditional investments before holding auctions, and because government officials will never be able to determine exactly which investments are additional. Thus, they should merely hope to screen out obviously nonadditional investments. BERGSMAN & EDISIS, *supra* note 217, at 20.

233. SCHILLING, *supra* note 136, at 26–27.

234. See BERGSMAN & EDISIS, *supra* note 217, at 25.

235. The IFC noted the following example:

A foreign investor was prepared to close down a heavily indebted manufacturing subsidiary. Instead, when a conversion program became available, the parent company elected to use a debt-equity swap to repay the subsidiary's loans. The parent was then able to find a buyer for the recapitalized company, selling it to a new foreign investor who had a more specialized knowledge of the industry and who was committed to making the plant succeed. Although the swap transaction itself did not create new productive capacity, it nevertheless made the difference between the life and death of the enterprise.

Id. at 13.

236. *Id.* at 15.

237. *Id.* at 11–12.

d) Countries should also encourage banks to participate in the swap program, perhaps through investment funds financed with swap proceeds.²³⁸ Banks are particularly likely to prefer buyouts, where they generally act as silent partners or bring in another foreign company to run the enterprise. Generally banks would like some sort of preferred status, whereby they limit their risk and agree to corresponding limitations on their profits.²³⁹

e) Finally, countries should establish reasonable timing restrictions on repatriation of dividends and capital.

2) Channeling Investment Into Priority Sectors or Regions

Countries should screen proposals to eliminate low-priority investments, and should consider creating normal and "super" incentives to apply to normal and high priority projects. They should avoid creating a "low" priority set of incentives, because the investments attracted by the lower grade of incentives are "nonadditional" and deserve no incentives at all. Attempts to create "fine-tuned" graduated incentives will probably fail to channel investment into the desired area.

3) Capturing a Larger Share of the Secondary Market Discount for the Debtor Government

a) Countries should use auctions to set discount rates. Competitive bidding for debt conversion rights will secure the debtor government whatever discount rate the market will bear.

b) Countries should allow participation of domestic investors in order to draw their flight capital into the debt swap program. Participation of the domestic investors will make the bidding for debt conversion rights more competitive and thus increase the government's share of the secondary market discount.

c) Countries should not screen out too many proposals. The fewer projects which are approved, the fewer investors there are, resulting in weaker bidding.

d) Finally, countries should not impose new money requirements. Fresh

238. In most debt swaps, corporate investors "want to get rich, while banks want to get out." The banks are not excited about the prospect of taking on risky equity stakes and would prefer that any debt swap look more like debt than equity. Banks with a strong merchant banking tradition have been more accepting of taking on equity. Banks are most reluctant to commit new money, even in local currency, to an equity investment. Even without a formal new money requirement, most foreign investment requires at least some machinery or equipment to be brought in from abroad, which cannot be financed by swaps. Mutual funds in the debtor country are attractive to smaller banks that lack the resources to select or manage individual projects. The IFC concludes that greater involvement by banks might be the single best means of achieving higher additionality. *Id.*

239. *Id.* at 8-9.

money requirements are unpopular with investors and drive down the debt in the secondary market, thus decreasing the secondary market discount captured by the government. A government would be better advised to refrain from new money requirements and to seek the benefits of greater discounts.²⁴⁰

IV. RUSSIA'S DEBT

Russia's transition from a command to a market economy faces daunting obstacles. While official aid and development assistance are beginning to trickle into Russia, these resources are limited and will not satisfy Russia's vast need for investment. Private sources of capital must augment official programs, but have thus far been reluctant to take advantage of Russia's investment opportunities because of the uncertain political and economic climate. An economic advisor to the Russian government warns that "without finance for new developments, there will be an economic and political catastrophe."²⁴¹ Perhaps the debt-equity swap can provide a partial solution.

A. Financing Investment in Russia

Russia's financing requirements in 1992 totalled about \$23 billion,²⁴² with estimates for 1993 running at about \$30 billion.²⁴³ The IMF estimates that the FSU will require up to \$100 billion in economic assistance over the next four years alone. In real terms, this represents more than twice as much as Western Europe received under the Marshall Plan.²⁴⁴ These huge figures do not include all the capital resources necessary to rebuild

240. *Id.* at 23.

241. *A Few Dollars More*, *ECONOMIST*, Apr. 10, 1993, at 51, quoting Richard Layard, a British economist advising the Russian government.

242. The figure includes a merchandise trade deficit of \$2-3 billion; a service deficit, excluding interest payments, of around \$2 billion; debt service payments of about \$12 billion, including arrears; foreign exchange reserve accumulation of \$1.6 billion; and about \$5 billion to compensate for short term outflows in 1992. *THE WORLD BANK, RUSSIAN ECONOMIC REFORM: CROSSING THE THRESHOLD OF STRUCTURAL CHANGE* 49-50 (1992) [hereinafter *RUSSIAN ECONOMIC REFORM*].

243. *Id.* at 50. The IMF estimates that in 1993, Russia will need \$22.2 billion for imports and another \$8 billion for debt relief. Steven Mufson, *Shake-Up in Russia Worries Western Advisors and IMF*, *WASH. POST*, Dec. 16, 1992, at F1.

244. Nicholas Eberstadt, *Wrongheaded Aid to Russia*, *WALL ST.J.*, Sept. 1, 1992, at A14. The figure could, of course, be much higher; based on German levels of investment into East Germany, economic aid to the FSU would require more than \$2 trillion annually. In a rare moment of agreement with the IMF, President Yeltsin also chose a figure of \$100 billion, which represents the amount actually injected into East Germany. Alan Riding, *19 Western Nations Give Russia an Extra 10 Years to Repay Debt*, *N.Y. TIMES*, Apr. 3, 1993, at A4.

Russia's shattered economy.²⁴⁵ Privatization in the FSU alone is estimated as requiring up to \$500 billion in the next several years, but Russia and the other republics must compete against more attractive investment climates in Eastern Europe, Latin America, and Southeast Asia for every investment dollar.²⁴⁶ Moreover, other sectors of the Russian economy must compete for investment dollars against the lucrative oil industry, which could consume \$25 billion in capital investment per year.²⁴⁷ Despite this enormous need for capital, there are very few sources of financing for investment projects in Russia, particularly those that do not generate hard-currency.²⁴⁸

In the short term, foreign direct investment will not play a major role in financing projects in Russia because most Western companies interested in investing in Russia are reluctant to commit capital until fundamental legal, economic, and political issues are resolved.²⁴⁹ Large-scale foreign direct investment will not occur until Russia succeeds in establishing a stable business climate.

Russia is also finding it increasingly difficult to get commercial loans due to its debt service problems. International commercial banks are unenthusiastic about extending loans to Russia without an official guarantee. Sometimes even an official guarantee is no help. One banker explained that banks remain unwilling to take on even limited risk or "put loans on their books on which they might wind up not earning any money" even if one hundred percent of the principal and a large portion of the interest is guaranteed.²⁵⁰ The supply of unguaranteed, voluntary private lending will likely be "insignificant" for the foreseeable future.²⁵¹

Russia's domestic banking and credit system cannot begin to supply the capital necessary to rebuild Russian industry. Although 3,000 commer-

245. One estimate puts Russia's annual foreign investment needs at between \$40 billion and \$50 billion. *Investment Needs for a New Russia are Mostly Unmet*, N.Y. TIMES, Dec. 14, 1992, at A1, Column 6.

246. William R. Rhodes, *Latin Lessons for the Russian Economy*, WALL ST. J., Sept. 21, 1992, at A12.

247. *Attali Warns Russia on Stifling Oil Industry*, E. EUR. FIN., Feb. 16, 1993, at 12.

248. Some sources suggest that Russia's investment needs might not be quite so overwhelming. The Economist notes that the dollar value of the economic output of Russia's 147 million citizens is only slightly greater than that of Singapore's 3 million inhabitants. *A Few Dollars More*, *supra* note 241, at 51.

249. RUSSIAN ECONOMIC REFORM, *supra* note 242, at 50. U.S. companies have now provided the largest amount of direct foreign investment in Russia, with approximately \$400 million invested in 1992. In addition, the number of U.S. companies with offices in Moscow has increased almost ten-fold in the past several years, to almost 300. *U.S. urges Immediate Repayment of Russian Arrears on U.S. Goods*, DAILY REP. FOR EXECUTIVES (B.N.A.), Mar. 8, 1993, at A-7.

250. James R. Kraus, *Bankers Applaud Russian Aid, But Remain Cool to Lending*, THE AMERICAN BANKER, Apr. 7, 1992, at 6.

251. RUSSIAN ECONOMIC REFORM, *supra* note 242, at 50.

cial banks have opened in Russia recently, most "are not capable of extending a loan with a maturity of more than 12 months" due to inflation and political uncertainties.²⁵² Although Russian banks control more than \$15 billion in hard currency accounts abroad, they have lent only three percent of that sum in Russia.²⁵³ The development of a viable banking system in Russia is crucial to the success of its free-market reforms.

The only real source of capital for major foreign direct investment has been official bilateral and multilateral aid in the form of loans, loan guaranties, and insurance. The European Bank for Reconstruction and Development (EBRD) will invest \$1.5 billion in Russia in 1993 into joint projects with other lending organizations which are providing an additional \$8.5 billion.²⁵⁴ In fiscal 1992, the Overseas Private Investment Corporation²⁵⁵ (OPIC) financed between three and five private sector projects worth approximately \$125 million, and provided another \$73 million in political risk insurance. The limited amount of capital available, however, means that projects in the oil and gas sector and in other export sectors can get financing only by starving other worthy projects of capital — smaller, riskier projects or those offering returns in local currency have no access to credit. Also, both organizations are currently geared toward making large loans but are hoping to establish enterprise funds to finance small and medium-sized businesses. Besides these project finance programs, Western nations and multilateral organizations have extended humanitarian aid and general economic assistance to Russia, both of which are discussed below.

B. Russia's Debt Problem

Russia's inability to find financing to rebuild its industry stems in large part from its \$80 billion in debt to Western governments, commercial banks, and multinational institutions. Russia's severe debt problems arose under Mikhail Gorbachev's tenure during the last few years of the Soviet Union.²⁵⁶ Soviet financial apparatchiks squandered all of the Soviet Union's foreign currency reserves while neglecting investment into key export industries such as oil. The consequent lack of foreign exchange reserves forced the

252. Leyla Boulton, *A Fragile Banking System Takes Root*, FIN. TIMES (London), Mar. 13, 1992, at 1, 28.

253. A Western banker commented that if he were a Russian banker, he would do the same, "because there are few alternatives to placing the money abroad. Lending is risky because you don't know if the person will disappear tomorrow or whether new legislation will come along to ruin the project." *Id.* at 1.

254. *Russia: EBRD to Invest \$1.5Bn in 1993*, NOVECON ECOTASS, Apr. 5, 1993, 3.

255. OPIC is a U.S. government-owned corporation that provides financing and political risk insurance for U.S. investing in developing countries.

256. *Russia's Debt: Burdensome*, ECONOMIST, Apr. 3, 1993, at 74-75.

Soviets to vastly increase foreign borrowing, which doubled to \$75 billion in the five years up to mid-1992.²⁵⁷ Gorbachev's ministers foolishly failed to stagger the maturities on the loans, which are now all falling due together.²⁵⁸

Russia's debt problems are of recent vintage. As late as mid-1991, the Bank Vneshnekonomichekoi Deyatelnosti (Bank of Foreign Economic Activities, or VEB), which handled most of the FSU's estimated \$80 billion debt, had a flawless debt-service record.²⁵⁹ In 1987, the Soviet Union's sterling credit rating allowed it to successfully place its first foreign bond issue since 1917 in Switzerland, followed in 1988 by a bond issue in West Germany at a lower interest rate than equivalent domestic borrowing by the West German government.²⁶⁰

Due to huge increases in the amount of external debt and declining hard currency revenues, the past two years have seen a major liquidity problem,²⁶¹ causing the VEB to suspend hard currency payments in December 1991.²⁶² Until 1985, Soviet external debt was made up primarily of suppliers' credits and commercial bank financing for imports.²⁶³ Foreign borrowing was tightly controlled. The "perestroika loans" in the late eighties were coupled with a decentralization of foreign borrowing decisions. In April 1989, thousands of Soviet state enterprises were authorized to engage in foreign trade and finance on their own account, without permission from the center. The short-term debt of these enterprises jumped by \$6.5 billion in 1989 alone. This decentralization of external financing decisions led to payment problems almost immediately: although the Soviets managed to service all medium-term debt in 1990, short-term debt owed by state enterprises fell into partial arrears.²⁶⁴

Although the FSU is only moderately indebted relative to GDP,²⁶⁵ debt service payments consumed thirty-seven percent of Russian export earnings in 1992, consuming valuable hard currency necessary for supporting

257. WORLD DEBT TABLES, *supra* note 2, at 36.

258. Almost 52% of the total debt stock falls due between 1993 and 1995. *Id.* at 29.

259. David Fairlamb, *Moscow's Financial Crisis*, INSTITUTIONAL INVESTOR, Jan. 1992, at 82.

260. ILIANA ZLOCH-CHRISTY, EAST-WEST FINANCIAL RELATIONS 35 (1991).

261. Principal payments jumped from an annual \$5 billion to \$6 billion between 1985 and 1988, to \$19 billion in 1990. WORLD DEBT TABLES, *supra* note 2, at 29-31.

262. From January to September of 1992, the Russians only paid \$500 million of the \$3 billion that had fallen due. *Sorting Out Russia*, ECONOMIST, Sept. 26, 1992, at 98.

263. At the end of 1985, more than \$16 billion of the USSR's total of \$29 billion in debt consisted of these trade finance obligations. WORLD DEBT TABLES, *supra* note 2, at 29.

264. *Id.* at 31.

265. Until 1989, the Soviet Union's debt burden was below the average of that of moderately indebted developing countries as a whole. *Id.* at 29-30.

economic reforms in Russia.²⁶⁶ Russia has sought to alleviate its debt problem through rescheduling, but in November 1992, President Yeltsin stated that short term rescheduling of Russian debt would not be sufficient and that full-scale restructuring and mechanisms such as debt-equity swaps would prove necessary to solve the debt problem.²⁶⁷ In July 1993, Russia's first deputy premier and economics minister, Oleg Lobov, believed that the debt issue could be resolved in two ways: either by consolidating the debts with a Russian governmental undertaking to repay them; or by selling shares of privatizing Russian enterprises to German firms.²⁶⁸

Estimates vary as to the exact size and composition of Russian debt. The best guess is that Russia currently owes \$80 billion, with \$40 billion of official loans owed to the Paris Club of Western governments,²⁶⁹ \$20 billion to the London Club of commercial creditors,²⁷⁰ and the remaining \$20 billion to multilateral organizations.²⁷¹ Of the \$1.18 billion in interest owed to banks and official creditors in the first five months of 1991, only about \$50 million was paid to banks, with another \$120 million to official creditors. The unpaid \$1 billion in interest was split between banks and

266. RUSSIAN ECONOMIC REFORM, *supra* note 242, at 55.

267. Patrick Worsnip, *Yeltsin Asks Understanding for Russian Debt Problems*, THE REUTER ASIA-PACIFIC BUSINESS REPORT, Nov. 9, 1992, available in LEXIS, News Library, Wires File.

268. *Russian First Deputy Premier on Russia's Debts to Germany*, BBC SUMMARY OF WORLD BROADCASTS, July 22, 1993, at A1.

269. The Paris Club debt can be partially broken down by country: Germany, \$18 billion; Italy, \$5.3 billion; the United States, \$4 billion; France, \$3 billion; Britain, \$1.7 billion; Canada, \$1.5 billion; and Finland about \$1 billion. *G-7 Offers to Delay Russia's Foreign Debt Repayments at A40; EBRD Could Play Pivotal Role in Promoting Debt Relief Via Swaps*, EBRD WATCH, Mar. 23, 1992, at 1; Eric Beauchesne, *Yeltsin Shocks G7 with Offer to Swap Debts for Russian Industries*, THE GAZETTE (Montreal), July 9, 1992, at A11; *Focus on the CIS*, 21 BUS. E. EUR. 575 (1992).

270. One estimate puts Russian debt to commercial banks at \$22.7 billion. Terence Roth, *Western Banks to Roll Over Ex-Soviets' Debt, Again*, WALL ST. J. EUR., June 24, 1992, § 2, at 9. German banks are Russia's chief creditors, holding about \$21 billion in debt, of which about 20% (\$4.2 billion) is not guaranteed by the German government. The largest commercial creditor is believed to be Deutsche Bank A.G., Germany's biggest bank, with \$632 million in unguaranteed debt. Ferdinand Protzman, *Debt for Equity in Rubles*, N.Y. TIMES, Aug. 9, 1992, at C10. French banks hold between \$3.7 billion and \$4.6 billion in Russia's private debt. Alice Rawsthorn, *Russia and the G7: French Commercial Banks Oppose Rescheduling of Russian Debt*, FIN. TIMES (London), Apr. 16, 1993, at 4.

271. Riding, *supra* note 244, at 4. Another source places Russian debt at about \$70 billion, with \$34.3 billion owed to the Paris Club, \$4.1 billion to other official creditors, and \$31 billion with the London Club of Commercial creditors. *Russian Debt Talks Stall as Aven Leaves*, TRADE FIN., Jan., 1993, at 20. Other estimates of Western commercial bank exposure is \$16 billion. *Sorting out Russia*, *supra* note 262, at 97. One estimate puts total Russian debt as high as \$86 billion. *Kohl Grants Debt Relief to Russia and Offers Confidence in Yeltsin*, N.Y. TIMES INT'L, Dec. 17, 1992, at A14.

official creditors, \$600 million to \$400 million.²⁷² One major problem is that Russian exporters have not been complying with the Russian government's requirement that they transfer a certain portion of hard currency proceeds into official accounts for conversion into rubles.²⁷³ Debt service for 1993 is put at \$18.3 billion of principal and interest, most of which has been rescheduled under a Paris Club rescheduling agreement reached in April 1993. The debt that is being paid is mainly short-term bonds and import credits for essential items.²⁷⁴ As part of a more comprehensive multilateral aid package, the United States is pushing for comprehensive rescheduling and restructuring agreements to include some amount of debt forgiveness.²⁷⁵ Germany resists debt relief because it holds more than half of official debt to the FSU, and its commercial banks hold most of the commercial debt.²⁷⁶ Moreover, German Chancellor Helmut Kohl granted \$11.2 billion worth of debt relief to Russia in December 1992.²⁷⁷ In July 1993, Russia and Germany reached an agreement on the terms of Russia's DM30 billion debt to Germany "in the framework of the Paris Club and London agreement." This figure does not include the DM2 billion owed to German companies by Russian firms which is not guaranteed by the Russian or German governments.²⁷⁸ Sources indicate that the German banks, holding most of Russia's unguaranteed London Club debt, were

272. Banks are interested in punctual interest payments because such payments are necessary to keep the Soviet debt on their books as performing assets. Roth, *supra* note 270, at 9.

273. *Id.* at 9.

274. *Russian Debt Talks Stall as Aven Leaves*, *supra* note 271, at 20.

275. The eagerness of the United States to restructure Russia's debt is probably attributable at least in part to the fact that the United States has little official debt to the FSU other than in agricultural credits. In early 1993, U.S. official exposure to Russia stood at a mere \$4 billion, only \$1 billion of which is subject to rescheduling in 1993. Approximately \$3 billion of that total was in agricultural credits. *Sorting out Russia*, *supra* note 262, at 98. At the end of 1992, Russia was suspended from the USDA agricultural loan guarantee program for defaulting on payments under the program. Russian chess master and political figure Garry Kasparov argues that the United States should forgive Russian debt, because the debt issue gives the government's opponents a political stick to beat it with. Moreover, Egypt's \$7 billion in debt was forgiven for its participation in the Persian Gulf War. What about Russia's 30,000 nuclear warheads?

276. At the negotiations, a German Foreign Ministry official sniffed that Germany's allies "in Washington, London, and Paris are very gracious in their willingness to spend more German money" by forgiving Russian debt. Jerry Knight, *West Lets Russia Defer Repayment of Its Debt*, WASH. POST, Apr. 3, 1993, at A1, A18. Even the rescheduling agreement cost Germany about DM8 billion. Judy Dempsey, *After the Summit: Cri de Coeur from Kohl on Burden-Sharing*, FIN. TIMES (London), Apr. 6, 1993, at 4. In return for the rescheduling, however, Yeltsin renounced Russia's DM18 billion claim on Germany for Soviet military facilities located in Eastern Germany. *Russia, Biggest Creditor Agree; Paris Club is Next*, E. EUR. FIN., Feb. 2, 1993, at 18.

277. *Kohl Grants Debt Relief to Russia and Offers Confidence in Yeltsin*, *supra* note 271, at A14. German banks still have \$11 billion in bad loans. *No Rush for Banks in Moscow*, E. EUR. MARKETS, Feb. 19, 1993, available in LEXIS, News Library, EEM File.

278. *Russian First Deputy Premier on Russia's Debt to Germany*, *supra* note 268, at A1.

eager for an agreement "at any price," with Deutsche Bank leading the rescheduling efforts.²⁷⁹

Russian debt negotiations have been hampered by disagreement between Russia and Ukraine over their respective obligations to repay the Soviet Union's debt.²⁸⁰ The terms of the Debt Allocation Treaty of December 1991 require Russia to pay 61.3% of the Soviet Union's debt, and the Ukraine to pay 16.4% of the debt.²⁸¹ Russia has proposed to assume all of the debt liabilities of the Soviet Union in return for all of its assets and claims abroad. Although the other republics agreed to this proposal, Ukraine believed its share of the Soviet assets abroad to be greater than its share of the debt and refused to sign.²⁸² Moscow and Kiev have been engaged in intensive negotiations and are set to resolve the issue soon.

The Paris Club has provided what is perhaps the most generous and useful aid to Russia by rescheduling \$17 billion of Russia's \$20 billion in debt service obligations falling due in 1993. This rescheduling relieves Russia of the necessity to pay out a substantial portion of the money that it has received in foreign aid to service its debt. Russia's agreement with the Paris Club in April requires repayment of \$1.9 billion of the \$17 billion due to the Paris Club in 1993. This is still a large sum,²⁸³ but the agreement with the Paris Club will allow Russia to seek new loans and has allowed rescheduling of Russia's London Club debt. The agreement also provides that some of the debt will be converted into tradeable notes and bonds, which will help develop the secondary market for Russian debt and will help facilitate debt-equity swaps.²⁸⁴

Although the standard Paris Club restructuring scheme would have required Russia to pay \$13 billion in 1993, Russia insisted on nonstandard treatment due to its unusual debt situation in that an agreement for joint and several liability for the Soviet Union's debt had been signed by the republics. However, with the dissolution of the Soviet Union, only Russia was willing to assume full liability for all of the Soviet Union's debt. Russia sought to ensure that all debts incurred in 1992 were being serviced, but

279. Steve Liesman, *Debt Rescheduled After Banks Hear Russia's Poverty Plea*, INTER PRESS SERVICE, Aug. 3, 1993, available in LEXIS, News Library, Wires File.

280. *Russia's Debt: Burdensome*, *supra* note 256, at 74.

281. *Id.*

282. *Id.*

283. Jeffrey Sachs, a Harvard University professor and advisor to the Russian government, notes that an equivalent payment for the United States, based on its larger economy, would be \$240 billion. Sachs also referred to Russia as "basically a financially bankrupt country right now." Knight, *supra* note 276, at A18. Before rescheduling, another \$3.5 billion in London Club debt payments were due in 1993. See *infra*, note 287.

284. Liesman, *supra* note 279.

was less eager to pay the debt incurred by the Soviet Union in 1991.²⁸⁵ Russia argued that for it to pay much more than \$2.5 billion would increase Russia's budget deficit dramatically, and, more importantly, would force Russia to divert hard currency-earning exports, such as oil from the former republics to hard currency markets to earn hard currency needed to service its debt. This would have devastating economic effects on the other republics of the FSU. Negotiators eventually agreed to Russia's lower repayment schedule. In another break from standard policy, the Paris Club rescheduled Russia's debt before Russia concluded a standby agreement with the IMF, which is expected by October 1993.²⁸⁶ The Paris Club agreement does not cover the interest on the \$20 billion that Russia owes to private creditors in the London Club.

In late July 1993, Russia reached an agreement with the London Club of creditors on terms similar to those of the Paris Club. Russia owes approximately \$24 billion to 600 members of the London Club. Under the agreement, Russia will repay only \$500,000 of the more than \$3.5 billion it owed to Western commercial banks in interest payments for 1992 and 1993. The remaining interest payments have been rescheduled and spread out over ten years, with a five-year grace period. Russia will repay its London and Paris Club creditors less than \$3 billion of its foreign debt in 1993, up from \$1.8 billion in 1992.²⁸⁷ The \$24 billion in principal has also been deferred and must be repayed in a fifteen year period after a five-year grace period. In 1994 and beyond, Russia will be expected to make undetermined annual interest payments.²⁸⁸

Although Russia has now reached agreements with both the London and Paris Clubs, some nonmember creditors are still demanding payment in full. On July 30, 1993, South Korea announced that it was expecting \$1.5 billion in debt payment from Russia despite Russia's claims of "economic difficulty."²⁸⁹

Even after the Paris and London Club agreements, Russia is unlikely

285. In a speech at London's Stock Exchange in November 1992, Yeltsin argued that the cut-off date for rescheduling Russian debt should be changed from January 1, 1991 to December 8, 1991, the date the Soviet Union ceased to exist. Germany has strongly resisted such a change because it would exclude the large sums loaned by them to the Soviet Union in 1991. Yeltsin proposed that the Soviet Union's 1991 debt should be treated in a special agreement. *Yeltsin Pushes for Rescheduling Of Soviet Debt Owed to the West*, WALL ST. J., Nov. 10, 1992, at F9.

286. Leyla Boulton, *High Hopes in Russia of IMF Accord*, FIN. TIMES (London), Apr. 7, 1993, at 3.

287. Liesman, *supra* note 279.

288. *Id.* French banks opposed attempts to reschedule Russia's \$20 billion in private debt until Russia stabilizes its economy and curbs corruption. Rawsthorn, *supra* note 270, at 4.

289. *One More "Credit of Trust" for Russia*, REUTER TEXTLINE, Aug. 4, 1993, available in LEXIS, News Library, Wires File.

to prove capable of servicing its debt without further debt relief. In August 1993, a Russian official revealed that Russia intended to request debt forgiveness similar to that granted to Poland, where the Paris Club effectively forgave half of the outstanding debt. Noting that Russia would have to allocate half of its export earnings for the rest of the century to debt repayment, the official simply stated that "Russia will not be able to fulfill its debt obligations."²⁹⁰

Besides these restructuring agreements, Russia needs to devise a means of staunching the flow of flight capital from Russia. Estimates put flight capital during 1992 at \$13 billion, more than the Western aid received by Russia.²⁹¹

In addition to debt reduction, Russia has also received multilateral and bilateral general economic aid.²⁹² At the Group of Seven (G7) meeting in Tokyo in April 1993, the Russians received pledges for an aid package of \$49 billion, \$43.4 billion of which came in the form of multilateral assistance.²⁹³ Although the United States and Japan contributed about \$1.8 billion each to the package, the other G7 members declined to extend additional bilateral aid because of their own domestic economic problems and their doubts that Russia could use the aid effectively.²⁹⁴ The G7 aid package included \$4 billion in initial "fast-track" loans from the World Bank and IMF, \$10 billion for long-term stabilization programs, and \$14 billion for structural reforms and essential imports, including \$300,000 for an EBRD small and medium business enterprise fund.²⁹⁵ The United States earmarked \$500 million of its package for investment into privatizing Russian enterprises, but this was conditioned upon its allies' providing an additional

290. Rich Miller, *Russia Seeks Debt Write-Off*, *MOSCOW TIMES*, Aug. 7, 1993, at 2 (quoting Konstantin Kagalovsky, Russia's representative at the IMF.)

291. *Russia's Debt: Burdensome*, *supra* note 256, at 75.

292. The VEB indicated that official disbursements to the FSU (chiefly to Russia) amounted to \$8.5 billion in the first six months of 1992, with another \$5.6 billion in undisbursed loans. About half of these funds were committed by export credit agencies to fund project finance investment, while the remainder came from other bilateral sources for imports of food, raw material, and medicine. *WORLD DEBT TABLES*, *supra* note 2, at 33.

293. Of the \$43.4 billion in multilateral assistance, \$28.4 billion was in loans and \$15 billion in Paris Club debt relief. The IMF and the World Bank will fund \$4.1 billion between them, with the first tranche to be disbursed once Russia embarks on a convincing program of economic austerity. If the policies remain in place, the first tranche will be followed by \$10.1 billion for a full IMF stabilization program and another \$14.2 billion for structural reforms and imports. *To Russia, From Tokyo*, *ECONOMIST*, Apr. 17, 1993, at 50.

294. Germany, Italy, France, and Canada refused to provide more aid, and Britain conditions \$600 million in further aid on Russian cooperation on foreign policy issues. Daniel Williams, *U.S. Presses Its Allies For More Aid to Russia: Washington to Unveil New \$1.8 Billion Contribution*, *WASH. POST*, Apr. 15, 1993, at A1, A23.

295. Daniel Williams, *Rich Nations Approve Aid to Russia*, *WASH. POST*, Apr. 16, 1993, at A1, A18.

\$1.5 billion.²⁹⁶ An additional \$50 million is set aside for the establishment of an enterprise fund to assist in the creation of new businesses.

Western attempts to provide assistance to Russia have been impeded by debates over whether or not Russia is capable of putting billions of dollars in aid to good use. The crucial issue has become not the amount of aid provided, but rather the timing and policy decisions concerning disbursement.²⁹⁷ In April 1992, the G7 promised Russia \$24 billion in aid.²⁹⁸ A year later, only \$13.8 billion had been delivered, along with \$2.5 billion in debt deferral.²⁹⁹ Most of the aid remained undisbursed because Russia failed to meet economic criteria established by the IMF. Critics demanded that something be done to assist Russia regardless of compliance with IMF conditions, while others asserted that any aid given to Russia before economic stabilization had been achieved would be wasted. Realistically, stabilization efforts require that foreign financing start flowing "at the beginning of the credit squeeze, not in the middle of it."³⁰⁰

The IMF's role in dispensing aid to Russia has been controversial. Western governments turn to the IMF for guidance on the timing of the disbursement of the various types of aid to Russia. The IMF has been criticized for blocking meaningful assistance to Russia on the basis that it has failed to reform its economy enough to make the aid effective. Partly in response to these criticisms, during the G7 meeting in Tokyo in April 1993, the IMF introduced a special temporary financing facility for Russia without insisting on the stringent conditions required by a typical IMF standby agreement.³⁰¹ However, the IMF does not foresee any more IMF loans to Russia in the near future until a standby agreement is concluded and Russia implements a credible set of economic reforms.³⁰²

The IMF's economic experts are trying to resuscitate the Russian economy with the same remedies they applied to faltering Latin American

296. The funds would be used to modernize factories, train laid-off workers, and provide a temporary subsidy to social services previously supplied by the state-owned factories. Williams, *supra* note 294, at A23.

297. *A Few Dollars More*, *supra* note 241, at 51.

298. Consisting of \$11 billion in bilateral support, \$4.5 billion from the IMF and World Bank, \$2.5 billion in deferments on official debts, and a \$6 billion ruble stabilization fund. Don Oberdorfer & Ann Devroy, *Clinton Said to Have Ordered "Bolder" Ideas on Russian Aid*, WASH. POST, Apr. 3, 1993, at A18.

299. Bilateral support reached \$12.2 billion (exceeding the initial pledges). The ruble stabilization fund and most of the other IMF loans were not disbursed because Russia failed to meet IMF economic criteria. *Id.*

300. *A Few Dollars More*, *supra* note 241, at 51.

301. Leyla Boulton et al., *West to Reschedule Dollars 1.5bn of Russian Debt: Eve of Summit Deal Offers Boost for Yeltsin's Reforms*, FIN. TIMES (London), Apr. 3, 1993, at 1.

302. *Russia's Debt: Burdensome*, *supra* note 256, at 75.

economies.³⁰³ Although Russia and Latin America share similar symptoms, such as huge debts, high inflation, and shortage of capital, the same remedies (lower government spending, currency stabilization, open trade, and price liberalization) have proven much more difficult to implement. Similar IMF structural adjustment programs failed miserably in Africa, where billions of dollars in aid have had negligible results.³⁰⁴ The chief problem faced by the IMF is that no one knows whether the remnants of Russia's command economy will respond to their program as a market or semimarket economy would.³⁰⁵ Meanwhile, the economies of the newly independent states contracted by an estimated 18.2% in 1992, probably slowing to 6.5% in 1993.³⁰⁶

At least some economic experts concede that the differences between Latin America and Eastern Europe will mean a much slower recovery in Eastern Europe.³⁰⁷ One big factor is the different levels of foreign investment. In 1991, Mexico, Argentina, and Chile attracted \$7.8 billion in foreign direct investment, while the three most promising Eastern European economies, Poland, Czechoslovakia, and Hungary, received a paltry \$2.2 billion. A Central and Eastern European investment fund sponsored by OPIC had to be dissolved after no investors had been found after a year.³⁰⁸ Investment in the FSU has been "negligible."³⁰⁹ At the same time, trade among the former Eastern European trade partners has plummeted. The market economy has been unable to expand to fill the vacuum created by the disintegrating command economy.

Despite these problems, the chief lesson learned in Latin America remains valid: economic reforms that rely only on stabilization measures

303. Tim Carrington, *Eastern Europe's Ills May Defy Usual Cures*, WALL ST. J., Dec. 7, 1992, at A1. In Russia, as elsewhere, "[t]here's a feeling that the IMF medicine is killing the population." *Only One-Fifth of Large Russian Firms Seen Being Privatized in 10 Years*, BNA INT'L TRADE REP., Sept. 16, 1992, 1615 (quoting Andreas Gummich, Assistant Vice President of Deutsche Bank Research, commenting on the unpopularity of IMF reforms in Russia.).

304. The IMF's policies have resulted, however, in its increasing unpopularity in Africa. Kenya's president recently dismissed the IMF as "dictatorial" and reversed all of the IMF-sanctioned economic reforms he had recently introduced; IMF speakers are often booed by African audiences. IMF demands to eliminate subsidies on food and fuel and cut public sector jobs are very unpopular and politically disruptive, as are charges that the IMF mandates violate the sovereignty of the debtor country. IMF officials maintain that the failure is not in the plan, but in improper implementation, and they have occasionally tried to increase a country's commitment to its program by involving local officials in formulating the plan. *Aid For Africa: Nothing to Lose But Your Chains*, ECONOMIST, May 1, 1993, at 44.

305. Eberstadt, *supra* note 244, at A14.

306. IMF estimate reported in BNA DAILY REP. FOR EXECUTIVES, Sept. 17, 1992, at 1.

307. Carrington, *supra* note 303, at A1.

308. *OPIC Fund Stalls as US Investors Shy Away*, CENTRAL EUR., Dec. 1992/Jan. 1993, at 9.

309. Carrington, *supra* note 303, at A1.

like restricting credit and devaluing the currency are insufficient. Structural adjustments are essential for economic reform. Privatization, price deregulation, tax reform, and the creation of a viable financial sector and capital markets are essential steps only now being undertaken in Russia, and particular difficulties have been encountered in establishing a well-defined investment regime and a banking system.³¹⁰ Russia's heavy debt burden impedes reform by diverting any increase in foreign exchange to creditors instead of to furthering reforms.³¹¹ Ultimately, no amount of official aid will turn the Russian economy around. The best that such aid can hope for is to serve as seed money to stimulate the vast pools of international private capital.

C. Development of Debt-Equity Swaps in Russia

A prerequisite for any large scale debt-equity swap program is a secondary market for the country's debt. As of mid-1991, the secondary market for Eastern European debt resembled the Latin American secondary debt market at its early stages of development, with debt unstructured and illiquid.³¹² There are two key differences between Latin debt and typical Eastern European debt: First, in Latin America, the main creditors were U.S. commercial banks, not official creditors; second, Latin debt was largely in the form of syndicated loans, while Eastern European debt mostly takes the form of trade credits and letters of credit, with the result that a debt package with a face value of \$20 million might have 150 types of instrument, each with different components and terms. This makes the debt harder to price and raises transaction costs.³¹³ Another difference is that European, not U.S., banks are emerging as the principal players in Eastern European debt markets. So far, demand has been somewhat slack on Eastern European secondary markets because of the lack of debt-equity programs in the area.

The main similarity in the Latin American and Russian debt markets is that both should prove to be vehicles for the return of flight capital and privatization. The secondary markets provide a useful, but not always welcome, measure of confidence in a government's policies. In early 1993, for example, Russian debt traded for 171/2 cents on the dollar on the

310. Rhodes, *supra* note 246, at A12.

311. CLAESSENS ET AL., *supra* note 89, at 5.

312. Rupert Wright, *Debt for Debt*, EUROMONEY TRADE FIN. AND BANKER INT'L, Aug. 26, 1991, available in LEXIS, News Library, TXTNWS File.

313. *Id.*

secondary market.³¹⁴ While Western banks are eager for the development of a full-scale Eastern European secondary debt market, activity in mid-1991 was largely limited to debt-for-debt swaps to adjust country risk portfolios, with perhaps an annual volume of \$300 million.³¹⁵ The London Club agreement triggered an unexpected surge in the secondary market for Russian debt. In less than a week after the deal was announced, the price of Russian debt rose from twenty-eight cents to the dollar to forty-two cents.³¹⁶ Two days after the deal, one London debt broker reported thirty transactions in Russian debt, with an average value of \$2 million to \$3 million.³¹⁷ The main purchasers seem to be North and Latin American investors who had made a killing in Latin American debt markets.³¹⁸

Since the VEB froze payments on December 5, 1991, many Western companies have been unable to get paid under letters of credit with the bank for goods delivered to Soviet or Russian organizations. The amount of frozen letters of credit is estimated at \$800 million.³¹⁹ Western investors have proposed resolving the issue through debt-equity swaps, but "confusion over exchange rates and about land ownership" have thus far prevented development of a swap program.³²⁰ Instead, a presidential decree issued on December 7, 1992 calls for transforming the VEB deposits into interest bearing foreign currency bonds with an interest rate of three percent *per annum*, and maturities of one to fifteen years. Until the decree, companies sought release of frozen funds on a case-by-case basis, relying on well-placed connections.³²¹

Yugoslavia became the first Eastern European country to introduce a debt-equity swap program in April 1989.³²² The 1988 Polish Debt Restructuring Agreement makes express provision for debt-equity swaps, and Poland's agreement with the Paris Club in 1991 reduced Poland's official debt by fifty percent and included provisions allowing a further ten percent to be converted via equity swaps.³²³ Neither program is currently

314. Leyla Boulton, *Trade in Russian Debt Up Sharply in Wake of Agreement*, FIN. TIMES (London), Aug. 5, 1993, at 15.

315. Wright, *supra* note 312.

316. Boulton, *supra* note 314, at 15.

317. *Id.*

318. *Id.*

319. Guzel Anulova, *Payments & Credits: Frozen Letters of Credit: Latest Developments*, BUS. E. EUR., Sept. 7, 1992, available in, LEXIS, World Library, ALLNWS File.

320. *Id.* at ___.

321. Guzel Anulova, *Vneshekonombank to Issue Dollar Bonds*, BUS. E. EUR., Feb. 1, 1993, at 7.

322. Wright, *supra* note 312.

323. *Debt Equity Could Be Solution For Struggling Eastern Countries*, EBRD WATCH, Mar. 23, 1992, at 1.

operating.

Russia is also considering instituting a debt-equity swap program.³²⁴ At a meeting with G7 leaders in Munich in July 1992, Yeltsin proposed debt-equity swaps, offering to provide Russia's creditors with land, buildings, and minerals in exchange for debt reduction. Yeltsin included the oil sector in the proposal, and Russia was supposedly already in discussions with one German bank about reducing debt in return for equity in oilfields in Northern Russia.³²⁵ G7 leaders were surprised by the proposal, which Prime Minister John Major described as "the most important step of this trip which would make this whole meeting worthwhile."³²⁶ U.S. and Canadian government officials expressed doubt that their governments would be interested in trading their official debt for Russian assets,³²⁷ but were enthusiastic about making the option available to businessmen.

In early August 1992, Acting Prime Minister Yegor Gaidar raised the possibility of swapping Russian debt for property rights and rights to invest in Russian companies and indicated that Russia had already begun swap negotiations with Austria.³²⁸ Preliminary debt swap discussions have also begun between Russia and Finland, with full negotiations pending until Russian legislation is changed to allow debt-equity swaps.³²⁹

Russia has also initiated discussions with its Eastern European neighbors about debt-equity swaps. In 1991, the Soviet Union owed Hungary as much as \$2 billion. Slim prospects of repayment and the desire of Hungarian companies to retain their footholds in the Russian market led to discussions on debt-equity swaps, with Hungarian companies taking equity stakes in Soviet oilfields and other enterprises. Hungary might also consider forgiving

324. At a press conference in September 1992, deputy prime minister Shokhin referred to debt-equity swaps as "an absolutely new direction from the legal point of view. We are only at the start of this road." *Press Conference by the Vice-President of the Russian Federation Government Alexander Shokhin on the Russian Federation Foreign Economic Affairs*, Sept. 8, 1992.

325. *Yeltsin Proposes Debt For Equity Swap*, REUTERS, July 8, 1992, available in LEXIS, World Library, TXTNWS File,

326. Graham Barrett, *Group of Seven: G7 Pledges Aid for Russia*, THE AGE (Melbourne), July 10, 1992, available in LEXIS, News Library, TXTNWS File.

327. While national governments do not seem keen on reducing Russian debt in return for equity, the United Nations is considering a scheme that would allow Russia to pay off its debts to that organization by providing men or equipment for U.N. peace-keeping forces. *Polishing Blue Helmets*, ECONOMIST, May 1, 1993, at 39.

328. *Gaidar Backs Russian Debt-for Equity Swap*, THE REUTER BUSINESS REPORT, Aug. 10, 1992, available in LEXIS, World Library, ALLNWS File. The next day, Austrian finance ministry officials confirmed that Russia and Austria had signed an agreement providing for debt-equity swaps in April, but said that the negotiations had stalled on practical details and the uncertain Russian political situation. Christian Gutleiderer, *Austria Keeps Russian Debt Equity Swaps on Ice*, REUTERS, Aug. 11, 1992, available in LEXIS, World Library, TXTNWS File.

329. *Focus on CIS*, BUS. E. EUR., Nov. 23, 1992, available in LEXIS, World Library, ALLNWS File.

portions of Russian debt in return for former Soviet military facilities in Hungary.³³⁰ Czechoslovakia had similar aims.³³¹ In 1992, Czech officials presented Russia a list of fifty energy and high-tech firms whose shares would be acceptable to Czechoslovakia in return for cancellation of Russian debt.³³²

However, Russia is not only on the receiving end of debt-equity swaps. It has also proposed taking an equity stake in a Yemeni refinery in Aden in return for Yemeni debt of \$4 billion to Moscow. Discussions have not yet reached the intergovernmental level.³³³ Russia is also seeking to acquire equity in a Ukrainian export gas pipeline and in underground storage facilities in return for Ukrainian debt to Russia, although Ukraine has resisted the idea.³³⁴

At a conference in London in September 1992, Sergei Vasiliev, director of the Russian government's Center for Economic Reform, explained that the Russian government was still debating whether to pursue debt-equity swaps and expressed the concern that debt-equity swaps have both "good and bad aspects."³³⁵ Nonetheless, Russia has already approached the IFC about setting up a debt-equity swap program and Russia has already received proposals from banks to participate in the swaps.³³⁶ The chief obstacle appears to be the general instability of the legal regime and the political opposition evoked when converting foreign debt into Russian property.

Multilateral institutions would probably play an important part in any debt-equity swap program in Russia. The EBRD has proposed that it play a major role in implementing debt-equity swaps in the FSU. The EBRD

330. *Hungarian-Soviet Contacts-A Debt Equity Swap?*, MTI ECONNEWS, Apr. 9, 1991, available in LEXIS, World Library, ALLNWS File.

331. *Czechoslovakia: Investing in Russia*, INT'L REP., May 15, 1992, available in LEXIS, World Library, ALLNWS File.

332. The Czechs remain interested. In a meeting with Russian Prime Minister Victor Chernomyrdin in July 1993, the chairman of Skoda Plzen proposed that the Russian government pay off some of its debt to the Czech government with debt-equity swaps. The debt is estimated at \$5 billion. Under the plan, the equity would actually be transferred to Skoda or other Czech firms. *Skoda Offers Debt Solution*, MOSCOW TIMES, July 27, 1993, at 12.

333. *Yemen: Moscow Frames Debt-Equity Proposal*, MIDDLE EAST ECONOMIC DIGEST, July 3, 1992, at 25; *Russia and the Gulf — New Investment, Old Debt*, MIDDLE E. MAG., Oct. 1, 1992, at 39.

334. *Press Conference by Russian Federation Vice-Premier Alexander Shokhin*, Government Press Center, Staraya Ploshchad, Feb. 17, 1993. Russia might become more interested in debt-equity swaps in other countries as well because many of its loan recipients cannot service their debt. At the end of 1991, developing country debtors owed the FSU more than \$142 billion, with much of this held by such economic basketcases as Cuba, Vietnam, and Angola. *WORLD DEBT TABLES*, *supra* note 2, at 35.

335. *Russian Inter-Company Debt at Two Trillion Rubles*, REUTERS, Aug. 21, 1992, available in LEXIS, News Library, Wires File.

336. *Shokhin Press Conference*, *supra* note 331.

thinks that the official debt of Eastern European countries will require a different approach from the Latin American models and is interested in developing debt-equity as well as debt-for-nature and other swaps.³³⁷ Debt obligations could be swapped for government undertakings to pursue environmental and nuclear safety projects. EBRD President Jacques Attali has proposed that Western governments forgive FSU debt in return for the dismantling of Soviet nuclear warheads. The EBRD's ability to conduct prolonged negotiations with the Eastern European governments makes it well suited for developing and implementing debt-equity swap programs in Eastern Europe.³³⁸

V. DEVISING A DEBT-EQUITY SWAP PROGRAM FOR RUSSIA

What sort of debt-equity swap program is desirable or feasible in Russia? Although the Russian government's priorities should doubtless lie in more fundamental problems such as dealing with inflation, imposing structural reform on the economy, pushing through land reform, and creating a competition-driven private sector, debt-equity swaps could play an important role in developing local financial institutions, attracting additional foreign investment, and reducing Russia's debt servicing obligations. But are such debt-equity swaps feasible?

The first step in considering whether or not to implement a debt-equity swap program is to evaluate the economic and political condition of the debtor country to determine if a debt swap program would be desirable.

A. Objective Conditions in Russia

Russia shares many of the characteristics that made debt-equity swaps an attractive option for heavily indebted Latin American countries. First, although Russia's level of debt might be sustainable in the long term, it has experienced serious liquidity problems that will continue for the foreseeable future. During its transition to a market economy, Russia needs to reduce its debt servicing requirements, if not the debt itself.

Second, Russia has been virtually cut off from access to international investment capital. The only way to finance an investment project in Russia is through multilateral or bilateral lending organizations such as the EBRD, IFC, or OPIC.³³⁹ Even the projects funded by these investors are concentrated in a few sectors of the economy such as oil and gas. To rebuild its

337. *EBRD Could Play a Pivotal Role in Promoting Debt Relief Via Swaps*, EBRD WATCH, Mar. 23, 1992, at 1.

338. *Debt Equity Could Be Solution For Struggling Eastern Countries*, EBRD WATCH, Mar. 23, 1992, at 1.

339. RUSSIAN ECONOMIC REFORM, *supra* note 242, at 51.

industrial base, Russia must find a means of attracting significant amounts of foreign investment into a wide range of enterprises.

Third, just as in Latin America, Russian economic and political instability has led to excessive levels of flight capital as domestic investors take their investment capital abroad for safe keeping.³⁴⁰ Russia desperately needs to bring flight capital back into the country to boost levels of available investment capital.

Fourth, Russia must channel foreign and domestic investment into the thousands of Russian enterprises undergoing privatization. Without infusions of capital and new management and technology, the newly privatized companies will differ little from the remaining state-owned enterprises. Experience in Latin America indicates that privatization is an excellent means of implementing debt-equity swaps in countries without developed capital markets.

Finally, to put foreign and domestic investment capital to effective use, Russia must develop a viable financial sector and long-term capital market to grant the nascent private sector access to long-term financing. Consideration of these factors should determine the appropriate goals of the debt-equity swap program, which are discussed in the next Section.

B. Goals for a Russian Debt-Equity Swap Program

The lessons drawn from the Latin American debt-equity swap programs suggest that a Russian debt-equity swap program should have four objectives, in descending order of importance. First, Russia should seek to attract "additional"³⁴¹ foreign and repatriated flight capital into the private sector (either privatizing enterprises or start-up companies), especially into export industries. Second, it should, facilitate the development of a domestic financial sector and capital markets.³⁴² Third, Russia should aim to reduce its debt servicing obligations, and, if possible, the debt principal, to preserve Russia's limited hard currency reserves for more productive use. Finally, the debt swap program should play a positive role in an overall effort to boost investor and creditor confidence in Russia's business climate.

1) Attracting Additional Investment

As noted above, the Russian swap program should emphasize attracting

340. WORLD DEBT TABLES, *supra* note 2, at 33.

341. By "additional", the author means investment that would not be made without the incentives offered by the swap program.

342. Guzel Anulova & Jim Nail, *Aid for the CIS: Mechanisms Will Be Key*, BUS. E. EUR., at 185.

additional investment. Although export industries would be particularly welcome because of their capacity to bolster Russia's currency accounts, Russia needs investment into virtually all industrial sectors in all regions of the country. Moreover, studies of Latin American programs have shown that debt-equity swap programs are more likely to attract investment in export sectors than in domestic sectors even without special incentives.³⁴³ Excessive efforts to channel investments will only complicate the program.³⁴⁴

In pursuing this general objective, Russia should bear in mind three other considerations. First, the investment must be additional. Some companies, especially in extractive sectors, are already eager to invest in Russia with or without any additional incentives offered by a swap program. The sectors where Russia enjoys a comparative advantage, such as oil and gas, mineral, and timber concessions, should thus be excluded from the program or restricted.

Second, Russia should encourage foreign investors to participate in buy-outs and financial restructuring to reap the benefits of follow-on investment and infusions of managerial and technical skills.³⁴⁵ Russia's prime objective should be to get foreign investors engaged in the Russian economy given that Russia's current investment climate makes many companies justifiably cautious about committing even minimal resources to Russia.

Third, Russia should be especially concerned about attracting back flight capital.³⁴⁶ Repatriation of flight capital is a strong indication of domestic investors' confidence in investment climate and has the benefit of reducing future potential foreign exchange outflows by retaining profits in Russia instead of sending them abroad.³⁴⁷

2) Developing the Financial Sector and Capital Markets

Russia's desperate need for a domestic financial sector and capital markets should be obvious.³⁴⁸ A modern industrial economy simply cannot exist without such institutions. Although Russia has witnessed a huge expansion in the number of banks and stock markets, these organizations need substantial development before they will prove capable of financing

343. BERGSMAN & EDISIS, *supra* note 217, at 11.

344. *See supra* note 193.

345. BERGSMAN & EDISIS, *supra* note 217, at 13.

346. *Id.* at 24, 26; WORLD DEBT TABLES, *supra* note 2, at 33.

347. WILLIAMSON, *supra* note 154, at 65.

348. *See No Rush for Banks in Moscow, supra* note 277; Konstantin Shtoiko, *Stock Marketeers' Hopes Disappointed*, MOSCOW NEWS, Jan. 13, 1993, available in LEXIS, World Library, ALLNWS File.

the rebuilding of Russia. Experience in Latin America, especially in Chile, has shown that debt-equity swaps can play a major role in developing the host country's financial sector.³⁴⁹

3) Reducing Debt Servicing

Although Russia has had considerable liquidity problems in the last few years due to the sudden expansion of its debt and the contraction of its foreign trade, it should not be considered incapable of paying its debts in the long term. Ultimately, Russia's vast resources and export potential will allow the Russian government to satisfy its creditors. During the current transitional period, however, Russia needs to free up its scarce foreign currency resources from its debt servicing obligations to put them to more productive use.

4) Cultivating Investor and Creditor Confidence

Finally, all of these goals should be tailored to achieve the primary objective of improving investor and creditor confidence in Russia. While considering measures to restrict investment to "additional" sectors or to reduce debt servicing obligations, Russia must keep in mind that these goals are really just means to the end of improving Russia's investment climate to the point where programs such as debt-equity swaps are no longer necessary. Moreover, the debt-equity swap program must be only a small part of an overall legislative and administrative effort to make Russia a stable environment for business. One observer of Latin America's debt-equity swaps noted that the programs are essentially an exercise in "buying friends . . . to re-engage [the host country] in the international financial system."³⁵⁰ However, the debt-equity swap is not a "magic wand" to remedy all of a country's problems with foreign investors.³⁵¹

The achievement of these objectives faces daunting obstacles which experience gained in the Latin American programs can help overcome. The next Section will discuss the chief obstacles to debt swaps in Russia and suggest means of avoiding or overcoming them.

C. Obstacles to a debt-equity swap program in Russia

Attempts to devise a debt-equity swap program for Russia must recognize tensions inherent in all debt swap programs. The program must

349. WILLIAMSON, *supra* note 154, at 35.

350. *Id.* at 67.

351. *Id.*

be politically acceptable to the Russians while offering significant financial incentives to Russia, her creditors, and potential investors. Meanwhile, the program must be flexible enough to survive the ongoing wrenching changes in Russia and yet have enough structure to prevent it from bogging down in ill-defined regulations or conflicting legislation. Attempts to reduce potential for red tape and corruption by making the process transparent will have the effect of increasing the program's visibility and thus arousing greater political opposition.

Besides these tensions, there are at least four obstacles to establishing a viable debt-equity swap program in Russia: (1) the type of debt; (2) lack of a favorable investment climate; (3) lack of a developed financial sector and capital markets; and (4) political problems. A properly designed debt-equity swap program would not only take these problems into account, but would also present a partial solution to the problems themselves. The Sections below address these obstacles and possible solutions.

1) Russia's Debt

The composition of Russia's debt presents a problem to the implementation of a large-scale, debt-equity swap program in that much of its debt would be considered ineligible under most debt swap programs. Most debt involved in Latin American debt-equity swaps involved long-term syndicated loans from commercial banks.³⁵² Russia's debt is largely composed of short-term debt and official credits, neither of which are generally eligible for debt-equity swaps.³⁵³ In June 1992, Russia's total external debt stock of \$75 billion was composed of \$62.7 billion in long-term debt, and \$12.7 billion in short-term debt.³⁵⁴ Official credits (i.e., credits extended or guaranteed by Western governments or multilateral organizations) constitute \$37.6 billion of the \$62.7 billion total long-term debt. If long-term official debt and the various short-term trade credits are excluded from the program, \$23 billion in long-term commercial debt remains available for swaps. Thus, two-thirds of Russian debt would be ineligible under a typical debt-equity swap program.³⁵⁵

Although the composition of Russian debt is atypical, it is not necessarily a barrier to the development of a swap program. For purposes of determining eligibility, Russia's debt can be broken down into four

352. Hilton, *supra* note 71, at 9.

353. WORLD DEBT TABLES, *supra* note 2, at 36.

354. *Id.* Short-term debt is composed of tied and untied credits, letters of credit, overdue interest payments, etc. *Id.* at 31.

355. Note that Chile had only \$14.5 billion in eligible debt for its successful debt swap program. SWAP GUIDE, *supra* note 57, *Country Chapters: Chile* at 1.

categories:³⁵⁶ (1) short-term VEB guaranteed debt; (2) short and long-term non-VEB debt;³⁵⁷ (3) long-term official debt; and (4) long-term commercial debt.

Initially, short-term VEB guaranteed debt must be repaid on terms acceptable to the creditors. This debt consists chiefly of short-term suppliers' credits guaranteed by the VEB, and repayment is very important to restoring the credit-worthiness of the Russian government. These accounts were frozen for a long time, but VEB has recently started issuing low-yield bonds to replace the guaranteed debt. Next, the Russian government should offer to assume the short-term non-VEB debt of those debtor companies willing to participate in a debt-equity swap and then sell the debt on the secondary market. The purchasers of these debt instruments would have the right to participate in special auctions to bid for equity stakes in the eligible companies.

The limited size of this debt stock would obviously limit the size of the swap program, but it would also offer several advantages. First, it would boost the confidence of creditors, investors, and traders in dealing with Russian enterprises by giving them value for their short-term debt. It would also spark interest in the further development of a full-scale debt-equity program in Russia and provide a valuable test for developing appropriate procedures. Moreover, this small program, limited to exchanging debtor companies' short-term debt for an equity stake in those companies, would be a useful test for the depth of political opposition to debt-equity swaps.

The third category of debt, usually considered off limits for a debt-equity swap program, is long-term official debt. Official debt is usually not eligible for debt swap programs because official creditors are generally not interested in acquiring equity in Russian enterprises via debt-equity swaps and have fewer incentives to get rid of nonperforming debt by selling it on the secondary market. Although official creditors generally find it inappropriate to participate in debt-equity swaps by exchanging their debt for equity in debtor country enterprises, they could sell the debt at a discount to investors for use in debt-equity swaps. The U.S. government already has enacted several programs in Latin America and Eastern Europe that allow official U.S. debt to be used in debt-equity swaps.³⁵⁸ These

356. Within each category, there will be wide variations in the terms of the debt, i.e., precut-off versus postcut-off, maturities, etc.

357. Non-VEB debt is debt incurred by Russian enterprises without the benefit of a VEB guarantee.

358. See the Enterprise for the Americas Initiative, 22 U.S.C. § 2430 (1988); the Support for East European Democracy Act of 1989, 22 U.S.C. § 5401 (Supp. III 1991); the Freedom for Russia and Emerging Eurasian Democracies and Open Market Support Act of 1992, Public Law 102-511 [S.2532].

programs could be modified for use in Russia to help achieve the goals of the debt-equity swap program.

Existing U.S. legislation that allows various types of debt swaps in Latin America and Eastern Europe could easily be modified to facilitate a Russian debt swap program. Chapter 7 of the Foreign Assistance Act of 1961 authorizes debt-for-nature exchanges.³⁵⁹ Section 461 allows the cancellation of a debtor country's official debt in return for its government's policy or financial commitment to protect the environment in that country.³⁶⁰ Section 462 allows the Agency for International Development (AID) to provide nongovernmental organizations with grants to purchase debtor countries' debt on the secondary market in order to engage in debt-for-nature swaps.³⁶¹ Both types of debt-for-nature swaps are only available to countries that AID determines are committed to a long-term plan that they have prepared.³⁶²

The Enterprise for the Americas Initiative (EAI) is a policy initiative intended to provide debt relief to eligible³⁶³ Latin American countries "to encourage and support improvements in the lives of the people of Latin America . . . through market-oriented reforms and economic growth."³⁶⁴ To the extent that Congress has provided appropriations, the president may forgive concessional debt granted to the debtor country. The unforgiven portion of the principal must still be repaid in dollars, but interest payments will be made in local currency into an Enterprise Fund established in the debtor country. The local currency funds in the Enterprise Fund are to be used in accordance with the terms of an Americas Framework Agreement between the United States and debtor governments. An administering body composed of representatives of the United States, debtor country governments, and debtor country nongovernmental organizations will accept proposals for grant assistance for environmental activities. Any grant of more than \$100,000 could be vetoed by representatives of the United States or debtor countries.³⁶⁵ The EAI also authorized the sale of official U.S. debt to purchasers with approved debt-for-nature or debt-for-development swaps.³⁶⁶

The Support for East European Democracy Act of 1989 (SEED Law)

359. 22 U.S.C. § 2281 (Supp. III 1991); 22 U.S.C. § 2282 (Supp. III 1991).

360. 22 U.S.C. § 2281 (Supp. III 1991).

361. 22 U.S.C. § 2282 (Supp. III 1991).

362. 22 U.S.C. § 2284 (Supp. III 1991).

363. Eligible countries are those Latin American and Caribbean countries that have democratically elected governments that have implemented appropriate economic and investment reforms and that support U.S. antiterrorism and narcotics policies. 22 U.S.C. § 2430b (1988).

364. 22 U.S.C. § 2430 (1988).

365. *Id.*

366. 7 U.S.C. § 1738p (Supp. IV 1992).

was intended to promote the development of democracy and a market economy in Poland and Hungary and provided a broad aid mandate.³⁶⁷ Section 104 of the SEED Law authorizes the President to "take all appropriate actions to explore and encourage innovative approaches to the reduction of the . . . debt burden of East European countries," and allows the President to authorize the discounted sale of U.S. government debt obligations of Eastern European countries to private purchasers if the obligations will then be converted into equity in a privatizing enterprise, into local currency, or into policy commitments.³⁶⁸

Section 201 of the SEED Act provided for another type of assistance.³⁶⁹ The SEED Act earmarked funds to set up private nonprofit "Enterprise Funds" to engage in "loans, grants, equity investments, feasibility studies . . . and other forms of assistance to private enterprise activities" in the designated countries.³⁷⁰ Congress also enacted the "Freedom for Russia and Emerging Eurasian Democracies and Open Markets Support Act of 1992."³⁷¹ The goals of the program included development of private enterprise and free market systems and the promotion of trade and investment in the FSU. FSU countries that have adopted economic and foreign policy reforms are eligible for various aid provisions under the Act. The Act extended provisions of the SEED Act to Russia and other FSU nations.

One provision of the Act provided for the establishment of a nongovernmental, nonprofit research and development foundation to provide opportunities for joint research on high technology civilian applications.³⁷² Although part of the funding for this foundation consisted of conventional appropriations, the Act also provided that "local currencies or other assets resulting from government-to-government debt conversions may be made available to the Foundation."³⁷³ These debt conversions would take the form of an agreement "whereby a country's government-to-government or commercial external debt burden is exchanged by the holder for local currencies, policy commitments, other assets, . . . or for an equity interest

367. James D. Whisenand et al., *Polish Debt: Will Swaps Provide the Key?*, INT'L FIN. L.REV., Mar. 1990, at 33, 34.

368. *Id.*; 22 U.S.C. § 5414 (Supp. III 1991).

369. 22 U.S.C. § 5421 (Supp. III 1991).

370. Initially, the only eligible countries were Hungary and Poland. 22 U.S.C. § 5401 (Supp. III 1991). These Enterprise Funds would be governed by a Board of Directors made up of private citizens of the United States and the host country, with a majority being U.S. citizens. 22 U.S.C. § 5421 (Supp. III 1991).

371. Public Law 102-511 [S.2532].

372. 22 U.S.C. § 5861 (Supp. IV 1992).

373. *Id.*

in an enterprise theretofore owned by the debtor government.”³⁷⁴ Thus, this nonprofit, nongovernmental foundation could receive an equity stake in high-technology privatizing Russian enterprises in return for cancellation of commercial or official U.S. debt.

Other types of programs are also possible. Some call for debt-equity swaps to be tied into other forms of aid and for governments to provide subsidies for participating banks. This aid might not require much in the way of appropriations, but would funnel large amounts of private capital into Russian industry.³⁷⁵ One such approach would be to use official debt as a kind of “matching fund” for private investors that have investment projects approved by the Russian government. One of the biggest reasons that many policymakers hesitate to commit greater foreign aid resources to Russia is that the economy is not ready for untied foreign aid, which will merely be swallowed up in the economic chaos without any real beneficial effect on the Russian economy.³⁷⁶ A debt matching fund program, on the other hand, would channel foreign aid in the form of debt relief into productive use by tying it to a particular project sponsored by a Western company. This debt could be either donated or sold at a discount. If donated, the Russian government would be able to capture much more of the face value of the debt for itself while still leaving handsome financial incentives for the foreign investor.³⁷⁷ Such a program would be especially useful if structured to encourage investment into privatizing Russian enterprises.³⁷⁸

Long-term commercial debt is the final category of Russian debt. This debt would not be particularly difficult to work into the debt-equity program. However, it might be useful to limit the amount of debt to pre-cutoff date debt because this includes most of the unguaranteed commercial debt and because Russia is not particularly eager to repay this debt, which was incurred by the Soviet Union.

As outlined above, however, long-term commercial debt would not necessarily even be necessary in a Russian debt-equity swap program. Determination of eligible debt should ultimately not turn out to be a major obstacle.

374. *Id.*

375. Anulova & Nail, *supra* note 339, at 186.

376. Eberstadt, *supra* note 244, at A14.

377. *See supra* note 93.

378. Many argue that investing in a privatizing enterprise in Russia is more trouble than it is worth and that green-field or start-up investments are the only way to invest in Russia without the disincentives associated with most privatizing enterprises. This argument certainly has merit, but the debt-equity swap program should offer sufficient incentives to induce investment into privatizing enterprises to keep factories open and help facilitate the development of active capital markets to trade the shares of the privatizing enterprises.

2) Lack of an Investment Climate

Debt-equity swap programs generally perform poorly when the host country lacks a favorable investment climate.³⁷⁹ They fail under such conditions for two reasons. First, the debtor country authorities cannot adequately administer the program. Second, even if they could administer the program, the unhealthy business environment means that few investors are willing to participate. Even under prevailing conditions in Russia, however, both of these problems are surmountable.

The question of who should administer the program is of critical importance. Although the central bank typically administered debt-equity swap programs in Latin America, the administrative chaos in Russia calls for the establishment of a two-tier administrative mechanism. On the federal level, a dedicated government agency should oversee the allocation of debt conversion rights through auctions. This federal body should also establish summary screening procedures to determine which investors are eligible to participate in the auctions. These prescreenings should only seek to eliminate fraudulent applicants or those trying to invest in ineligible sectors such as gas and oil.

Once the debt has been sold in the federal auction, it could be invested by means of a second tier consisting of three alternative investment programs. Under the first program, investors would bring their purchased debt to designated regions to exchange for an equity stake in a particular privatizing enterprise. These regions, or special economic zones (SEZs), would retain responsibility for choosing and negotiating the eligible investment projects. Under the second alternative, investors would convert their debt into shares in investment funds that would in turn select investment opportunities anywhere in the country. The third alternative would be a debt-for-debt conversion for domestic investors whereby they could convert foreign debt purchased at the auction into gold-backed ruble bonds issued by the Russian government.

At the federal level, the recently-established State Investment Corporation (SIC), headed by Yeltsin's former chief of staff, would be the best institution for handling debt-equity swaps. The SIC's mandate is to carry out the analysis, selection and implementation of investment projects, and it will have exclusive control over state-funded investment projects and investment involving central bank loans.³⁸⁰ The SIC could chair a small

379. Basile, *supra* note 133, at 56.

380. *Russia Sets Up Corporation to Encourage Investment*, REUTERS, Feb. 5, 1993 available in LEXIS, News Library, Wires File.

joint committee composed of members of the State Property Committee, State Committee on Foreign Investment, and the Central Bank (or successor to the VEB) capable of administering the program without opening the forum to too many contending constituencies.

The role of the SIC would be limited to the administration of central auctions for the right to convert Russian debt. Besides devising the auction procedures and setting the ceiling on the amount of debt to be auctioned, the SIC should establish summary screening procedures to screen out participants whose investments are fraudulent or clearly nonadditional.³⁸¹ In the second tier, the auction winners would then use their funds for one of the three alternative purposes outlined above and discussed in more detail below.

First, if an investor wished to acquire an equity stake in a particular enterprise, he could take the debt conversion rights obtained in the federal auction to the SEZ that was home to the target enterprise. This type of investment should be limited to SEZs for administrative and political reasons. There are several advantages to delegating the details for most aspects of swap transactions to the SEZs. The regional approach is attractive for three principle reasons.

First, limiting substantive investment project review, negotiation, and approval to regions will cut out the federal bureaucracy in Moscow and allow those regions serious about attracting foreign investment to devise the best methods of doing so. Delegating project review and approval to regional authorities will help reduce one of the chief drags on investment activity in Russia — bureaucratic deadlock. Currently, red tape from federal, regional, and local authorities can stop projects in their tracks. Cutting out the federal level will allow regional officials greater leeway to choose what they consider to be appropriate investment projects for their regions. Finally, regions will be free (within certain limits) to devise their own investment policies, thus promoting experimenting and competition by ensuring that regions that devise the most favorable investment climate will attract the lion's share of investment capital.

Investors should submit investment proposals to an investment board in the SEZ. Despite the increased risk of corruption and bureaucratic delay, regional authorities should rely on case-by-case negotiations to settle the final terms of the debt-equity swap. Otherwise, the results at federal debt auctions might subvert the SEZ's investment development plan by allowing the sponsors of especially lucrative projects to outbid everyone else, even

381. No screening would be necessary for investment into the investment funds. The right to convert debt into equity in the investment funds would be represented by a form of privatization voucher which could be immediately credited to the investment fund's account.

though they would have made the investment even without the debt swap program. Thus, case-by-case procedures should be implemented for considering individual investment proposals, while investments through the investment funds discussed below should be converted in special auctions for holders of the privatization vouchers.

The reasons for relying on case-by-case approval on the regional level seem sound. Regional officials will know best what sort of investments their regions need and should be eager to cut through the red tape to make it happen. Once the auction process is completed, there should be no further involvement by Moscow authorities. This reliance on regional authorities also has favorable political consequences, which are discussed below.

The second attraction of the regional approach is that the concentration of investment into certain regions will allow the business climate in that region to reach a "critical mass." On a practical level, much of Russia lacks the infrastructure and general business climate necessary for intensive foreign investment. One problem immediately obvious to those investing in Russia is that it will do little good to invest millions of dollars into a promising facility in the Russian hinterlands. Vast expanses of Russia lack proper telecommunications and transport infrastructure, proper banking facilities, rapid access to international markets, and ancillary services which are necessary for a successful business. Moreover, some regional governments are lukewarm towards outsiders seeking to invest in their regions because they fear that a shift in the balance of local political power will accompany powerful outside investors.

Concentration of investment into SEZs alleviates these problems. First, they should be located by a port or other major transport facility to allow development of exports and imports. Second, the Russian government might find it easier to improve the infrastructure in these regions first, rather than dispersing development efforts all over the country. With adequate infrastructure, businesses could move in and hope to operate efficiently, without worrying about how they will carry out standard business operations. This concentration of businesses will, in turn, attract more businesses as companies move in to provide services. Banks and regional capital markets can develop to provide financing for these emerging small businesses. Even if oil and gas projects are excluded from the debt swap program, the energy sector could provide the "locomotive" that will attract foreign investment in other sectors within a SEZ. While the Russian oil sector alone might require \$25 billion of investment³⁸² (which promises

382. Which would be provided by the EBRD, OPIC, the IFC, and leading international banks.

quick and lucrative returns³⁸³), transport, service, hotel, and other sectors could also be developed through the swap program.³⁸⁴

The third attraction of the regional approach is that limiting direct debt swaps to SEZs has useful political consequences. The political benefits of delegating responsibility for debt-equity swap investment decisions to the regions are discussed below.

This first alternative is also feasible. Russian SEZs already exist. In July 1992, Yeltsin signed a decree on SEZs providing for: (1) Reduced export duties for certain raw materials; (2) the organization of custom controls in the SEZ; (3) acceleration of privatization in the SEZ; and (4) utilization of some privatization proceeds for development and insurance funds for the SEZ. The decree also allocated federal funds for infrastructure projects in the SEZs. Particularly important projects include mortgage banks, duty free areas, and the construction of seaports, airports, and storage and transportation facilities.³⁸⁵ This decree could be modified to encourage SEZs to participate in a debt-equity swap program.

SEZ legislation would have to be carefully drafted to bind regions to the center. Regions are currently ignoring Moscow's economic dictates, establishing their own trade policies, customs tariffs, and hard currency regulations.³⁸⁶ Regions' demands for special economic privileges threaten to undermine Russia's economic future; economic authority remains undetermined, but several regions have successfully extracted economic concessions from Moscow to forestall threats of secession from the Russian Federation.³⁸⁷ Federal Russian authorities can use the lure of billions of dollars of potential debt swap funds to impose certain minimal conditions on the regions to stabilize economic relations between Moscow and the regions.

383. *World Bank Writing New Loans for Russia, Including \$500 Million for Oil Industry*, BNA DAILY REP. FOR EXECUTIVES, Sept. 17, 1992, at d25.

384. Another possibility, not explored here, would be the conversion of Russian foreign debt into rubles to be used for mineral and oil exploration. The initial stages of exploration pose the highest risks, and anything that reduces costs at this stage exerts a disproportionate influence to proceed; moreover, a successful outcome would result in increased export, tax, and royalty earnings for the Russian government, as well as jobs. *Funding Exploration Through Debt-Equity Swaps*, MINING J., May 29, 1987, 418.

385. *Interregional Commercial Land Bank Formed*, REUTER TEXTLINE, Feb. 22, 1993, available in LEXIS, News Library, Wires File. Western shipowners transporting agricultural aid to Russia report that Russian ports are simply overwhelmed and cannot handle the volume of aid entering the country. Some U.S. vessels have to wait as long as 40 days to unload, at a cost of \$25,000 per day. Jack Anderson & Michael Binstein, 'Greed Versus Greed' in Russian Aid, WASH. POST, May 10, 1993, at C12. *Presidential Decree on Special Economic Zones*, Fin. E. Eur., July 16, 1992, at 14.

386. Betsy McKay, *Yeltsin asks Army to Secure Stability*, MOSCOW TIMES, Feb. 23, 1993, at 1.

387. *Id.*

This arrangement would also prove beneficial for the federal government in other respects. The federal government could condition the regions' eligibility for the program on acceptance of certain tax and tariff measures designed to enhance federal revenues, and on the establishment of mechanisms to carry out these measures. By allowing regional authorities a certain amount of discretion in handling the swap program, the federal authorities could compare the results of several slightly different programs. The federal government could avoid a lot of political problems by making the adoption of a debt-equity swap program optional for the region's elected officials.

One particularly interesting region would be Russia's Maritime Territory on the Pacific Coast, which is currently leading the country in the rate of privatization.³⁸⁸ The region has the largest number of privatized enterprises and shareholders of any region in Russia, with the result that only ten to forty percent of the economies of major cities like Vladivostok and Nakhodka remain in state hands.³⁸⁹ Most of the privatization activity in the Maritime Territory was undertaken not by investment funds or banks, but by enterprise management and workers.³⁹⁰ Such a region could be ripe for increased participation of foreign investors.

The second alternative in the second tier of the proposed swap program would be a handful of investment funds that would be free to swap foreign debt for the shares of privatizing enterprises. These funds would not be restricted to enterprises operating in SEZs, but could be restricted to holding a certain percentage of an enterprise's equity and could be prohibited from investing in certain industrial sectors. The establishment and administration of these funds probably would initially require the assistance of multinational agencies such as the EBRD and IFC, although it would be politically important to ensure that the funds were primarily "Russian." All domestic and foreign investors should be eligible for participation in these funds by acquiring debt conversion rights at the federal debt auctions.

The Russians have already proposed establishing funds in an effort to "privatize" the \$3 billion in privatization aid promised Russia by the G7 at their Tokyo summit in July 1993.³⁹¹ This aid will be virtually the only source of fresh capital for privatizing Russian enterprises, and Russian privatization officials are keen to keep the aid out of the hands of the State bureaucrats: "Control of the state is the lethal touch. . . . The money from

388. See *supra* note 382.

389. *Id.*

390. Yelena Ryzhova, *Far East Leads the Way in Privatization*, COMMERSANT, April 28, 1993, at 12.

391. *How Not to Help Bolshevik Bisquit*, ECONOMIST, July 17, 1993, at 64, 67.

the privatization fund must be lent to enterprises on a market basis. This money must not be captured by the state."³⁹² Reformers hope to set up a network of thirty regional enterprise funds, with at least ten established in the first year. These enterprise funds will each begin with \$75 million, half in equity and half in long-term loans.³⁹³ Moreover, the investments would be profit-driven and would work from the bottom up. Analysts suggest that US\$4 billion in such investment funds could give Russia's free market reforms a real boost.³⁹⁴

Involving these funds in a debt-equity swap program would require them to exchange debt conversion rights obtained by their shareholders at the federal debt auctions for privatization vouchers to be exchanged for government-held shares in privatizing enterprises. This approach would work well with the Russian privatization program, which grants workers and managers large stakes in their businesses, but leaves large amounts of stock in government hands for eventual sale to private parties. This government stake would be ideal for a debt-equity swap program.³⁹⁵ Also, workers would retain a considerable share of the newly valuable equity.

The establishment of these new funds will also allow another type of debt swap transaction, either as an alternative or a complement to the approach outlined above. A version of U.S. EAI legislation could be modified to allow Russia to repay interest on official debt into the funds in local currency. The Modigliani-Dornbusch approach allows similar treatment for commercial debt.³⁹⁶

These funds would provide a vital source of credit to Russian enterprises. Any privatized Russian enterprise could go to one of the investment funds to apply for loans to finance investment or imports, but not current expenditures such as wages. Applicants would complete a standard form detailing their business plan and, upon approval, would have to bid for

392. *Id.* (quoting Maxim Boiko, chief of the Russian Privatization Center and a senior advisor to Anatoly Chubais, Russia's minister for privatization.)

393. Once the enterprise funds are established, private companies (hopefully, but not necessarily, headed by Russians) will bid for the rights to run the funds. Once up and running, the enterprise funds will concentrate their investment activities on midsize enterprises to avoid the inevitable political problems of dealing with the megaenterprises common in Russia. After ten years, the original investors will be allowed to sell their shares in the funds. The chief problem is in the attitude of the donor countries, which are wary of committing the \$4 billion requested by President Clinton. They agreed to the \$3 billion figure only on the condition that one third of that is tied export credits, not true privatization aid. These tied export credits threaten to bankrupt the very enterprises that the privatization aid is meant to assist. For instance, the Bolshevik Biscuit Factory received a \$50 million export credit from Italy to purchase Italian equipment; factory management has now idea how it will sell enough biscuits to even begin paying off the loan. *Id.*

394. *A Few Dollars More*, *supra* note 241, at 51.

395. Charles Wolf, Jr., *Latin-Style Swaps for Russia*, WALL ST. J., Nov. 19, 1992, at A14.

396. *See supra* note 101.

the loans if the applicants' demand exceeded the supply of cash. The interest rate on such loans would rise as the ruble falls.³⁹⁷

Besides investing in privatizing enterprises, the investment funds could provide financing for newly-created private businesses. Perhaps a certain fraction of investment funds could be set aside to finance employee stock ownership plans (ESOPs). To boost the political popularity of the debt-swap program, the authorities could divert a small percentage of the funds into some kind of pension augmentation fund.

While there would be few if any restrictions on eligible investors for participation in the funds, the size and scope of authorized equity acquisitions could be regulated. Investment into the funds would be subject to certain restrictions on eligible enterprises and sectors and maximum percentage of shares.

The third alternative in the second tier of the proposed debt swap program involves the conversion of foreign debt into ruble-denominated, gold-backed bonds. In October 1993, the Russian Ministry of Finance introduced gold-backed bonds with a maturity of one year and an interest rate linked to that offered by Russia's largest savings bank. The attraction of the gold bonds, however, is that upon maturity, investors may redeem the bond for either ten kilograms (twenty-two pounds) of gold or its ruble equivalent (calculated using prices fixed in London). The Ministry ultimately intended to sell 10,000 gold bonds, backed by 100 tons of Russian gold.³⁹⁸ A modified version of these bonds³⁹⁹ could be offered to domestic investors as an alternative to participation in debt-equity conversions. Although the amount of bonds would be limited by the amount of gold available and the inadequacy of Russian capital markets, significant amounts of Russia's foreign debt could be exchanged for these ruble denominated instruments by allowing Russian investors to bid for the gold bonds using face values of external debt purchased on the secondary market. This aspect of the program should be limited to Russian citizens to maximize the amount of returning flight capital and to restrict the amount of Russian gold leaving the country.

Even if the two-tier mechanisms discussed above for administration of the program are successfully established, as noted at the beginning of this Section, it does not necessarily follow that investors will be interested in participating. The investment climate in Russia is such that few investors will be attracted without the most generous of financial incentives. Property and contract rights are difficult to ascertain and enforce; nor can investors

397. *A Few Dollars More*, *supra* note 241, at 51.

398. *Golden Bonds*, *ECONOMIST*, Oct. 23, 1993, at 98.

399. For instance, a longer maturity date would be necessary.

be sure of their ability to repatriate their profits. Investors are wary of the unstable economic and political situation in Russia, with its disintegrating distribution system, "archaic technology, cumbersome bureaucracies, currency uncertainties, the lack of legal protection, debt burdens of local companies, the lack of incentives . . . for workers, and woefully inexperienced local managers."⁴⁰⁰ Even under normal circumstances, it is not easy to find investors "to help privatize entire industries with productivity standards that are fifty to seventy percent below Western levels."⁴⁰¹ Another Western businessman explains that investors "are all standing here with plugs in our hands, looking for an outlet to plug into, but the infrastructure is all wrong."⁴⁰² Basically, most Russian enterprises would not attract foreign investors unless the proposed investment could hope to generate significant hard currency revenues; EBRD officials report that Western companies often lose interest in a project when asked to contribute their share of the financing.⁴⁰³ Helmut Schmidt, former German chancellor, estimates that it will be fifty years before Russia achieves economic and political stability.⁴⁰⁴ Mr. Schmidt concludes by stating that "[i]f I were the head of a company or a rich man, I wouldn't invest a penny there."⁴⁰⁵

Russia's investment situation is not hopeless, however. First, the concentration of investment into SEZs and the greater ability of regional officials to push through investment projects will improve the business climate to a certain extent. Moreover, there are Western businesses ready to invest in Russia right now, despite the considerable risks. These companies are eager to invest despite the economic conditions in Russia because they seek to invest all over Eastern Europe based on strategic considerations, not merely return on capital. The chairman of Daimler-Benz AG recognizes a need to establish a presence in the Russian market, despite the "daily risk of catastrophes . . . social unrest, economic disaster, or even a coup."⁴⁰⁶ Major Western companies such as Coca-Cola, McDonalds, Chevron, and others have entered the Russian market for the long haul.⁴⁰⁷ Aggressive smaller firms have also taken the plunge, sensing big rewards for those on the ground first. At least one German bank, Dresdner Bank, has proposed to accept portions of Russian interest payments in rubles if

400. Terence Roth, *Daimler's Chief Sees Risks in Russia, Reflecting Caution of Western Firms*, WALL ST. J., July 17, 1992, at B5.

401. *Id.*

402. *Id.*

403. *Id.*

404. *Id.*

405. *Id.*

406. *Id.*

407. Laurie Hays, *Building a Market*, WALL ST. J., Apr. 6, 1993, at A1.

these rubles could then be invested in Russian companies.⁴⁰⁸ Wolfgang Roller, chairman of Dresdner Bank's management board, submitted a proposal to the steering committee of the banks in debt negotiation with the Russian government.⁴⁰⁹

Although a debt swap program would not single-handedly alleviate all of Russia's problems in attracting investment, it is not meant to. Rather, the debt swap program would comprise just one component of an overall policy and would offer valuable incremental investment incentives.

3) Lack of a Financial Sector and Capital Markets

The third major obstacle to the development of a debt-equity swap program in Russia is the lack of a financial sector and capital markets. The financial sector in Russia is currently incapable of supplying credit to the emerging private sector. As of 1992, there were over 1,600 banks in Russia, but almost all of them are small and undercapitalized or owned by groups of enterprises which use them to get cheap credit.⁴¹⁰ The Soviet banking system was used not as a means of providing loans to credit-worthy enterprises, but as "a vehicle for financing loss-making firms . . . Central Bank credit [was] funnelled through the banking system to loss-making enterprises."⁴¹¹

Banking supervision and the financial infrastructure are also hopelessly inadequate, leading, respectively, to "incestuous and often fraudulent lending practices" and illiquidity.⁴¹² Moreover, the uncertainty and misinformation under current economic conditions prevent a bank from distinguishing creditworthy from uncreditworthy enterprises. The World Bank concludes that the "current structure of the financial system discourages market-based credit decisions and perpetuates the existence of fragile financial institutions with concentrated loan portfolios and substantial outstanding credits to unprofitable firms."⁴¹³

Although complete reform of Russia's financial sector will take years, Russia must begin creating a market-based financial system to provide credit to the emerging private sector. While Russia writes new banking laws and regulations and upgrades accounting and supervisory standards, new

408. Peter Torday, *Novel Proposal to Ease Soviet Debt*, INDEPENDENT, Apr. 10, 1992, Business and City Page, at 27.

409. Wolfgang Munchau, *German Call for CIS Swaps*, THE TIMES (London), Aug. 5, 1992, Business section at 17.

410. RUSSIAN ECONOMIC REFORM, *supra* note 242, at 109.

411. *Id.* at 106.

412. *Id.* at 113, 115.

413. *Id.* at 109.

financial institutions are beginning to emerge. Some joint venture banks are already thriving in Moscow, although they still rely on banking services rather than lending for most of their profits.⁴¹⁴

To promote the further development of the Russian financial sector, the World Bank advocates the development of an elite group of banks known as International Standard Banks (ISBs) that would provide Russian and foreign clients with enhanced financial services. These banks would receive special banking privileges in return for conformity to international banking standards.⁴¹⁵ In return for meeting capital adequacy standards and complying with international accounting standards, annual external audits, insider transactions provisions, and acquiring a Western bank or technical or joint venture partner, the ISBs would be granted privileges such as an "ISB" designation, and lower discount rates and reserve requirements.⁴¹⁶

The debt-equity swap program could facilitate this process by requiring that investors retain an ISB to represent it during the swap transaction. The resultant fees would prove a lucrative source of revenues for the new banks.⁴¹⁷ Banking personnel would also receive valuable transactional experience.

Similarly, capital markets in Russia remain woefully inadequate. About ten specialized stock markets exist.⁴¹⁸ Although trading volume has been steadily increasing, it remains low and trading is generally purely speculative in nature.⁴¹⁹ The lack of developed capital markets hinders a potential swap program by precluding the use of long-term local currency instruments to "sterilize" the monetary impact of the swaps, and by denying investors a liquid means of disposing of their equity stakes.

Nonetheless, important steps have been taken, as the stock markets have established nascent brokerage systems which will facilitate further development of capital markets.⁴²⁰ The investment funds envisioned under the debt-equity swap program would prove an excellent catalyst by

414. One Western banker explains: "How does IMB (international Moscow Bank, a joint venture) make its money? It takes dollar deposits and doesn't pay any interest on it. Not only does it do that, but it charges you coming in and charges you going out. That's banking!" *No Rush for Banks in Moscow*, *supra* note 277.

415. RUSSIAN ECONOMIC REFORM, *supra* note 242, at 110.

416. *Id.*

417. During the Chilean debt swap program, Chilean banks earned 25% of their profits by fees and commissions generated by swaps. U.N. GUIDE, *supra* note 51, at 82-84.

418. The busiest stock markets include the Siberian Stock Market and those in Moscow, St. Petersburg, Nizhni Novgorod, and Yekaterinburg. Konstantin Shtoiko, *Russian Stock Marketeers' Hopes Disappointed*, *Moscow News*, Jan. 13, 1993, available in LEXIS, World Library, MOSNWS File.

419. Between September and December 1992, trade volume doubled in monetary terms every month, reaching 23 million rubles by December. *Id.*

420. *Id.*

stimulating much greater demand for the shares of privatizing enterprises and by providing a body of professional fund managers.

It is critical that the funds control large cash reserves as well as the privatization vouchers distributed through the central auctions because the vouchers do precious little for the target firm other than dilute control. Target firm management will justifiably remain unenthusiastic about outside investors until they can provide capital infusions to expand capacity. For this reason, it is imperative that the funds receive either the billions promised by the G7 or the right to receive interest payment on foreign debt in local currency, as envisioned by the EAI or Miller-Modigliani approaches.

The speed and scale of Russia's privatization program has been phenomenal. By July 1993, more than 2,300 medium to large enterprises, employing fifteen percent of Russia's workforce, have been privatized through voucher auctions. By 1994, 6,000 enterprises will have been privatized.⁴²¹

A debt-equity swap program in Russia would not be desirable or possible without a sizable privatization effort. Countries such as Russia, without well-developed domestic financial markets to absorb long-term local currency denominated instruments to "sterilize" the monetary effect of the swaps, must try to limit the monetary effect by implementing the swaps in conjunction with a privatization program and to impose ceilings on the amount of debt to be converted. At the same time, the debt-equity program can serve as a catalyst to the privatization effort by stimulating foreign interest in Russian equity and by providing "captive" investment capital that must be invested in privatization directly or via investment funds to have any value and by increasing trading volume at Russia's nascent stock markets.

4) Political Problems

Despite the considerable difficulties outlined earlier, the greatest obstacle to a debt-equity swap program in Russia is political. In Latin America, swap programs generally aroused political opposition from nationalist legislators or labor representatives who feared foreign economic domination and who were critical of investment incentives granted to foreigners.⁴²² Attempts to grant domestic investors equal access to the debt swap program can result in charges that speculators or crooks are using the swaps to violate currency exchange restrictions to launder their ill-gotten gains. Swap

421. *The Revolution Begins*, *ECONOMIST*, July 3, 1993, at 69.

422. Hilton, *supra* note 71, at 11.

programs can also lead to allegations of official corruption or complaints that the swaps are fueling inflation. Political passions are easy to arouse when the participating investors are large multinational corporations or banks, particularly when they are perceived to be snatching up the commanding heights of the debtor country's economy at bargain basement prices.⁴²³

These problems must also be addressed when devising a Russian debt-swap program. There are several possible means of resolving the most significant political problems. One such solution involves the scale and visibility of the program. The best way to reduce opposition to a debt-equity swap program is to keep it small and inconspicuous, in terms of the sheer volume of swap transactions, the procedures followed, and the sorts of eligible investment. Although Russia's debt problem is pressing, primary emphasis on a pell-mell reduction of Russia's debt would be short-sighted and could court a disastrous political backlash by wresting control of the swap process out of the hands of the Russian authorities. A test program with the short-term debt or limited amounts of official debt would provide a good measure of the degree of political opposition to be expected under a full-scale swap program.⁴²⁴

The program's public profile will be determined to a great extent by the procedures used to convert the debt. Auctions are often hailed as the best means of converting debt, because the authorities have less discretion to interfere in the investment process. However, this lack of control over the use of swap funds can become a political liability if investors start using the swap program for speculative ends or to engage in nonadditional investment.

Even if case-by-case negotiations are used, investors would prefer that they be public to the greatest extent possible. Although debt swap conversion procedures would ideally be fully transparent, transparency greatly reduces the discretion of the authorities to encourage additional investment by offering certain investors higher incentives and opens the program to greater public inquiry and criticism. Focus on creating additional investment will allow the authorities more control and also allow the program to maintain a much lower profile.

Another means of reducing the profile of the program is to limit eligible investment sectors or the type of investment. Giving foreign investors

423. The Economist reports that someone seeking to invest \$730 million could buy Cray Research (a U.S. supercomputer manufacturer), Vickers (a prestigious British engineering firm), or about half of Russia's manufacturing industry. *Bargain Debasement*, *ECONOMIST*, May 8, 1993, at 79.

424. The Bulgarian government has established a debt management team that proposes to establish debt-for-nature swaps for use as a "lightning rod" to raise debt-equity swap issues. Sung & Troia, *supra* note 211, at 35.

special incentives to undertake nonadditional projects justifiably leads to charges of allowing foreigners to dominate the economy at bargain basement prices. Sectors most likely to attract nonadditional investment must be excluded from the program. The extractive industries, such as oil, minerals, and lumber, would be the most obvious exclusions. The exclusions may or may not be extended to industries and enterprises ancillary to these industries.⁴²⁵

Another possibility is to limit debt-equity swaps to projects in the export sector. Studies have shown that investment directed toward the domestic sector is motivated more by strategic business reasons than by the financial incentives of the swap program.⁴²⁶ In other words, these investors enter the Russian market because they feel that they need to enter the Russian market, and swap incentives play little role in the decision. Investments directed at the export sector are more likely to be attracted by financial incentives, particularly those offering an up-front discount that will reduce the initial size of the investment and give them a cost advantage in world markets. Without swap incentives, these investors could well decide to locate the project in a different country. In light of Russia's vast need for all sorts of investment, export-oriented projects should perhaps be encouraged, but not at the expense of prohibiting all investment into domestic sectors.

This conclusion leads to the related question of whether buy-outs and restructuring should be allowed. Although these types of investment are criticized for not adding new productive capacity, most investors are currently very wary of entering the Russian market and should be allowed to test the waters with a minority equity stake, particularly as even these investments generally lead to follow-on investments that increase productive capacity.⁴²⁷ At least initially, there is little point in restricting the size of equity stakes.

Still another solution to the problems discussed above involves the inclusion of domestic investors in Russia's debt-equity swap program, for both economic and political reasons. First, the huge scale of Russia's capital flight problem must be addressed because domestic investors need an incentive and a mechanism to bring this money home for investment in Russia. Second, restricting the program to foreign investors would be particularly unpalatable to Russians, who are very sensitive to foreign penetration of their economy. Moreover, if the program is attractive,

425. With perhaps the best policy being to allow swaps for these kinds of companies for a limited period of time or for a limited number of companies.

426. BERGSMAN & EDISIS, *supra* note 217, at 11.

427. *Id.* at 12-14.

domestic investors will participate in any event through off-shore companies or other subterfuges. It is better to have their participation above-the-board.

The participation of domestic investors leads directly to another potentially serious political problem. The recent expansion of economic activity in Russia has fuelled the creation of a new class of wealthy traders, speculators, and shady characters. Russians tend to view members of all of these classes with suspicion and resentment, often loosely referring to them as their *mafia*. The *mafia's* participation in the swap program would do little to increase its popularity and would become a political issue in its own right. There is little the government can do to limit the participation of the actual crooks without imposing a chilling effect on the participation of legitimate Russian businessmen. The only thing the government could really do is to make considerable efforts to publicize the most favorable examples of participating Russian investors.

Another aspect of the potential political problems which a debt swap in Russia may cause involves inflation. The possible inflationary effects of debt-equity swaps often cause considerable political opposition. Even if the inflation is really due to fundamental macroeconomic policies rather than the swaps, swap opponents can pin the blame on the debt-equity swap program. A properly structured, debt-equity swap program in Russia could be implemented without a significant rise in the rate of inflation. The most obvious means of precluding inflationary effects is to refrain from printing the rubles necessary to exchange for the foreign debt instruments. This could be done by relying on the privatization scheme to provide most of the assets to be swapped. Instead of handing over rubles for investment, the Russian government could transfer to the investor equity in privatizing state enterprises. No increase in Russia's money supply would result.⁴²⁸

Another common means of preventing inflationary effects is to issue long-term ruble bonds with staggered maturities in exchange for the foreign debt instruments.⁴²⁹ Russia's lack of developed capital markets and the lack of creditor confidence in Russian long-term bonds would probably make this option unavailable in Russia.

Finally, an IFC study concluded that swap programs might end up financing nonadditional investment or have inflationary effects, but cannot do both.⁴³⁰ The simple reason for this is that a nonadditional investment project, with its potential inflationary effects, would be incurred even without the swap program. Only programs that attract investments that

428. WILLIAMSON, *supra* note 154, at 64.

429. *Id.* at 42-43.

430. BERGSMAN & EDISIS, *supra* note 217, at 32.

would not otherwise have been made would have inflationary effects attributable to the swap program.

Finally, there would be several political benefits to delegating responsibility for the program to the regions. First, both the federal and regional governments could claim credit for the beneficial aspects of the program while pointing the finger at the other for the negative aspects. The federal government provides the means to implement the program, but the regional officials actually administer it.

Holding regional officials responsible will help reduce the national political impact of any corruption that arises. National officials can blame the region for appointing improper personnel to run their program. Moreover, the regions will be more receptive to any program that they have a greater role in implementing. Different regions will be able to formulate different programs to suit their needs. Moscow can set certain strict parameters for the program while leaving the details to the regions; regions will be much less likely to ignore such an initiative from Moscow. Also, regions will be free to opt out of the program if elected officials there feel that the region does not want or need foreign investment. If the program proves successful, regions will seek to participate on the initiative of regional leaders. Regions will compete to appear most attractive to foreign investors.

CONCLUSION

A debt-equity program is feasible in Russia if limited in the amount of eligible debt, the type of eligible investment, and eligible geographic area. Such a program will obviously have a limited impact, but debt-equity swaps are merely one arrow in a government's quiver of economic and foreign investment policies. Substantial amounts of foreign investment will ultimately depend upon the development of an overall favorable business climate, not on the effects of a debt-equity swap program.

Nonetheless, a debt-equity swap program would provide a valuable means of stimulating the flow of investment capital, the development of capital markets, and the reduction of debt servicing obligations. After introduction of a pilot program, the program could be expanded or quietly dropped without further development. Ideally, the program would serve as a catalyst for the development of private enterprise in Russia.

In conclusion, a debt-equity program should be established because Russia needs to pursue all available means of attracting investment capital during its transition to a market economy, and debt-equity swaps will allow Russia to advance simultaneously towards several critical objectives.

