Debt Equity Swaps – Will They Become the Wave of the Future?

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IN MANY developing countries debt equity swaps have become one major weapon with which to confront the debt problem. Latin American countries are noted for their debt equity transactions, in which they transfer state-owned assets to creditor institutions in lieu of cash to cover portions of their outstanding liabilities.

Most countries use debt equity swaps when they are unable to generate enough cash to pay off their debts. Instead of repaying their debts in cash they pass over equity of assets owned by the state in return.

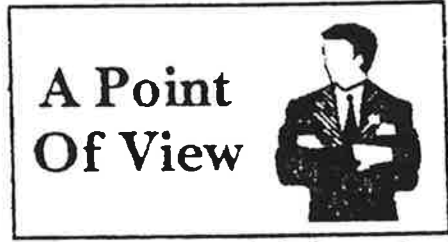
Today, Egypt too, is starting to apply the debt equity swap mechanism to address a part of its outstanding liabilities. The Egyptian government has already agreed to three debt equity swaps and has just concluded a major transaction.

Egypt is one of those lucky countries that owe a large portion of their debts to donor states rather than banks. The transactions that have been carried out using the debt equity swap mechanism have all dealt with either modest bank loans or donor liabilities.

In the most prominent debt equity swap to date, the Egyptian government allowed a local institution to acquire a debt that it owed to a foreign government in the range of $43 million. This local institution paid only $22 million to acquire this outstanding loan on which Egypt had defaulted several times. The local institution then approached the Egyptian Central Bank and converted the outstanding liability to Egyptian pounds at an agreed-upon exchange rate, and an investment project in the agricultural sector was started with these funds.

Why did the Egyptian private-sector institution involved go through the hassle of linking a debt equity swap scheme to an agricultural investment project? Primarily because it appreciated the size of its investment by acquiring additional funds from the debt equity transaction. It was able to reap additional pounds from exchanging a smaller number of dollars.

Let's use an example to explain how debt equity swaps function. Assume that an Egyptian businessman approaches a foreign bank to which Egypt owes $100 million. The hypothetical foreign bank has received no interest on an outstanding loan from Egypt and the bank expects Egypt to default. The bank will settle for an amount less than what it lent in order to get some return instead of no return at all. Thus, when approached by an Egyptian investor who offers, say, $60 million to acquire the $100 million debt, it may agree to such a transaction to minimize its losses.



The Egyptian businessman or institution acquiring this loan then approaches the Central Bank of Egypt and converts the $100 million debt to Egyptian pounds and reaps the difference in revenue. Assuming a hypothetical exchange rate of E£2 to the dollar, the Egyptian businessman would receive E£200 million for the acquired debt of $100 million, when in fact he only paid $60 million, equivalent to £120 million. This means a windfall of E£80 million on the transaction.

Debt equity swaps are usually permitted in countries where the government has foreign exchange and the private sector has a lot of it. The private sector thus assumes the burden of buying outstanding liabilities, and receives a financial reward in local currency from the transaction.

Most governments that have chronic debt problems, though, also have chronic budget deficit problems. A country such as Egypt, which had a budget deficit of over E£12 billion last year, does not want its money supply to grow further because it already suffers from high inflation, and sizeable debt equity swap transactions like those described could lead to a further increase in domestic prices.

Thus, many countries trade state enterprise assets to third parties who undertake to repay their debts. For a country such as Egypt, debt equity swaps could be a viable way through which privatization programs could be implemented, trading state assets for debt that is bought by the private sector. This system is ideal for Egypt, which has seemingly limitless state assets as well as measureless foreign debts, and no sizeable foreign exchange revenues to repay them.

However, the transactions completed by the Egyptian government in the debt equity swap arena thus far have not been linked to the state's objective of privatizing some state assets, and it would seem wise for the state to do so. One hopes that the debt equity swap mechanism will become part of what the government is now proposing as a solution to its foreign debt problems.

Debt equity swaps could be one way of solving the liability problem Egypt faces in the short term, and at the same time they could aid the government in moving the economy toward a more market-oriented system of allocating resources.