OECD DEVELOPMENT CENTRE

Working Paper No. 54
(Formerly Technical Paper No. 54)

DEBT CONVERSIONS IN YUGOSLAVIA

by

Mojmir Mrak

Research programme on:
Financial Policies for the Global Dissemination of Economic Growth

OECD OCDE

February 1992
OCDE/GD(92)27

Technical Paper N° 54

"Debt Conversions in Yugoslavia", by Mojmir Mrak, Research Programme on Financial Policies for the Global Dissemination of Economic Growth, Head of Project: Jean-Claude Berthélemy, February 1992.

TABLE OF CONTENTS

RÉSUMÉ

Ce texte commence par une brève description des relations entre la Yougoslavie et ses créanciers dans les années 1980, dans le contexte desquelles la conversion de dette a été mise en oeuvre. Les principaux traits de l'environnement réglementaire de la conversion de dette sont ensuite examinés, en particulier en ce qui concerne le programme établi à partir de mars 1989. Par la suite, ce document examine les caractéristiques principales des conversions de dettes réalisées par la Yougoslavie, en termes de volume, de structure des transactions, d'origine des fonds et de réduction de la dette. Il apparaît en particulier que le programme de conversion de dette yougoslave présente beaucoup d'aspects originaux par rapport à des programmes similaires appliqués dans plusieurs pays en développement. Pour finir, ce document passe en revue les implications micro et macro-économiques des conversions de dettes, avec une comparaison des coûts et bénéfices associés à ces transactions. L'auteur conclut que ce programme a été plutôt un succès pour la Yougoslavie.

SUMMARY

The paper begins with a brief description of the relationship between Yugoslavia and its creditors throughout the 1980s, providing a background for the introduction of debt conversions in Yugoslav practice. The main features of the legal environment for debt conversions, especially of the debt conversion programme initiated in March 1989, are then reviewed. The paper then focuses on the main patterns of debt conversions executed in Yugoslavia with respect to their volume, structure of transactions, sources of funds and debt reduction effects. It appears in particular that the Yugoslav debt conversion programme presents many original features when compared with similar programmes implemented in several developing countries. Finally, the paper provides a review of the micro and macroeconomic implications of debt conversions, including the cost and benefits of these transactions, and concludes that this programme has been quite successful for Yugoslavia.

PREFACE

Yugoslavia, one of the principal highly indebted countries, experienced an important programme of conversion of its commercial debt from 1988 to recently. This experience provides lessons which may be useful for policy makers deciding on debt management policy in over-indebted developing countries and in Eastern Europe.

Yugoslavia's debt conversion programme presents several features which differentiate it from debt swap programmes of developing countries such as Argentina, Brazil or Chile. It is a highly flexible programme, which imposes few restrictions on participants, and which is decentralised at the commercial bank level. It provides many options, including an original debt-export conversion scheme. All these options are designed to maximise the additionality of funds provided by the buyers of the debt. Hence, the risk of immizerisation of the economy by debt conversion, which has been discussed at length in the literature on market-based debt reduction operations, is minimised here.

As a consequence, this debt conversion programme, through which Yugoslavia has withdrawn more than $ 1.8 billion — 25 per cent — of its commercial debt, may be regarded as successful and may provide a useful blueprint for countries engaging in similar operations.

Louis Emmerij
President, OECD Development Centre
February 1992

I. INTRODUCTION

Since the outset of the debt crisis, Yugoslavia, like many other debtor countries, has been running a large non-interest current account surplus. The country has reduced consumption and has operated at an historically low level of investment and imports in order to transfer resources abroad to service its debt. The Baker plan, aimed at avoiding these undesirable effects through advocating adjustment by pumping more fresh money into highly indebted economies, has lagged far behind the lending goals originally envisaged. The main reason for this has been the growing conviction of commercial banks that heavily indebted countries are unlikely to become creditworthy in the foreseeable future. As a consequence, banks have become increasingly interested in selling off their claims on developing countries at a discount. This approach was subsequently officially supported by the Brady plan.

A whole set of market-based instruments for trading below face value (debt reduction and debt service reduction instruments) has thus been developed. These instruments comprise schemes which aim at converting debt into other forms of liabilities (debt/equity conversions into equity; debt securitization into foreign exchange denominated bonds) or other schemes, which aim at repaying debt by repurchasing a country's debt on the secondary market (debt buy-backs) or by export of goods and services (debt/export conversion).

Despite five years of restrictive stabilization programmes and repeated external debt restructurings, Yugoslavia found itself in 1987 (as in 1982/1983) in a situation in which the country was not able to service its external payments obligations. At the same time the country's volume of external debt still exceeded $21 billion.

According to the new external debt strategy adopted in 1987, the Yugoslav government has specified three main objectives: not to increase the volume of external debt, to reduce the debt service ratio and to maintain foreign exchange reserves at a level of at least three months' import payments. An integral part of the government's policy to achieve these objectives has been debt conversions. At the outset, the government's approval was needed for each individual deal; in March 1989 this case-by-case approach was supplemented by an integral legislative framework which laid down detailed rules for eligibility and procedures for debt conversions. In contrast to the experiences of some other highly indebted countries, which have introduced programmes exclusively for the conversion of external debt into equity, Yugoslavia's debt conversion programme has allowed a variety of debt conversion forms.

The purpose of this paper is to present the main features, and especially the specific characteristics, of Yugoslav debt conversions in the period 1988-1990 as well as to analyze the micro and macroeconomic implications of these transactions. The paper is based on published and unpublished information available from the National Bank of Yugoslavia (NBY), reports in newspapers, books, specialized information services and conference papers as well as information gathered through interviews with government officials, representatives of the NBY, representatives of commercial banks and businessmen from enterprises which have carried out debt conversion transactions.

The paper begins with a brief description of the relationship between Yugoslavia and its creditors throughout the 1980s, in order to provide a background for the introduction of debt conversions in Yugoslav practice (Chapter II). The main features of the legal environment for debt conversions, especially of the debt conversion programme initiated in March 1989, are then reviewed (Chapter III). The paper then focuses on the main patterns of debt conversions executed in Yugoslavia with respect to volume, structure of transactions, sources of funds and debt reduction effects (Chapter IV). The next focus of the paper is a review of the micro and macroeconomic implications of debt conversions, including the cost and benefits of these transactions (Chapter V). Finally, there are conclusions (Chapter VI) that summarize the main patterns of debt conversions in Yugoslavia.

II. BACKGROUND FOR DEBT CONVERSIONS

Unbalanced growth and increasing distortions of the Yugoslav economy during the 1970s, together with the effects of the second oil shock and increasing interest rates, resulted in a large current account deficit and an external debt of over $21 billion in 1981. In the light of these developments and due to the growing reluctance of the international banking community to provide further credits to Yugoslavia, the government was forced to introduce various economic policy measures aimed primarily at stabilizing the balance of payments position and halting the growth of external debt. Like other debtor countries, Yugoslavia has had to run large non-interest current account surpluses in order to meet its external debt obligations. This has been achieved not only through the reduction of consumption but also, and even mainly, by reducing investment and imports, resulting in a deterioration of the country's present and future living standards.

Throughout the 1980s, Yugoslavia undertook an almost continuous commitment to multilateral financial institutions and other group of creditors to service its external debt obligations regularly. In that decade, the country entered into a number of stand-by arrangements with the IMF and one "enhanced surveillance procedure" with this institution as well as into a structural adjustment programme with the World Bank. On the basis of these arrangements, Yugoslavia concluded four debt restructuring agreements with commercial banks in 1983, 1984, 1985 and 1988[1]. Only the 1983 and 1988 restructurings were accompanied by the provision of new financing: $600 million in 1983 and $300 million in 1988.

The first two restructurings of the Yugoslav external debt in 1983 and 1984 were achieved, as in other highly indebted countries, under very unfavourable conditions. They reflected the power relationships of that particular period in the global economy, when debtor countries were forced to bear practically all of the costs of the debt crisis. Among the specific conditions accepted during the 1983 negotiations which had, and still have, a significant impact on the country's external debt position was the clause that the government would take over the responsibility for servicing not only public and publicly guaranteed debt but also private unguaranteed debt. This socialization of external debt obligations can be understood only through the following illustration: while Yugoslavia entered 1983 with $5.5 billion of public and publicly guaranteed debt, private unguaranteed debt amounted to almost twice that amount — $10.9 billion. The other important provision legally sanctioned in the context of the 1983 negotiations with foreign creditors and which had an impact on debt conversions obliged all Yugoslav companies to reschedule their external debts regardless of their actual debt servicing capability.

Increasing internal economic problems and the constant pressure of uncertainty related to the year-by-year restructurings underscored the need for a longer term approach to the external liquidity problem of the country. Within this context, the programme "Basic policy measures for the normalization of external liquidity, 1985-1990" was introduced in October 1984. On the basis of this programme, Yugoslavia reached a multi-year rescheduling agreement based on the two-plus-two year formula in 1985.

However, none of the objectives of the 1984 programme was achieved in the period 1985-1987. On the contrary, due to the very different interests of various parts of Yugoslavia and under the pressure of domestic economic problems, especially growing inflation, the government abandoned in 1985 its policy orientation of the previous two years which aimed at establishing positive real interest rates and a real exchange rate. It is, therefore, not surprising that balance-of-payments results were poor despite improved external conditions (lower interest rates, decrease in oil and other commodity prices, and decline of the dollar against other key currencies).

Within the context of the 1985 change in the government's macroeconomic policy there was also a change in the type of co-operation arrangement between Yugoslavia and the IMF. Instead of stand-by arrangements, an "enhanced surveillance" type of cooperation was introduced in May 1986. The IMF began applying this type of arrangement to countries where some achievements in economic restructuring were seen. Unfortunately, in the case of Yugoslavia this method did not prove successful. During the period of "enhanced surveillance", many of the expected economic goals failed to materialize; the inflation rate reached triple digits, real interest rates remained negative, and there were large capital outflows, so that in June 1987 the government proclaimed its inability to meet repayments. Representatives of the IMF, the World Bank and OECD had pointed out these developments in their reports, with warnings, and the result was an increased disbelief on the part of creditors that Yugoslavia was willing and/or able to implement independently what it planned. The consequence was further erosion of Yugoslav credibility.

Late in 1987 and in the first half of 1988, Yugoslavia experienced significant difficulties in servicing its external debt (45 per cent of foreign exchange earnings went for this purpose) in spite of the current account surplus. The government started a new round of negotiations with its creditors with a return to the 1988 stand-by arrangements with the IMF. This agreement reflected the unpleasant truth that without the "tutorship" of the IMF, or in other words, without external pressure, Yugoslavia was unable to execute an economic policy which could yield satisfactory macroeconomic results. The programme on consolidation of external liquidity for the period 1988-1995 endorsed in November 1987 required reduction of the debt servicing ratio to 25% of foreign exchange earnings and stagnation of the overall level of external debt (the 1984 programme sought a reduction of $3 billion). To achieve these goals, an increase of foreign exchange earnings was needed, together with restructuring of existing external debt obligations and provision of fresh money. Also required was the application of various innovative forms of external debt conversion.

The conversion of external debts of debtor countries first started in the mid

1980s, when banks/creditors realized that in spite of numerous debt restructurings, a number of indebted countries could never meet their external debt obligations. During this period, the banks carried out various transactions related to developing countries' debt which only changed the structure of their claims. These transactions were carried out at nominal value or at minimal discount.

It became increasingly clear, however, that the banks would not be able to collect their claims in full and that at least part of their claims would have to be written off. This led to a fall in the real value of commercial bank loans extended to developing countries as well as to an increased volume of transactions with developing countries' debt at a more significant discount.

Discount for the sale of Yugoslav debt was not more than 20 per cent by the end of 1986; in other words, the market price of Yugoslav debt was 80 per cent of its nominal value. A 20 per cent discount did not prove sufficiently attractive for debt conversions in Yugoslavia. The situation changed significantly in 1987 and 1988 when the discount for Yugoslav debts increased rapidly (53 per cent in September 1988).

The fact that Yugoslav debt was available at significant discount was used by the Yugoslav government in its 1988 negotiations for a new financial agreement with commercial banks. In these negotiations, the Yugoslav requests for the inclusion of the possibility of debt conversions was based on the experiences of other countries as well as on the 1987 programme on consolidation of external liquidity of the Yugoslav government. This programme defined the platform for negotiations with creditors.

III. THE LEGAL ENVIRONMENT FOR DEBT CONVERSIONS

1. The Agreement with Commercial Banks in September 1988

A new stand-by arrangement with the IMF was a precondition for a new financial arrangement between Yugoslavia and its foreign creditor banks. The agreement known as the New Financial Agreement (NFA) was signed in September 1988. It not only provided rescheduling of debt to commercial banks for 18 years with a five-year grace period at a margin of 13/16 over LIBOR and $300 million of fresh money, it also allowed Yugoslav entities to enter into debt conversion transactions aimed at reducing the country's external debt and debt service ratio. In contrast to all previous restructuring agreements with commercial banks, which explicitly prohibited such transactions, the NFA defined debt eligible for debt conversions as the total volume of rescheduled publicly guaranteed commercial bank debt, which amounted to $7.1 billion. It should be pointed out, however, that this theoretically possible maximum of debt reduction transactions on Yugoslav debt is far higher than the volume which could be achieved in practice (for example, some banks are not willing to sell their Yugoslav debt papers). According to some estimates, it is not realistic to expect that debt conversion transactions in Yugoslavia will amount to over $3 billion (which would only be possible under optimal conditions for debt conversion, i.e. when the market price is low and the debt conversion programme is not restrictive), that is to say around 40 per cent of the country's commercial bank debt in 1988 and 15 per cent of its total debt in that year (Drnovek, p. 8).

The following four types of debt conversion transactions ("qualified debt transactions") were made possible by the NFA:

— Debt/dinar conversion (Qualified Dinar Payment);
— Debt/equity swap (Swap for Qualified Investment);
— Debt/export of products or services swap (Qualified Purchase); and
— Debt/debt swap.

Debt conversion transactions envisaged in NFA can therefore be classified into two groups. **First**, indirect debt conversions such as transactions in which a foreign partner converts claims arising from Yugoslav external indebtedness into dinars, acquiring simultaneously rights to dispose of these dinars for purchasing goods and services in Yugoslavia, for setting obligations vis-a-vis creditors in Yugoslavia or for equity investment in Yugoslav enterprises. **Second**, direct debt conversions or debt swaps, such as transactions in which the foreign partner exchanges claims arising from Yugoslav external indebtedness into goods and services or investment in Yugoslav enterprises. In contrast to debt conversions for debt swaps, there is no need for intermediation via the flow of dinars.

As in the Yugoslav legislation, the term "debt conversions" will be used in this text as a common expression for indirect debt conversions as well as for debt swaps (see Chapter 3.2.).

2. Debt Conversions on a "Case-by-Case" Basis Prior to April 1989

Due to significant interest on the part of Yugoslav companies and banks, as well as their partners abroad for sharing the profit by purchasing debt at a discount), on the one hand, and on the other, the already mentioned macroeconomic interest for cutting down debt servicing costs, reducing external debt, pursuing other development objectives), the Federal Executive Council (FEC) started issuing permits for debt conversion transactions in the middle of 1988, i.e. even before the NFA, which formally sanctioned trading Yugoslav debt between Yugoslav partners and foreign creditor banks, was signed. This reflects the high level of responsiveness of the Yugoslav government on this issue.

Until the end of March 1989, the FEC gave approval to debt conversion transactions on a case-by-case basis. For each transaction, the opinions of the NBY, the Federal Secretariat of Finance and Federal Secretariat for International Economic Relations were required. This means that applications and approvals were, in fact, a direct consultative process. The first application which combined debt/export and debt/debt conversion was received in March 1988, and within the next two months three more applications were received. All four were approved by the FEC in June and July 1989 and their implementation began as soon as the NFA was signed (in September 1988).

Throughout the period of FEC approvals of debt conversion transactions on a "case-by-case" basis, no specific criteria for such transactions were in existence. The basis for FEC activity in this area was an internal working paper which specified some general conditions and criteria. Thus, no fixed price of debt on the secondary market was stipulated as a condition for debt conversion, but it was assumed that such prices would be around 50 per cent of the nominal debt value. No formal statements by the participating parties were required as to availability of dinars for debt conversions or of additional export. The time frame for the execution of the transaction was also not clearly specified.

Over the period May-December 1988 some 70 applications for debt conversion were submitted, with approvals given for 39. Of transactions approved, the period up to February 1989 saw the implementation of only 11 and the initiation of a further six transactions. Taking into account only the transactions finalized up to the end of February 1989, the face value of external debt was reduced by $221 million.

3. Debt Conversions Under the Official Debt Conversion Programme Since April 1989

a. Legal framework

After lengthy preparation and delays caused in part by the resignation of the full FEC at the end of 1988, the Federal Assembly passed the Law on Amendments and Supplements to the Law on Foreign Credit Relations (henceforth, the Law) on March 9, 1989. The Law specified the types of conversion deals, general and special criteria for their implementation, the approval procedure and the annual size of such transactions in relation to balance of payments. The approvals for debt conversion deals were transferred to NBY. The amendments and supplements to the Law on Foreign Credit Relations were needed since it did not permit early debt repayment in the country or purchase of external debt.

On March 17, 1989, the FEC passed a special Decision on the Mode for Early Discharge and Early Cancellation of Foreign Credit Obligations (henceforth, the Decision) which specified in detail the procedure for approval and implementation of conversion deals and set forth other details of the Yugoslav debt conversion programme.

The first meeting of the new commission (henceforth, the Commission) for debt conversions (under the Law, it was constituted by the NBY) took place at the end of March. Since the new Law and the Decision took effect only as of April 1, 1989, the first approvals of the Commission were issued at the beginning of April. This means that the process of issuing approvals for debt conversion transactions was re-established after a three month break.

The following paragraphs give some basic characteristics of the Law as well as of the Decision.

Article 1 of the Law specifies that business enterprises, banks authorized for transactions with foreign partners and other legal entities are allowed early discharge of foreign credits, early cancellation of foreign credits and early settlement of their claims abroad.

Early discharge of foreign credits is in fact an internal transaction which does not have a direct impact on the level of foreign debt but does restructure the corporate financial position of the debtor. The transaction involves cession of debt to a bank or other legal entity which agrees to take over repayment of the debt. Terms of the transaction are drawn up in the contract between the debtor and the cessionary. According to this contract, the debtor pays to the cessionary the dinar equivalent of the principal, interest and all other costs which account for the total external debt obligation. In return, the cessionary takes over repayment of the debt to a foreign creditor. The obligation towards the foreign partner thus remains unchanged. Such debt discharge is possible, of course, only if the cessionary agrees to the terms under which the repayment is taken over.

As far as **early cancellation of foreign debt** is concerned, the Law specifies the following types of eligible conversions:

— debt-to-dinars conversion;
— debt-to-product/services conversions;
— debt-to-receivables conversions;
— debt-to-debt conversions;
— debt to time-sharing conversions; and
— debt to equity conversions in a domestic firm, bank or other financial organization.

From the wording of the Law it could be understood that the debtor has the right to early discharge of foreign debt and the bank has the right to use the dinar deposit for debt cancellation. Since the relationship between the debtor and the guaranteeing bank is regulated through a contract which specifies the obligations and rights of each contractual partner, the question was raised as to whether this means that the bank has the legal commitment to enter into a contract with the debtor who wishes to discharge its foreign debt early. This dilemma was resolved by the Decision, which specifies that early discharge of debt is possible only if the bank or other legal entity agrees to take over the responsibility of foreign debt repayment. Such an arrangement therefore means that even after the NFA, and in spite of the new legislation relating to foreign credit relations, the debtor cannot prepay its obligations arising from foreign debts, unless the bank gives its consent (Mrak et al., 1990 b, p. 36).

As already mentioned, the Law specifies six types of eligible conversions. Such specification is problematic, since new forms of debt conversions (debt for nature swaps, for example) keep emerging in the world and, due to the formulation of the Law, the cannot be applied in Yugoslav economic environment. The wording of the Law also does not allow a true "debt for equity swap" since it only provides grounds for the conversion (not swap) of debt into investment in a domestic company, bank or other financial organization.

The Decision has broadened the specifications of eligible debt conversions so that they are grouped into three categories:

debt conversions — transactions in which a foreign partner converts claims arising from Yugoslav external indebtedness into dinars, acquiring simultaneously rights to dispose of these dinars for:

— payment of goods and services;

— payment of goods re-exported from countries with bilateral clearing payment arrangements to countries with convertible currency;
— payment of claims to domestic enterprises which have exported goods on credit;
— purchase of domestic securities;
— equity investment in a company, bank or other financial organization.

Debt swaps — transactions in which the foreign partner directly exchanges claims arising from Yugoslav external indebtedness for:

— goods or services (only for incremental export);
— claims in countries with clearing payment arrangements;
— claims of Yugoslav companies abroad;
— bonds offered under the same conditions to all foreign commercial creditor banks;
— equity in a company, bank or other financial institution, including time sharing arrangements in tourist facilities.

Debt buy-back transactions if the foreign currency used for these transactions comes from the following sources:

— foreign exchange inflow derived from permitted debt conversion transactions;
— foreign exchange inflow derived from export of goods and services (only for incremental export);
— foreign exchange inflow derived from re-export of goods from countries with clearing payment arrangements to countries with convertible currency payment;
— new foreign credits for this purpose;
— foreign exchange reserves within the amount specified by the balance-of-payments projection of Yugoslavia.

b. Main Features of the Programme

With the adoption of the debt conversion programme (the Law and the Decision) the NBY has been empowered to issue approvals. The programme does not have specified ceilings or yearly quotas for the amount of debt to be converted, although the NBY is requested to ensure that the volume of debt conversions is consistent with the balance of payments projections and foreign exchange policy. The NBY has, therefore, the authority to slow down or suspend the approvals and execution of the programme, if it feels that this is necessary due to the programme's adverse effects on the balance of payments, inflation or other macroeconomic variables.

Although not quantified, the Law has explicitly specified that the following two criteria be taken into account in the process of issuing debt conversion approvals:

— the domestic participation in the discount;
— participation of cash payment in a debt conversion transaction.

Besides these two main criteria, the Law stipulates that preferential status should be given to debt conversion proposals of those enterprises, banks and local governments with a level of indebtedness above the country's average. Additional criteria should apply to debt/export of goods and services conversions. If a transaction of this type is approved, the authorities can reasonably request that such a conversion only apply in the case of additional exports. In the case of regular exports, such approval is granted only if a substantial increase in exports is achieved through debt conversion.

The priority given to entities from republics and autonomous provinces whose debt is above the country's average is more questionable. In this case, the criteria are not applied to the type of transaction, but to the "type of the applicant". Legally, the provision specifying preferential treatment is poorly written, since it is unclear which data should be taken into account when making the comparison. Here, the criterion for indebtedness has to be pointed out. Priority is given to all entities from republics and autonomous provinces whose debt is above average (and what is taken into account is total, not just external debt), with no account taken of the specific indebtedness of an individual legal person. Applicants from other areas only get preferential treatment if their individual indebtedness is above average, but here only external indebtedness is taken into account (Mrak et al., 1990b, p. 40).

While, on the one hand, such preferential treatment makes sense from the point of view of assisting the most indebted parts of the country (of course, only in cases not involving the current loss-incurring enterprises), on the other hand, such treatment can be unjust to those enterprises which are not over-indebted and which have not been a direct cause of the Yugoslav external debt crisis. These are mainly enterprises which could have repaid their debt within the agreed contract terms, but were forced into debt rescheduling in 1983 (see Chapter II).

The most common form of debt conversions in Yugoslavia has been the conversion of claims arising from the Yugoslav external indebtedness into dinars and the use of these dinars by foreigners for one of the possibilities specified by the Law. The use of primary emission for debt conversions was permitted by law only in exceptional cases.

In contrast to debt conversion programmes in some other countries, the Yugoslav programme does not impose a minimum or maximum amount of debt to be converted by each particular deal, it does not contain restrictions on profit repatriations (while restrictions on capital repatriation are prescribed in line with the NFA requirement — the foreign partner can not withdraw the investment in less than 8 years), and it does not have a specific requirement regarding the share of the discount which should go to the Yugoslav and foreign partners in the deal. This has allowed the NBY to maintain flexibility in assessing debt conversion deals on a case-by-case basis and judge each case on its own merits. While programmes of some other countries envisage fees or commissions for the approving authorities, the NBY does not participate in the discount and does not exact a commission for approved transactions.

There is another substantial feature specific to the Yugoslav debt conversion programme. In contrast to most developing countries (Brazil, Argentina, Chile, etc.), where debt conversions have been made through a single intermediating point in the country, normally the central bank, the approach used in Yugoslavia in debt conversion transactions is decentralization. This means that debt conversions are made directly by commercial banks after the enterprise wishing to extinguish its external debt deposits the dinar equivalent of the debt to the bank.

Domestic participants in conversion transactions in Yugoslavia are the domestic debt buyers (enterprises, local government agencies, banks and the NBY), the country's commercial banks authorized for international banking operations and the NBY. The banks and the NBY are eligible to take part in debt conversions as the original debtors or as cessionaries. On the side of the foreigners, all banks and other legal persons in possession of the eligible debt paper can take part in the Yugoslav debt conversion programme.

4. The Procedure for a Debt Conversion Transaction

On the basis of legislation and practical experience, a specific procedure for debt conversion has been developed in Yugoslavia. This procedure has the following seven stages (Mrak et al., 1990b, p. 43):

— First, the application has to be submitted to the Commission at the NBY. The applicant may be a domestic enterprise, a bank or any other legal person. The application must include all major features of the deal, especially the type of the conversion, the volume of debt to be retired, the resources involved (exports, foreign debt claims, foreign exchange, investment) and the terms in which the transaction will be signed and executed.

— The Commission of the NBY issues the licence on the basis of written opinions of the Federal Secretariat of Finance and the Federal Secretariat of International Economic Relations (they are required to present their opinions on each individual transaction, but their opinions do not bind the Commission). Also in this stage, the authorized domestic bank must inform the NBY that it is prepared to execute the conversion. The NBY is required by the Decision to give approval or to reject a debt conversion proposal within 30 days.

— The purchase of Yugoslav debt on the secondary market through a foreign bank intermediary, who charges a fee for the work done.

— Conversion of debt in foreign exchange into its dinar equivalent is executed by the NBY or by the banks authorized for international banking operations. Commercial banks act in the conversion deals as a neutral intermediary or on their own account.

— The agent of the bank creditors (Manufacturers Hanover Ltd.), according to the requirement of the NFA, issues a statement specifying the reduced debt as the result of the debt conversion. This "certificate" is presented to the agent of Yugoslav debtors (NBY).

— On the basis of the creditor agent's statement that the debt has been reduced as a result of conversion, the NBY gives the applicant's guarantor bank a certificate of debt reduction.

— On the basis of a certificate of debt reduction received from the NBY, the applicant's guarantor bank gives the applicant who made the dinar deposit a certificate of debt cancellation.

IV. DEBT CONVERSION IN ACTION, 1988-1990

1. Volume of Debt Conversions

From middle of 1988 to June 1990 Yugoslavia managed to reduce its external debt via debt conversions by $1 880.4 million (face value of retired debt), or about 25% of the total refinanced debt to commercial banks[2].

Table 1. **Volume of debt conversions, quarterly, 1988 - 1990 (June)**

(in million dollars)

	I	II	III	IV	Total
1988	-	-	3.1	132.0	135.1
1989	183.3	306.2	264.7	614.3	1 368.5
1990	215.9	160.9	-	-	376.8
					1,880.4

Source: National Bank of Yugoslavia (internal sources).

From Table 1 it can be seen that by far the largest share of debt conversions was implemented in the last quarter of 1989, when in November alone $392.7 million of debt was retired. The increased rate of debt conversions in the last quarter of 1989 was mainly the result of two factors. First, before the end of year the supply of debt on the secondary market usually increases since the banks at that time tend to "clear" their portfolios. Second, from October 1989 the NBY has actively engaged in debt conversions for the needs of Yugoslav commercial banks (see Chapter 4.4.).

In 1990 the average monthly amount of retired debt dropped significantly. This was caused not only by the increased price of Yugoslav debt, but was also a result of reduced interest on the part of Yugoslav debtors for early discharge of their external debts in dinars. Their interest declined due to the fixed exchange rate (and thus lack of exchange rate differences), while the interest rate in the country for dinar loans was higher than interest rates for foreign loans.

2. Structure of Debt Conversions

The conversion transactions implemented in the period from August 1988 to December 1989 can be divided into five categories:

- transactions on the basis of foreign investment (debt/equity conversions);
- transactions on the basis of export (debt/export conversions);
- transactions on the basis of Yugoslav claims abroad (debt/debt conversions);
- transactions on the basis of Yugoslav claims in countries with which Yugoslavia has clearing payment arrangements (debt/re-export conversions);
- direct purchase of external debt with foreign exchange (debt buy-back).

The structure of Yugoslav debt conversions reflects a very different pattern from that of other countries, especially in Latin America, primarily, in terms of the number of different types of transactions it permits. A large number of countries, for example, do not allow debt for exports conversions, while in the case of Yugoslavia this type of transaction has been among the most popular. On the other hand, debt/equity conversions in many countries constitute the core of the debt conversion programme, while in Yugoslavia the share of these transactions is somewhat symbolic.

Table 2 shows the structure of debt conversions according to different types for the years 1988 and 1989. The table reflects the fact that by far the largest share of debt conversions are accounted for by debt/export conversions and debt/re-export conversions. In the total volume of transactions executed in 1988 and 1989, debt/export conversions accounted for 39.7 per cent and debt/re-export conversions for 39.1 per cent. This means that the other types of debt conversions were of considerably less importance, since all three together did not add more than 20 per cent to the total value of retired debt.

Table 2. **The structure of debt conversions, 1988-1989**

(in million dollars; per cent)

Type of Conversion	1988		1989	
	Face value of retired debt	% of total	Face value of retired debt	% of total
I. Debt/equity conversions	-	-	57.3	4.2
II. Debt/export conversions	10.9	8.1	585.4	42.8
III. Debt/debt conversions	29.9	22.1	157.5	11.5
IV. Debt/re-export conversions	64.6	47.8	523.8	38.3
V. Debt buy-back	29.7	22.0	44.5	3.2
TOTAL	135.1	100.0	1 368.5	100.0

Source: National Bank of Yugoslavia (internal sources).

Debt/export deals have accounted for the highest share in the total volume of Yugoslav debt conversions for two main reasons: first, producers of exports have been attracted by the possibility of capturing part of the discount (the producer of the export is usually granted a higher than market price if foreign exchange revenue from the export is used for the purchase of debt instruments on the secondary market), and second, the Yugoslav economy has relatively strong export potential but a relatively low level of actual exports.

Debt/re-export conversions were developed as a specific scheme in Yugoslavia in conjunction with its clearing surpluses, mainly with the USSR. Yugoslavia imports goods from eastern European countries, debits them against its clearing surplus and re-exports them for hard currency. This hard currency is then used for the purchase of debt on the secondary market. In this way Yugoslavia has tried to reduce its surplus on its clearing account with eastern European countries. In addition to debt conversions, a number of other proposals have been made to eliminate the surplus (the construction of the Belgrade metro, for example). The most active Yugoslav actors in debt/re-export conversions have been large trading houses which have extensive networks in eastern and western European countries. Taking into account that trade with eastern European countries will in the future be carried out through convertible payments (not clearing accounts), it is realistic to expect that the importance of this type of debt conversion will be significantly reduced.

With the introduction of the programme of debt conversions it was assumed that

debt/equity conversions would represent an important segment in the system. Yet the data show that in 1988 and 1989 this type of transaction retired only $57.3 million of debt. The only big project which was realized by the middle of 1990 on the basis of debt for equity conversion was the Hotel Hyatt in Belgrade. The $51 million project is a joint venture by Hyatt International and First National Bank of Chicago on the foreign side and a consortium of five Yugoslav companies led by Jugoexport (Russel-Wahling, p. 41) on the domestic side. The project was approved under a special federal law to facilitate construction of several projects in Belgrade as top priority in preparing for the September 1989 summit of non-aligned countries. As such, the project got very special treatment. The government not only granted special tax benefits to the project, the NBY also provided a dinar equivalent of $36 million from the primary emission. According to the available information, this has been the only debt conversion transaction made in Yugoslavia so far for which NBY was willing to print money.

3. Participation of Domestic and Foreign Banks in Debt Conversions

There is a large degree of concentration in the participation of domestic and foreign banks in debt conversion transactions in Yugoslavia (only data for the period to June 1989 are available). On the side of Yugoslav banks, two banks, namely Jugobanka and Udru`ena banka Hrvatske, participated with nearly 50 per cent of the total value of all transactions, while the share of no other bank involved exceeded the value of 10 per cent. On the side of foreign banks, the concentration was rather similar, since Citibank and Manufacturers Hanover Trust handled nearly 50 per cent of the total market (see Table 3).

Table 3. **Participation of domestic and foreign banks in debt conversions, 1988-1989 (June)**

(in million dollars; per cent)

DOMESTIC BANKS	IV. Quarter 1988		I. Quarter 1989		II. Quarter 1989		TOTAL VALUE
	Value	%	Value	%	Value	%	
1. JUGOBANKA UB, BEOGRAD	72 388.5	53.9	20 024.7	10.9	10 661.2	3.5	103 074.4
2. UBH, ZAGREB	30 870.6	22.9	53 882.7	29.4	95 538.7	31.2	180 292.0
- PBZ	-	-	24 292.5	13.3	62 810.2	20.5	87 102.7
- ZAGREBAKA BANKA ZAGREB	21 871.4	16.2	13 350.5	7.3	11 761.4	3.8	46 938.3
- SPLITSKA BANKA, SPLIT	8 999.2	6.7	16 239.7	8.8	20 967.1	6.8	46 206.0
3. PRIVREDNA BANKA, SARAJEVO	-	-	45 997.6	25.1	3 552.4	1.2	49 550.0
4. UDRUENA BEOGRADSKA BANKA	10 000.0	7.5	13 510.9	7.4	31 169.7	10.2	54 680.6
5. LJUBLJANSKA BANKA-ZB, LJUBLJANA	-	-	20 578.2	11.2	40 042.7	13.0	60 620.9
6. VOJVODINSKA BANKA UB, NOVI SAD	-	-	11 018.1	6.0	41 914.4	13.7	52 932.5
7. INVESTICIONA BANKA, TITOGRAD	-	-	9 500.0	5.2	2 500.0	0.8	12 000.0
8. UDRUENA KOSOVSKA BANKA, PRITINA	-	-	-	-	-	-	-
9. STOPANSKA BANKA - ZB, SKOPJE	-	-	-	-	-	-	-
10. NARODNA BANKA JUGOSLAVIJE	21 076.9	15.7	8 816.1	4.8	80 863.9	26.4	110 756.9
TOTAL	134 336.0	100.0	183 328.3	100.0	306 233.0	100.0	623 897.3
FOREIGN BANKS							
1. CITI	66 792.5	49.7	23 977.7	13.1	79 054.6	25.8	169 824.8
2. MANUFACTURERS	26 466.7	19.7	68 936.3	37.6	33 034.2	10.8	128 437.2
3. LLOYDS	10 888.9	8.1	41 434.4	22.6	25 506.1	8.3	77 829.4
4. NMB	20 188.0	15.0	-	-	38 176.4	12.5	58 364.4
5. SALOMON	-	-	13 816.1	7.5	33 694.5	11.0	47 510.6
6. FIRST CHICAGO	-	-	15 135.2	8.3	28 940.4	9.5	44 075.6
7. SHEARSON	-	-	11 018.1	6.0	24 240.8	7.9	35 258.9
8. LAZARD	-	-	6 936.5	3.8	12 539.5	4.1	19 476.0
9. BANKERS	10 000.0	7.5	-	-	-	-	10 000.0
10. UBB-CYPRUS	-	-	2 074.0	1.1	23 955.8	7.8	26 029.8
11. WEST LB	-	-	-	-	5 932.2	1.9	5 932.2
12. CONTINENTAL	-	-	-	-	1 158.5	0.4	1 158.5
TOTAL	134 336.1	100.0	183 328.3	100.0	306 233.0	100.0	623 897.4

Source: National Bank of Yugoslavia (internal sources).

4. The Price of Yugoslav Debt on the Secondary Market

Until the end of 1986 the price of Yugoslav debt was at a fairly constant level of over 80 per cent of its nominal value. In the second half of 1987 the price suddenly dropped, for two main reasons. The first was the increased reserves of most large banks. This caused an expansion of the supply of debts of many developing countries on the secondary market, which resulted in a general fall of prices for external debt (see Table 4). Second, in the middle of 1987, Yugoslavia interrupted regular servicing of its debt, which pushed the price of its debt on the secondary market down even further.

In early 1988 the price of debt stabilized at a level of 44-48 per cent, meaning that the discount was 52-56 per cent, which represented sufficient incentive for the beginning of debt conversions in Yugoslavia. The price remained at more or less the same level until mid-1988; then it started to increase and reached 53-55 per cent in December of that year. This increase was strongly influenced by the growing demand for Yugoslav debt which followed the start of the country's debt conversion activities in the second half of 1988.

Due to the high level of debt conversion transactions approved by the end of 1988, the authorities temporarily suspended the issuing of new approvals at the beginning of 1989; this was accompanied by reduced demand and consequently by a lower price for Yugoslav debt in the first quarter of 1989. The price started to rise again in the second quarter of 1989, at first gradually and then at a faster pace. It rose to 55 per cent in summer and stayed there until November 1989. Due to the very unstable economic situation in the country at that time (the country had already entered a period of hyperinflation), the increase of the debt price did not reflect improvement in the economic and political situation in the country, but was attributed to significantly increased demand for Yugoslav debt. A large number of new debt conversion approvals were given after the inception of the formal debt conversion programme in March 1989.

In summer 1989, the NBY introduced the following measures to stabilize the price: the issuance of new approvals for debt/export conversions was halted, only banks were allowed to operate on the secondary market (previously enterprises also could) and the limit on the highest acceptable price of debt was introduced. Due to the continuing increase in the price of debt, the NBY Commission decided on additional measures. It introduced monthly quotas for the volume of debt purchase by commercial banks, and this quota was divided among commercial banks on the basis of their participation in the refinanced debt and the total amount of debt conversions executed in the previous period.

But even the quota system failed to function effectively. The price had stabilized, but at a relatively high level of 55-57 per cent (October 1989). Therefore it was decided that the NBY should execute all debt conversion transactions, both for commercial banks and for other legal entities interested in debt conversion. Relatively quickly the price of debt dropped to 51-52 per cent, partly due to the better co-ordination of demand on the secondary market, and partly due to other factors (the increased supply of developing countries' debt on the secondary market at the end of the year).

From February to June 1990 the price of Yugoslav debt again increased significantly, this time to a level of 63-64 per cent in July. There were two main reasons for this increase: increased demand of the NBY for debt of the federation (a special law was adopted for this purpose) and the initial success of the anti-inflation programme in the first half of 1990. In the second half of 1990 debt price went down again due to significantly reduced incentives to enterprises for debt conversions (dinar credits were more expensive than foreign credits), the end of the Soviet - Yugoslav clearing trade arrangements and increased political tensions in the country.

In analyzing this trend of the secondary market price for Yugoslav debt, it is necessary to identify the factors determining this price and to determine their relative importance in the case of Yugoslavia. As for any other country, the secondary market price is determined by a combination of the following three groups of "structural" factors: **first**, factors influencing the country's ability to service debt; **second**, factors influencing the country's willingness to do so; and **third**, factors influencing the demand for the country's debt on the market. In addition, there are some other country-specific factors which may have an influence, especially on short-term demand and supply in the market.

The development of the Yugoslav secondary market price in the period 1988-1990 seems to indicate that the country's ability and willingness to fulfil its debt-service obligations (which are in fact a reflection of the economic and political situation in the country) had a smaller impact on the price than factors influencing demand on this market, especially in the short run. This observation can be confirmed by a number of examples. For instance, in the second half of 1989 when economic conditions deteriorated in Yugoslavia and the inflation rate exceeded 50 per cent per month in December, the price of debt increased from 44-47 to 53-55 per cent due to strong demand. In contrast, in the second half of 1990, when the economic situation had somewhat improved, with inflation being drastically cut and foreign exchange reserves significantly increased, the price of Yugoslav debt declined from 63-64 to 53-54 per cent due to weak demand on the market. To conclude, it is rather safe to say that the price of Yugoslav debt has been more closely linked to the fluctuation in the demand for the country's debt than to the economic situation in the country.

Table 4. **Prices of developing countries' debt on the secondary market, 1987-1990**

(% of face value)

	June 87	Mar. 88	Jun. 88	Sept. 88	Dec. 88	Jan. 89	Jun. 89	Jul. 89
Argentina	47	26-28	26-30	20-22	22-26	21-22	17-18	17-18
Brazil	61	44-47	52-55	45-47	41-43	35-36	30-31	32-33
Chile	69	58-60	57-60	59-61	53-58	58-60	64-65	64-65
Columbia	..	62-65	62-65	61-67	56-58	58-60	57-59	63-65
Ecuador	49	32-36	25-28	21-24	14-16	13-14	13-14	14-15
Mexico	56	45-48	49-53	47-48	43-45	39-40	42-44	43-44
Peru	12	5-8	5-8	5-8	5-8	5-8	4-6	4-6
Philippines	69	47-49	48-52	52-54	50-53	48-50	49-50	52-53
Poland	..	42-44	42-44	39-40	35-36	33-35	37-38	37-39
Venezuela	70	53-55	54-56	50-51	55-57	38-39	38-39	38-39
Yugoslavia	75	44-47	44-47	47-48	53-55	44-46	51-52	52-54
	Sept.89	Oct. 89	Dec. 89	Apr. 90	Jul. 90	Aug. 90	Sep.90	Dec.90
Argentina	16-17	17-18	11-12	11-13	13-14	13-14	13-14	19-20
Brazil	30-31	26-27	19-20	25-26	22-23	17-18	21-22	23-24
Chile	64-65	62-63	59-60	66-67	67-68	70-71	70-71	74-75
Columbia	66-68	66-67	64-66	62-65	62-65	62-65	63-65	62-66
Ecuador	15-16	15-16	15-16	12-13	16-17	16-17	15-16	20-21
Mexico	42-43	39-40	35-36	41-42	44-45	42-43	42-43	46-47
Peru	4- 6	6- 7	6- 7	5- 6	4- 5	4- 6	4- 5	4-5
Philippines	49-50	49-50	49-50	50-51	53-54	49-50	41-43	35-37
Poland	37-38	33-34	18-19	15-17	15-16	16-17	14-15	15-16
Venezuela	41-42	40-41	33-34	43-44	46-47	45-46	45-46	50-51
Yugoslavia	54-55	56-57	51-52	59-60	63-64	61-62	57-58	53-54

Source: Trade Finance (various issues).

V. MICRO AND MACROECONOMIC IMPLICATIONS OF DEBT CONVERSIONS

1. Microeconomic Implications

Debt conversion transactions in Yugoslavia have been executed primarily by enterprises. Among enterprises participating in debt conversions a distinction must be made between those which prepay their own debt and those which prepay debts of other enterprises. The incentive for the latter group, which have, in fact, performed the role of conversion brokers, is a commission often calculated as a percentage of the discount. For the original debtors, the main incentive for debt conversion transactions is the participation in the discount and the avoidance of further interest payments for the refinanced foreign exchange-denominated debts.

The microeconomic aspect of debt conversions is a matter for the individual debtor. It is assumed that each initiator of such a debt conversion deal makes its own financial calculation of the deal on the basis of a cost-benefit analysis. In this analysis, the enterprise has to compare benefits related to the use of available dinar accumulation for prepaying debt costs (risk) involved in future servicing of its refinanced foreign loan, taking into account the cancellation of interest repayment.

The enterprise has to compare conversion effects with alternative ways of spending funds. In Yugoslavia, two main alternatives have been available:

— investment, where the effect of the conversion is to be compared with the average rate of return of investment; and

— savings, where the effect of the conversion is to be compared with the average interest rate received for the money deposited in the bank.

For Yugoslav debtor enterprises a strong incentive for debt conversions in 1988 and 1989 (with their own accumulation and/or with dinar bank credits) was the high rate of inflation. In an environment of high inflation, enterprises were very willing either to convert their foreign currency denominated loans into dinar loans or to repay foreign loans directly from their own accumulation. The problem, of course, was that few enterprises had their own accumulation and the liquidity of the banks was also very low. The short supply of dinars was the main obstacle to an even larger volume of debt conversions in these two years. In addition, the dinar constraint also influenced the distribution of the discount among the Yugoslav participants in debt conversion transactions in cases where the provider of dinars was not at the same time the original debtor. Thus, the enterprises which provided dinars (not the original debtors) insisted on higher participation in the discount which, therefore, meant lower participation in the discount for the original debtor. Dinars have been in short supply, especially for large deals and for those deals implemented over larger time periods. As the inflation rate was drastically cut in 1990, there was an additional disincentive for enterprises to enter into new debt conversion deals in that year.

The specific pattern of the Yugoslav financial system, where commercial banks have acted exclusively as a "service" of enterprises, has had significant implications for the banks' role in debt conversion transactions. According to the banking legislation from the 1970s (in force up to the end of the 1980s), the main objective of commercial banks was not maximization of profits, but the provision of financial resources to enterprises (called "founding members") at minimum cost. Actual subordination of banks to enterprises resulted in various distortions. In the area of foreign currency credits, banks performed only a transmission role, since foreign indebtedness was not on their behalf nor on their account. However, by figuring abroad as the formal debtor, they gradually accumulated more and more losses caused by negative exchange rate differences. Taking into account that servicing of external debt by commercial banks was not compensated for by banks' income from dinar loans (since real interest rates for dinar loans were negative), it is obvious that the enterprise sector, as the original debtor, enjoyed subsidies at the expense of the banking sector.

From the point of view of a commercial bank, early discharge of an enterprise's debt at the bank and early cancellation of the bank's foreign debt results in a reduction of the total volume of this bank's external indebtedness. The process, however, involves many technical problems and risks for the bank. In the simplest case, the bank succeeds in buying on the secondary market the very debt paper of the enterprise which made a dinar deposit for early discharge of this debt or a debt paper which has identical conditions in terms of the foreign currency, interest rate and the repayment period with the early discharged debt. Only in this case, does the debt conversion transaction not involve new risk (demand for debt papers with precisely determined terms has been a characteristic of Yugoslav debt trading and one of the very important reasons for the increase of the price of Yugoslav debts on the secondary market). In the event that any of the above conditions in the original debt paper differ from conditions in the debt paper purchased on the secondary market (transactions of this kind have been, of course, a high majority), the transaction involves new risks which have to be borne either by the bank or by the original debtor. The sharing of risks is normally specified in the contract between these two partners. In some cases banks have created special funds to cover risks arising from debt conversions, but more often debt conversion risks are taken over by the enterprises entering into the debt conversion deal. In this case, a bank has a neutral role in the debt conversion transaction, it does not participate in the discount and does not bear the risks derived from such a transaction, but it does charge a fee for services rendered.

2. Macroeconomic Implications

For purposes of examination, debt conversion transactions in Yugoslavia should be divided into two groups. First, there are transactions concluded for the purpose of reducing the total volume of external debt and the level of debt service obligations, of course at less than full nominal value of the outstanding debt (debt buy-back). In transactions of this type, almost the whole discount is captured by the debtor country and therefore the redemption price is practically the same as the price of the debt on the secondary market (see Table 5). Second, there are transactions concluded for the purpose of assisting the implementation of some other economic policy objectives, such as gaining additional exports (debt/export conversions), reducing surpluses with eastern European countries (debt/re-export conversions) or promoting direct foreign investments (debt/equity conversions). For transactions of this type, the redemption price is significantly higher (see Table 5), which means that foreign partners participate with a higher share in the distribution of the discount.

Table 5. **Debt reduction effects of debt conversions, 1988-1989**

	Debt/equity conversions	Debt/export conversions	Debt/debt conversions	Debt/re-export conversions	Debt buy-back	TOTAL
1. Face value of retired debt[a)] (in million dollars)						
1988	-	10.9	29.9	64.6	29.7	135.1
1989	57.3	585.4	157.5	523.8	44.5	1 368.5
2. Resources used[b)] (in million dollars)						
1988	-	7.1	20.6	41.3	14.8	83.8
1989	37.8	315.7	95.2	325.0	23.3	797.0
3. Redemption price[c)] (% of face value)						
1988	-	65.1	68.9	63.9	49.8	62.0
1989	66.0	53.9	60.4	62.0	52.4	58.2
4. Average price on the secondary market[d)] (% of face value)						
1988	46.0	46.0	46.0	46.0	46.0	46.0
1989	51.3	51.3	51.3	51.3	51.3	51.3
5. Realized discount[e)] (% of total discount)						
1988	-	64.6	57.6	66.9	93.0	70.4
1989	69.8	94.7	81.3	78.0	98.6	85.8

Legend:

[a)] Nominal value of debt, retired via debt conversion.
[b)] Resources used for conversions (discounted value of debt).
[c)] Redemption price is the price at which the debtor country (in this case Yugoslavia) redeems the debt to the foreign partner; 3. is 2. divided by 1.
[d)] The market price paid by the foreign partner for the purchase of Yugoslav debt on the secondary market.
[e)] The share of the discount (difference between nominal and market price on the secondary market) realized by the Yugoslav partners in conversion; 5. is (100-3.) divided by (100-4.).

a. Debt Reduction Effects

Debt reduction effects of Yugoslav debt conversion transactions in the years 1988 and 1989 were the following:

i External debt was reduced by $1 503.6 million (by $135.1 million in 1988 and by $1 368.5 million in 1989), which represents more than 20 per cent of Yugoslav total indebtedness to commercial banks (in the period January - June 1990 the debt was further reduced by $376.8 million or an additional 5 per cent of total debt to this group of creditors).

ii Savings in interest payments, which would have to be paid had the debt not been retired, amounted in 1989 to some $115 million, and in the period January - June 1990 alone to around $120 million.

iii In 1988 and 1989, $880.8 million were used for the purchase of external debt through different forms of debt conversions. This means that the debt was purchased at an average price of 58.6 per cent of the nominal value (62.0 per cent in 1988 and 58.2 per cent in 1989), or that one dollar spent retired $1.7 of external debt.

iv Considering the fact that the average discount on Yugoslav debt was 54.0 per cent in 1988 and 48.7 per cent in 1989, Yugoslav partners succeeded in those two years in capturing in debt conversion transactions on average 70.4 per cent and 85.8 per cent of total discount. This is a very high, if not the highest, share of domestic participation in the discount of all developing countries which have introduced debt conversions as a way of reducing their external indebtedness (Argentina: 69 per cent, Brazil: 49 per cent, Chile: 33 per cent and Mexico: 33 per cent; data for 1988, Bergsman and Edisis, p. 21), although the data are not directly comparable. While in all these countries data refer to debt/equity conversions, in the Yugoslav case other types of conversions, especially debt/export and debt/re-export conversions, have been very important.

The increase of the share of Yugoslav participants in the discount in 1989 was a result of two factors: **first**, the average price of the Yugoslav debt on the secondary market increased by 5.3 percentage points (46.0 per cent in 1989; 51.3 per cent in 1989) because of an increased market demand; and **second**, the redemption price of Yugoslav debt declined by 3.8 percentage points (62.0 per cent in 1988; 58.2 per cent in 1989), since in the context of the new official conversion programme, the authorities tightened quantitative limits and devised more restrictive criteria for some types of debt conversions, especially for debt/export transactions.

v Table 5 also indicates significant differences in discount sharing among the four types of debt conversions applied in Yugoslavia[3]. In 1989, which is the much more important of the two years for which data are available (the volume of transactions in 1989 was ten times the volume in the previous year; the official debt conversion programme was launched only in 1989), Yugoslav authorities gave top priority to debt/equity conversions, and consequently, domestic participation in the discount was by far the lowest. On the other side of the spectrum are debt/export conversions. Due to their potentially negative balance-of-payments impact (this happened in Yugoslavia in 1988), the NBY significantly tightened conditions for this type of transaction in 1989, resulting in their lowest redemption price by far in that year. The greatly increased participation of Yugoslav partners in the discount sharing for debt/export conversions in 1989 indicates the different level of efficiency of the NBY in capturing the discount for these transactions (higher in 1989 than in the previous year), which have never had a priority status among various types of debt conversion transactions in Yugoslavia.

b. Expenditure Effects

All debt conversions which require a debtor country to provide local currency in exchange for the external debt have fiscal implications for that particular country. Generally, there are four ways to finance this expenditure: raising taxes, obtaining resources from existing reserves, issuing of domestic debt and printing money. Accordingly, debt conversions for which local currency has to be provided will necessarily crowd out some other expenditures. The trade off is similar to that for all other cases of expenditure increase without additional foreign financing. The adjustment may take place through reduction of other expenditures induced either through higher tax revenues, higher interest rates, or higher inflation tax or through severe credit rationing. This clearly indicates that there is an opportunity cost to the domestic resources used for this purpose and that the country should therefore make a cost-benefit analysis to compare the costs related to the reduction in other expenditures with the benefits of prepaying external debt for each such transaction.

In Yugoslavia, the conversion of external debt into its dinar equivalent is performed by commercial banks licensed to operate internationally and by the NBY. According to the Law, dinars for debt conversions should be derived from real resources, i.e. from the accumulation of the debtor enterprise entering into the debt conversion deal, from other enterprises with available dinar resources (their incentive to enter into early discharge of other enterprises' debt is participation in the discount) and from the commercial banks' resources, as the NBY, in principle, does not provide dinars from primary emission. During the period of debt conversion transactions up to mid-1989 (this is the only period for which data are available), 61 per cent of debt was retired through conversions into dinars while the remaining 39 per cent was extinguished through direct debt swaps (see Table 6).

Table 6. **Source of funds for debt conversions in 1988-1989 (June)**

(in million dollars)

	IV. Quarter 1988	I. Quarter 1989	II. Quarter 1989	Total value	%
1. Conversion into dinars	84.3	95.6	201.1	381.0	61.0
2. Direct conversions (swap)	50.8	87.7	105.1	243.6	39.0
TOTAL	135.1	183.3	306.2	624.6	100.0

Source: National Bank of Yugoslavia (internal sources).

c. *Balance of Payments Effects*

Due to the variety of conversion types in the Yugoslav debt conversion programme, and especially due to the unavailability of data, it is practically impossible to give a comprehensive assessment of the programme's balance of payments effects. The programme is composed of the balance of payments effects of each type of conversion transaction. These differ among themselves, and there is a big difference in their relative importance within the total volume of the country's converted debt.

The most straightforward balance of payments implication of all debt conversion transactions is savings in interest payments. As already mentioned, these amounted to about $115 million in 1989 and to the order of $120 million in the first half of 1990. Other balance of payments effects of various types of Yugoslav debt conversions will be briefly surveyed below (therefore, the interest payments savings effect will be excluded from the analysis).

Debt/export conversions: The NBY has devised special criteria for these transactions so as to allow only transactions for which additional exports are ensured or where exports could not be achieved without debt conversion support. A request that only additional export earnings be used for debt conversion is meant to guarantee that the planned regular export earnings would be available for the planned import of goods/services. In the case that foreign exchange used for debt/export conversion is really a result of additional exports, this type of transaction does not have direct effects on the country's balance of payments. Yet, a doubt about whether all of the approved transactions were implemented under the required "additionality" conditions is justified. Companies have often prepared a very optimistic plan of export prospects, and when such a plan failed to be realized, the earnings from "regular" exports were used for debt purchase. In such cases, the effects on the balance of payments were undoubtedly negative due to the unexpected outflow of foreign exchange.

Debt/re-export conversions: This instrument has proved to be an important mechanism for reducing Yugoslavias surplus in its clearing account with some eastern European countries, especially the Soviet Union. This has been an important economic policy objective of the Yugoslav government for quite some time, since the surplus has been one of the major sources generating inflation (especially in 1989 when the conversion programme was the most active). Taking into account that hard currency earnings from re-export above the volume projected in the balance of payments could be considered as "additional", their use for foreign debt prepayment has not had negative effects on the country's balance of payments.

Debt/equity conversions: This type of conversion accounted for less than 4 per cent of the total value of debt retired in 1988 and 1989, and it is fairly safe to estimate that its share has not significantly increased in 1990. The reasons for such a state of affairs are many, and the following have been particularly important: first, the level of inflation was high in 1989; second, new legislation allowing for full foreign ownership was only introduced the beginning of 1989; and third, tax and labour legislation has not yet been clearly defined. In the second half of 1990, a rising political risk has become the main demobilising factor for foreign investment in general, and therefore also for debt/equity conversions. It is clear that the debt conversion programme as such has not been an obstacle to debt/equity transactions. On the contrary: the authorities have been encouraging debt/equity conversions for equity investment in enterprises and banks, but for the time being without much success.

As a result of the practically negligible participation of debt/equity conversions in the total volume of Yugoslav debt conversion deals, the balance of payments effects of these transactions have been very limited. The expansion of debt/equity conversions in highly indebted developing countries over the last five years has been accompanied by an intensive debate over their balance of payments effects. Because investment made through debt equity conversion allows the investor to acquire claims on a country's asset through a transaction with the country's creditor rather than its nationals, the transaction does not result in immediate foreign exchange inflow. It does, however, improve a country's short-term balance of payments position, because of reduced debt service obligations, while dividends may be remitted and capital repatriated only after several years. Besides, in contrast to debt service payments where the borrower has to service its debt regardless of the performance of the project, the equity investor's profit is decisively influenced by the performance of the projects as well as by the general economic conditions in the country. Over the medium and long term, the benefits arising from lower debt service obligations have to be compared with higher dividend remittances, capital repatriation and any additional factor payments to foreigners connected with the debt/equity conversion transaction. Debt/equity conversions do not reduce a country's foreign claims, but substitute one kind of external claim for another.

A crucial point in all the discussions about debt/equity conversions is whether these transactions are additional to capital inflows which would otherwise have taken place through regular direct foreign investment or whether they simply divert them. In this case, debt/equity conversions would have a negative impact on the balance of payments. An International Finance Corporation study on debt/equity swaps in Latin American countries has indicated that in 33 per cent of investments carried out by trans-national corporations, debt/equity conversion has been a determining factor and in another 10 per cent it was influential. This means that debt/equity conversions pursued by this group of investors have been only "partly additional". The situation with debt/equity conversions performed by banks is different. These transactions have exhibited "full additionality" because most of the creditors had no intention of investing directly when they first made loans (Bergsman and Edisis, p. 8). Debt/equity conversions have been seen by the banks as a useful tool of portfolio diversification as well as an instrument of banks for entering into certain markets without increasing their exposure in highly indebted countries. Contributions to closed-end debt conversion funds by original creditors which operate with mixed success in some Latin American countries and the Philippines have been seen as a useful mechanism for converting debt to equity, especially for small banks which have no physical presence in debtor countries.

Discussion about direct foreign investment's "additionality" of debt/equity conversions is, in the Yugoslav case, practically impossible because of the very small number of projects carried out so far. On the basis of interviews it is, however, possible to assume that most of the projects could be classified as "partly additional", meaning that the availability of the debt/equity conversion alternative has affected the timing and/or the amount of the investment.

Debt buy-backs: The main feature of this transaction is that the external debt is prepaid at a discount using foreign exchange. This means, of course, an outflow of foreign exchange and therefore a negative effect on a country's balance of payments. If, however, additional foreign exchange sources are available, debt buy-back may not have negative implications on the projected balance of payments position of a debtor country. In Yugoslavia, foreign exchange reserves increased from $1.8 billion at the end of 1987 to $6 billion at the end of 1989 and to more than $10 billion in the middle of 1990 (thereafter they started to decline, especially due to increased political tensions in the country which have negatively influenced the execution of the stabilization programme adopted at the end of 1989).

The relatively strong balance of payments position of Yugoslavia in 1989 and the first half of 1990, accompanied by a high increase of foreign exchange reserves (in April 1990 they were equivalent to more than 6 months' imports, while the 1987 programme of external liquidity required building up of reserves to a level of 3 months' imports; the debt service ratio was close to 25 per cent as required by the same programme), has seemed to be a convincing reason for the relatively strong activity of the Yugoslav authorities in buying back part of its debt. In 1989 and the first half of 1990 using reserves to retire debt could be considered a good alternative, as reserves were plentiful, not only for servicing the external debt and supporting the exchange rate but also for financing significantly increased imports. It is fairly safe to say that Yugoslavia at that time was in a situation in which Dornbush says that debt buy-back is a good idea when extra resources become available (high increase in reserves) and when the buy-back leads to efficiency gains (reduced financial instability, reduction of capital flight) or is at least neutral in these terms. When there are no extra resources, and no other advantages or very limited ones (efficiency gains, in Dornbush's terms), debt conversions would most probably misallocate resources and priorities (Dornbush, p. 701-702). This means that the whole debt buy-back analysis of Bulow and Rogoff, which is based on "non-additionality", does not fit the reality of Yugoslav debt buy-backs particularly well.

VI. CONCLUSIONS

The Yugoslav system for debt conversion, conceived of in 1988 with the introduction of various innovative solutions, can be considered as successful from many points of view. In approximately two years (between August 1988 and June 1990), the debt conversions resulted in the retirement of $1.88 billion of Yugoslav external debt and in significant savings on interest. In addition, the participation of Yugoslav partners in the discount rose from 70.4 per cent in 1988 to 85.8 per cent in 1989. This increase was a result of market demand growth for Yugoslav debt (consequently, its secondary market price increased) on the one hand and tightened control by Yugoslav authorities over debt conversion transactions (the redemption price declined) on the other.

The main characteristic of the Yugoslav debt conversion scheme is that it has been very flexible. Unlike some other national debt conversion programmes, it has no quotas, no per deal limits, no fees or commissions for the approving authorities and no restrictions on profit transfers. The discount split on the debt is negotiable but generally the following approach has been followed by the NBY: the less attractive the deal, the bigger the incentive offered to the foreign party.

Debt conversions have various micro and macroeconomic implications. From the point of view of a debtor enterprise, debt conversion is successful if it allows the enterprise to reduce its liabilities (an element usually looked at by foreign co-operation partners or for approval of new loans). The debtor company earns a discount, resolves the interest repayment, attracts foreign investors in the case of debt/equity conversion or wins new markets via debt/export conversion. A very strong incentive for debt conversions by Yugoslav enterprises in 1988 and 1989 was the high rate of inflation, while its drastic reduction in 1990 was, together with a permanent lack of dinars, the main reason for the decline in the volume of conversion transactions in that year. Due to the specific patterns of the Yugoslav banking system and its links with the enterprise sector, commercial banks have been mainly involved in debt conversions as neutral brokers.

From the point of view of balance of payments, the Yugoslav programme is rather unusual when compared to those of other debtor countries with debt conversion programmes. Its main characteristic is that it has been based on "additionality", meaning that additional foreign exchange resources (additional exports, increase in foreign exchange reserves) have been required by the Law (above the balance of payments projections) for all these transactions. While there have been cases where "regular" foreign exchange resources have been used for debt conversion (some mismanagement with debt/export conversions), in general the programme seems to have yielded positive balance of payments effects. As far as fiscal implications are concerned, the programme has, as in all other similar programmes, crowded out some other expenditures, but it has not been inflationary, since the Law stipulated that dinars for debt conversion should be derived from real accumulation. According to the available information, dinars have been provided through primary emission for only one project.

It has never been considered in Yugoslavia that quick-fix solutions through debt conversions can substitute for sound and stable economic conditions. On the contrary, debt conversions have always been seen as a segment of the country's overall relationship with its creditors. Besides these transactions concluded exclusively for the purpose of prepaying the debt at less than full nominal value of the outstanding external debt, the other transactions have been intended primarily to help achieve some other objectives, such as additional export of goods or services, settlement of claims on foreigners or obtaining of foreign investment. In all these transactions, debt conversion is used as a vehicle to accomplish one of these objectives more efficiently and quickly.

BIBLIOGRAPHY

BERGSMAN, Joel and Wayne EDISIS (1988), *Debt-Equity Swaps and FDI in Latin America*, IFC, Washington August, 27 p.

BREMEC, Nevenka (1990), *Debt Conversions* (in Slovene), November, 20 p.

BULOW, Jeremy and Kenneth ROGOFF (1988), *The Buyback Boondoggle*, Brookings Papers on Economic Activity, No. 2, p. 675-698.

DORNBUSH, Rudiger (1988), "Comments and Discussion on the paper of Bullow and Rogoff," Brookings Papers on Economic Activity, No. 2, p. 699-703, *op cit*.

DRNOVEK, Janez (1989), Introductory Statement on the Conference on Debt Conversions, Ljubljana, 18-19 January, 9 p.

EUROMONEY (1990), "Debt: A Successful Conversion", London, Special Supplement on Yugoslavia, p. 17-18.

IMF (1989), "International Capital Markets. Development and Prospects", April, 138 p.

MRAK, Mojmir *et al.* (1990a), *Financial System and Policies in Yugoslavia*, Ljubljana, July, 102 p (mimeo).

MRAK, Mojmir, Nevenka BREMEC, iva DROL, Ranko NIKOLI, and Pavle PENSA, (1990b), *Debt Conversions and Their Relevance for Overcoming the Yugoslav Debt Crisis* (in Slovene), Ljubljana, 69 p.

MRAK, Mojmir (1989), *Debt-Equity Swaps and the Industrial Sector*, 50 p.

ROBERTS, David and Eli REMOLINA (1987), *Debt Swaps: A Technique in Developing Country Finance*, London and New York, Group of Thirty.

RUSSEL-WAHLING, Edward (1990), "Big Dipper Debt Swaps", *Trade Finance and Banker International*, London, March, p. 40-41.

ARENAC, Miroslav (1989), "Experiences with Debt Conversion Transactions in Yugoslavia", Paper presented at the Seminar on Debt Conversions in Yugoslavia, Dubrovnik, March 14-16, 12 p.

ARENAC, Miroslav (1989), "Debt-Equity Swaps: Potential and Practice in Yugoslavia", Paper presented at the Conference on Privatization in Eastern Europe and the Soviet Union: Investment Opportunities for Western Business, Frankfurt, December 5-6, 9 p.

YUGOSLAV ECONOMIC NEWSLETTER (1989), "Debt Swaps", Ljubljana, November, 4 p.

YUGOSLAVIA Special Chapter in the *Economist's book on Debt Equity Swaps*. Part II, p. 69-78.

NOTES AND REFERENCES

1. According to the IMF definition, "restructuring" covers rescheduling (defined as formal deferment of debt-service payments with new maturities applying to the deferred amounts) and also certain refinancings (defined as either a rollover of maturing debt obligations or the conversion of existing or future debt-service payments into a new medium-term loan). See: International Capital Markets: Development and Prospects. IMF, April 1989, p. 80.

2. By September 1990 this figure increased to $2 billion or 28 per cent of refinanced commercial bank debt.

3. Debt buy-backs are not analyzed in this context, because in this type of debt conversion a debtor country captures, by definition, practically the whole discount.