5-1987

Debt-Equity Swaps

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Published In
The Euromoney-Mexico Debt to Equity Conversion and Investment Conference, Euromoney Conference Reports.

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DEBT-EQUITY SWAPS

Euromoney-Mexico Debt to Equity Conversion and Investment Conference.

It is a great pleasure to be here to talk about this important subject, and I congratulate the sponsors for organizing this session.

I have been a proponent of Debt Equity Swaps, so as to make the record clear, since 1982. That is, since the debt crisis began. And as you will see, as I go along, though I don't think that they are a perfect solution to anything; and believe that there are always problems involved in implementing the programme, they are the best approach which can be taken, and they are more promising than even many of the governments which are now beginning to embark on programmes of that kind.

And I will try to make some of that clear to you as I go along.

Secondly, I would like to give you a brief idea on how I intend to approach this topic.

I want to begin by looking at it in the international context in which it arises. What is the potential for countries like Mexico, or other countries which are now debtor countries, to be able to work out of their problems in a satisfactory way, and what has been accomplished so far? What remains to be accomplished? What is the target by which we decide that a country is now back in the market place or out of the problem so that it doesn't periodically have to go through re-scheduling crisis, bouts of austerity, and all of the other things with which we have become familiar in recent years? When does a country get itself removed from the problem of going to the Paris Club, the IMF, The World Bank, the International Consortium of Bankers and others, and so that it then goes back into the market place and borrows, as many countries did, (including Mexico of course) up to 1982. How do we accomplish that? And it seems to me that in thinking about that question, thinking about almost any question of this kind, we must lift our eyes above the short-term horizon, and ask ourselves, where will this programme that we now embark on, take us to. Where will it lead to in 1990 and 1995? We recognize I think, now that we are in the fifth or sixth year of concern
with the debt problem, that this is not a problem which is going to go away overnight. So we want to ask, what are we doing that is more than a stop gap? What are we doing that puts us on a road towards a general solution to the problem?

So let me turn to the general problem in the context of the next few years, which helps to explain why we must think differently about the debt problem.

I think the salient fact about the world economy is, and what we can say about the world economy is, that there is going to be a remarkable transformation. The role of the US which has been a net lender to Latin America and other parts of the world is going to change, and the reason for that is that in 1981 the US had accumulated 140 billion dollars worth of net assets in the world. That is, it has bought or loaned assets in the rest of the world, and it accumulated 140 billion dollars net. It had roughly 80 billion dollars worth of gross assets in the world, and 650 billion dollars worth of gross liabilities.

By 1986, that is just five years later, it had 200 billion dollars worth of net liabilities in the world. It had become the world's largest debtor, and by 1990, even under the most favourable circumstances of what could happen to the US trade position, the US will be a net debtor to the world, of from some 600 to 900 billion dollars.

That set of facts and the projection tell us a great deal of what is going to happen. The US is going to have to become a major exporting country. Germany, Japan and some other countries are going to have to become major consuming countries. Without those changes, there will be no satisfactory resolution to the problem of US debt. The options for other countries in the world are really simple to describe. They can lend more money to the United States; they can allow the rate of exchange against the dollar to depreciate; they can begin to consume more, and force the US to export more.

Those are really the descriptions of what is going to happen.
So, as these countries begin to want to lend less to the United States, they are going, through the exchange mechanism, to decide to consume more, produce less, and export less. The US is going to have to become a big exporting country, and a smaller consumer. In order to service the debt which I estimate at between 600 and 900 billion dollars by 1990, the US is going to have to run, not a trade deficit, but it's going to have to run a trade surplus of something in the order of 70 billion dollars, just to service its debt.

Now, that is an important fact for every country, which is a debtor or a creditor in the world. And it is a particularly important fact for Latin American countries. Latin America cannot pay its debt by net exports to the United States. It may export to the United States, but net exports to the United States are going to have to become less important, unless the US has even larger net exports to the rest of the world, especially Europe and Asia, otherwise the US will not earn, will not run the surplus, which is required to service the debt, and that would require either continuous decline in the value of the dollar, or continuous lending on the part of other countries to the US, or purchases of assets in the US by those countries. All or some parts of those things are of course going to occur, but the big main thrust of the comment is that we cannot look to the US to be a net importer from the rest of the world. You have to regard the US as being in transition to a position of being a net exporter. Therefore, Latin American countries which want to service their debts, and improve their growth rates, and improve their standards of living, are going to have to look for export markets in other parts of the world.

To end the current US trade deficit of 150 billion dollars and pay the interest on the debt in 1990, the US must double its exports, halve its imports, and reduce the growth of per capita real income in the United States, and perhaps lower its standard of living.

Now, in order to solve its problem there are really four options available to the US, which are perhaps important to Latin America.
One is that the US could choose, as it has done to some degree already, to protect against imports. To restrict the amount of imports coming in, in the interests of reducing its trade deficit. This would be a highly counter-productive activity on the part of the United States, not only from the standpoint of Latin America but from the standpoint of the US. The only way in which the US can work out of its current debt and trade deficit problem would be to have an expanding world economy, and the opportunity to earn the 70 billion dollars which it would have to pay to service its debt. It can inflate to wipe out part of the debt which has occurred. The US option unlike the option of Mexico, Brazil, Venezuela, Chile, Argentina and others is different in that the debt is denominated principally in dollars. Consequently we can inflate away part of the debt but that would have substantial costs. It would have some short-run benefits for Latin American countries but it would also have substantial long-term benefits, since voters, particularly in the United States don't like inflation, certainly don't like high inflation, the period of inflation would be followed by a period of anti-inflation policies, and we all have enough experience in the last ten years with anti-inflation policies to have some idea of what that would mean.

The US could finally try to increase its productivity by shifting its tax mix, encouraging the broader productive investment. And that is the lasting solution, the solution which every country which has a debt problem must ultimately come down to. The problem of increasing productivity, expanding exports, making the products that you produce more saleable and more attractive to other people in other parts of the world.

And I raised these points because it is important to understand that one of the principal sources of capital to Latin America has been the US, the US is a net debtor in the world, and will be a smaller source of capital than it has been in the past. It has sold off large parts of the assets which previously had accumulated. It took something in the neighborhood of 70 years to build up that stock of 140 billion dollars worth of net assets, which peaked in 1981, in four years it has all been run down and replaced by a 200 billion dollar net deficit, so we can see that over the course of the next few years, with increasing needs for productivity
growth in the US, the principal place for US investment will probably be in the US, and the US will continue to be a net capital importer during this period, and therefore it would be much less of a net capital exporter, and that is going to have important consequences for other countries, most importantly for countries in Latin America.

So the first reasons for thinking about Debt Equity Swaps are external. The chance of faster growth of world trade, looks ... likely but not extremely likely, it doesn't look like we're going to give ... given the US position, the growing restrictions on trade, the problems of negotiating further rounds of tariff reductions, it doesn't look as though they are going to be the major surge in world trade, such as it might have occurred in the 1950's or the 1960's, which were going to lift the world out of this problem.

The changes of slow growth and protectionism look very real. We have the Gephard Amendment, other moves to protection, and while we don't know how these are going to work out, we recognize that this would be probably a major issue in the 1988 presidential election campaign in the United States.

If we turn from these policies on a broader basis, we next want to ask as a second question, as to what have we accomplished in terms since 1982 in treating the debt problem of Latin America. We've seen in many cases substantial internal adjustment. Country after country has adopted austerity measures, squeezing consumption, trying to increase their net exports and the end of the early optimism such as is characterized by statements which viewed the debt problem as a problem which was transitory that would be over by the end of the decade. I think a good deal more realism has now crept into these discussions, and after four or five years ... there is some great understanding that in fact this problem of debt accumulation was not going to be solved by a sequence of bridge loans, and re-scheduling conferences; and we would like to look in a moment at what in fact has been accomplished.
The first way of looking at this problem is of course to look at what has been accomplished on the trading accounts. What have countries that have tried to improve their trade positions, actually succeeded in doing? And one of the first transparencies that I have, which is now going up on the screen to my left, shows how different countries have responded to the problems of the last few years. As you can see, many of these countries which had severely small trade balances in 1982 have, over a period of time, been able to lift themselves up, in 1984, 1985 and 1986 to substantially better improvements. Mexico is a particularly interesting case, where despite the oil problems of 1986 the country has managed to maintain a reasonable position in the world economy. Not quite as good as in 1982, but remembering that the oil price in 1982 was substantially higher it has managed to maintain considerable growth.

What I think one sees from the trade balance accounts is that the initial squeeze on consumption in order to get more exports was very effective in many countries and produced rising exports. Realigning exchange rates to something closer to the correct exchange rates has been quite successful. But that there seemed to be limits that can be reached in this range, that countries having reached some sort of a plateau of 8 billion dollars, in the case of net exports on the part of Mexico, seems to be a very good performance, and one which would be hard to get substantially above on a consistent basis very rapidly.

So what we see is that the initial effects of these in terms of squeezing out higher exports have been very useful, but when we turn to transparency two, we ask the question, what has this accomplished in terms of the debt/export ratio? Whether these countries have been squeezing so hard have accomplished anything in bringing their debt export ratios down to some number that would permit those countries to return to the market place? Now, no one knows exactly what that number, when you return to the market place, is going to be, but a rule of thumb which is widely used is that the number should be something in the neighborhood of two or headed towards two. And we see is that very few of these countries, in fact none of them, Argentina, Brazil, Mexico, Venezuela, that none of these countries, despite the increases in the growth of their exports, despite the remarkable turn around they've made in their net current
accounts, that none of these countries during this period had managed to substantially reduce the debt/equity ratios. As a matter of fact for countries like Argentina, Brazil - Brazil is slightly below what it was in 1982, but only slightly - and if we look at a country like Mexico we see that it is now, in 1986, based upon the estimated figures for the end of the year, it is above the level that it was in 1982. So, that they are no closer to solving the problem if we mean by a solution, and I think that's one of the things we mean by the solution, that the interest payments on the debt, as the share of exports begin to get down to the point where they can be more easily handled, when the debt itself in relation to the exports is a more meaningful number closer to two than to three and a half or four. So what we see from this transparency is that this policy has not been overly successful. It has not succeeded in bringing us to the position where we could comfortably look ahead to the time when the problem would be over. That is when Mexico, Brazil, Argentina, Venezuela, Chile, other debtor countries could return to the market place, as I described earlier, and go through the normal process of borrowing and lending, just the same as might be done by France, or the UK, or some country which is not in re-scheduling difficulties.

Now when we look at this question and we see that the debt/export ratio tells us - that there has been substantial improvement in exports and substantial improvement in trade balances in general, but not much improvement in the debt/export ratio, we want to ask what is going to happen. If we are not going to be able to import large sums of capital from the United States, if the amount of new debt that we're going to be able to accumulate in Latin America is going to be severely limited, what is going to take its place? What is going to be the principal source of capital to Latin America, which is going to help these economies to rationalize their production, to get into new activities, to expand their output, to grow their exports, to improve their economies, to do all those things? So much is needed to be done in order to raise the living standards. And if we rule out large inflows of capital from the US, possibly Japan would be a more important lender over the near term, but we must ask where would the additional capital come from? For Mexico, for example, interest payments in debt service now take 9-10 billion
US dollars. More debt means for every additional 1% increase in the
debt there must be 1% increase in exports permanently into the future,
to service that debt at the constant rate of interest. So the more
that a country borrows and the more that it accumulates debt, in order to
pay its interest or to grow its economy, the more it must raise its
exports in order to keep its debt/export ratio from rising, and to
service that particular kind of debt. So going into debt, while it may
bridge some short-term problems, doesn't get us closer to what I regard
as a long-term solution to this problem. And for the reason that I've
given, more debt - means that there must be a one time increase in debt
to solve the particular problem - requires that there must be a permanent
increase in the level of exports in order to service that debt in per-
petuity.

Now, there is the possibility of course, of higher domestic saving.
Mexico has a high saving ratio. It has historically kept its ratio, and
even though in the last few years, in the neighbourhood of 15-16 per
cent of its GNP, a much higher rate than for example its neighbour to
the north, and it has made substantial strives in trying to encourage
saving. But the opportunity for additional saving, which is going to
provide the net capital for Mexico, seems to me to be not a promising
path for the Mexican government, or for other Latin American governments
to take.

The third source which is the most promising source of capital, if it can
be achieved, is to repatriate the capital of Mexicans who have left.
And this is true for all of Latin American countries. And in transparency
3 we see something about the magnitude. Now, these numbers are not
precise. No one knows exactly what the amount of capital flight is,
and is even quite difficult to define what one means by capital flight.
Since after all capital can flee simply because someone sees a better
opportunity in another country. Nevertheless when you see the numbers
for the various countries, and particularly concentrating on a country,
on the Mexican numbers, what one sees is that a substantial part of the
debt which was accomplished, which Mexico now owes was the result, or
at least in part the result, of capital outflow.
So that the great source of capital which is available to Mexico, to other countries, to other debtor countries, is to attract back some of the capital which was left here during the periods in which people lost confidence in the policies of the Mexican government, in the rates of inflation and in the prospects for what was going to happen. And as you see that of all the countries, Argentina and Mexico, aside from Venezuela, but Argentina and Mexico have something in the neighbourhood of 50 per cent of the outflow to the debt of numbers, that if we could begin to attract them back even on a limited scale, would represent an enormous potential for investment in the domestic economy. So it is that capital which can be attracted. And attracting that capital is not without its problems, but it is also, - and that is most important not to forget - it is also not without its great prospects. The prospect of being able to see the economy improved, to raise the standard of living, and to begin to do this, and without raising fears of patrimony of the ownership of the assets or a substantial part of the assets, a fear which I first ran into when I proposed this policy in an international forum in 1982, where I was met with of course, the "if we did that then all of our assets will be owned by foreigners". This question of course, becomes easier to resolve if a great part of the capital flow, which is being attracted back, is capital which previously left the country during some earlier stage under less happy circumstances. And I think we saw it in 1986, the beginnings of capital re-flow to Mexico, which shows at least the potentials that can occur. But more than that, I would say, is that it's not just that the capital which has fled the country has been brought back, but if policies are adopted, which attract this capital back to Mexico by creating conditions under which people are eager to return it, then other capital, capital from other countries, savings from other savers, non-national savers, will of course be coming along also, because the conditions making it attractive to bring capital to Mexico would have been created. But attracting the capital of natives who have fled, or taken their money away, is a first step towards making a surge of capital spending come back into the country.

Now, one major problem with present programmes, as I have said, is that countries continue to borrow, and the more they borrow, the more they
must export; and the more they export, the more exports must grow ...
The more they borrow, the more exports must grow in order to get the debt/export ratio to a level at which they can return to the market.

In short, countries which go into debt, and substantially into debt, must run faster to stay in the same place, and the same place, of course, in this context means the same debt/export ratio.

Now in chart four, I assume that we don't completely cut off all debt/exports, all debt growth. In fact I allow debt to grow by 2% a year, which is the reasonable rate for many countries, and I look at what could happen, what would have to happen for a country, Argentina, Brazil, Chile or Mexico to reach a debt/export ratio of approximately two by 1995 with 2% rate of increase in the debt per year? How much would the exports have to grow, in order for that to occur? And how does that compare to the rate at which exports have been growing, historically or prospectively? And if you look at the first line you see, we take the case of Mexico, since that's most relevant here, we see that with the 1986 gross debt in billions of dollars ... of 98 billion dollars, and an estimated 1986 net debt/export ratio, net debt is essentially subtracting out the reserves of the Mexican government, and making the assumption that these reserves are not going to grow in proportion to the debt, which may or may not be true, what that would tell us that if we were to have the debt grow at 2% a year, and keep the reserves at exactly the same level, then the gross debt by 1995 would be 116 billion dollars. And in order to get the debt/export ratio to two or thereabouts, exports would have to grow at 13.9 per cent, approximately 14 per cent a year, and that compares to a number of the growth of exports for Mexico of 19.2 per cent during the period of 1973-1984, now of course, that includes the period in which exports of oil were very important. So it is useful in that comparison to look at how other countries would do. Countries which aren't quite so much affected by the rise and then later the decline in oil prices. And as we can see that for Brazil or Chile, the numbers are within striking distance. That is that it is possible for them to get their exports growing rates up by about 2 per centage points a year, above what they have been historically achieving, but they could in fact, with the 2 per
cent rate of growth, could bring the debt/export ratios down to the point where by 1995 they could be looking at an end to the problem. That is, an end to all the rescheduling crisis and a return to the market. And as we can see for Argentina the problem is a good deal more severe. So what that tells us is that a long-term programme of this kind, which doesn't ask for horrendous sacrifices on the part of these governments, which says that imports can continue to rise as long as they don't rise any faster than exports have been rising, we keep the gap between exports and imports that has been opened up by the austerity programmes of the middle 1980's, we get the export growth rate up a little bit more, we can continue to borrow, but a slow rate, and we can in fact see the end of this problem if we are willing to undertake a programme of this kind.

Now that's where I think we can get some ideas to where the role of debt, to Debt Equity Swaps could do. Because they of course can work on the problem instead of having to push the exports up, to rates which are substantially above the rates which have been achieved historically over this period, we can begin to keep the debt down from growing. Suppose for example, that we were to think about keeping the debt constant, let us suppose that each year we do the obvious thing: instead of allowing the debt to grow by 2 per cent a year, we do 2 per cent of the old debt ... is sold out, so that we may be continuing to borrow but we don't allow net borrowing to increase. That is, we keep the debt constant over this period by using debt equity swaps at the rate of approximately two per cent a year of the outstanding debt to reduce, or to keep the debt from growing, and allow the exports to grow. How well, where will we be by 1985 if we were to do something of that kind?

Well, if we look at the next slide, we'll see the answer to that question. First line tells us, for each of these countries, what would be the annual amount by which these swaps would have to be. If you see that they are not very large numbers for Mexico, they are within the range of the debt equity swaps that have been occurring over this period. That is essentially 1.6 billion dollars per year if they would end to do that, what would be the debt/export ratio in 1995 if we were to continue with ... debt equity exchange is equal to two per cent; that is, just hold off the
debt from growing, allow the exports to grow. If we allow them to grow at the required growth rate. The required growth rate is the rate in the previous table, which I said would be required under the assumptions of that table, or if we look at the bottom part of the table, and we look at what would be a historic way of growth we'll see that with the exception of Argentina, Brazil, Chile and Mexico get down into the range of which we could begin to think of the debt problem of the 1980's as being over by the middle of the 1990's.

Now that is an ambitious programme, but it is a programme which has as its main thrust the idea that the way in which we are going to work away through this problem is by beginning to do some of these debt equity exchanges. To do them in amounts which are not super-normal, and of course, if we did more, we could borrow more during this period of time, about doing any damage to the numbers in that table, if we were able to do debt equity swaps, or debt for debt swaps, because some of these could be done in exchange for debt, then that is exchange of dollar denominated debt for local denominated debt, if we did that, then we of course would be able to improve upon the performance of this thing, or we wouldn't have to squeeze the exports quite as fast.

So let me try to pull that together. There are three ways to service the past debt: you can earn enough to pay the interest for portfolio investment, and example of that is Korea, which is growing very rapidly and is being able to finance, although it had a very high debt/export ratio. It was able to raise it's exports rapidly enough so that it was able to service its debt without getting into difficulty, and never went into re-scheduling crisis. Suppose with enough investment abroad, or investment is profitable enough, we can get enough capital attraction into the country, so that assets would be growing, exports would be growing, productivity would be rising, and exports would be growing from that way, or of course we can cut consumption and imports, go to another round of austerity, or we can go through debt/export exchanges. And among these options as I have said, the debt equity exchanges are a significant and important element, which I believe offer great promise.

There are three more main elements in any solution to the debt problem
of the 1980's. There must be more investment, there must be more productivity and more exports, there must be less debt service.

So, the debt equity swaps provide us with a way to do in the market place what we have been unable to achieve in the re-scheduling conferences.

Now, there are some objections to doing these things, and it's important to take up some of these criticisms that have been made.

First, there is the problem of local patrimony. And I think we can allow for that problem, or if we are sufficiently adept at attracting back some of the capital that has left the country under the previous time.

Second, there is the problem of restructuring in the economy, none of these programmes are going to work if in fact there isn't substantial change in the outlook for investment within the country.

Thirdly, there is often the problem of inflation. Many people, when they look at the problem of debt per equity swap, say that when we get this debt coming into the country, what we are going to see, is we will have capital coming into the country, there will be exchange at the Central Bank, and as there is exchange at the Central Bank? We would see the money stock rise and therefore they would be inflationary.

Now, one wants to stop and consider that question. I mean, literally taken it would say that there would be an argument against having a capital inflow. Because there is nothing about the debt equity exchange which causes the problem of inflation, is the fact that you are attracting capital, and the fact that you have a capital inflow necessarily has an impact on what happens to the foreign exchange reserves of the Bank of Mexico, and therefore is potentially inflationary. The answer to that, has been known for several hundreds of years, of course you can prevent that increase in the money stock, that you can prevent that increase in capital from affecting the money stock by selling off domestic assets from the Central Bank with the same speed that you would have for foreign
assets coming in, and therefore avoiding the inflationary consequences. There is no necessary reason why there would be an inflation following the capital inflow, and the inflationary consequences should not be one which would deter capital inflows.

So how does one go about this? My own way of doing it will be to simply say, there is this enormous pool of capital available to Mexico and other debtor countries, provided they begin to restructure their economies. Much of this debt is selling in the market place at somewhere between 60 and 70 cents to the dollar, and consequently there is an opportunity for people who want to take advantage of that difference between those two prices; to buy the debt at its market value bringing it to the country and exchanging it at the current exchange rate, provided that they invest it in productive assets within that country. And the fact that you attract this money from foreigners, to come in as well as domestic citizens, to come in to the country means that you would have put in place the kinds of policies which would make that flow of capital attractive. Indeed, now some people would say, well, but what would happen of course as you continue to do this? How would we ever work out of a problem of this kind? As the demands for these programmes continue, for the debt equity swaps begin to increase, then as the debt begins to come down and to look more manageable, as the economy of Mexico begins to approach a debt/export ratio of two, the value of the debt in the market place will rise somewhere closer to its face value, and that is the way the problem would come to an end, so that the sacrifice on the part of the people who originally made those loans, they would be recognised in the write-off which they have to take. Recognising the losses which have already occurred, they would begin to write them off by selling them in the market place. And second, of course the government of Mexico would recognize, and in other countries, that it made a mistake in accumulating this large amount of debt relative to its exports, that many of these investments should have been in equity or in some kind of marketable instrument in the first place and by making these exchanges we really reconstruct the balance sheet to reflect the mistakes that have been made on both the lender and the borrower side in the past. Not without cause but with some benefits to other people.
So, I am a believer that not only this is a useful programme, but it is a good programme. It is one that has historically worked. It after all is the programme which has been used to restructure the debt of corporations all over the world when they have gotten into trouble. We wiped out some of the claims; we restructured them with equity - that is basically the principle that has been applied here, it is the principle of banking, it is a good principle, it has worked many, many times, and it would work again, it would lead us, properly administered and run, to what we all should be looking for, namely, the answer to the question "Where would we be in 1995?" That we can look back and say, the policies that we adopted in 1986 and 1987 were the policies that led this programme, not to be in a better position, but to be over and done with.

Thank you.