

ACCELERATING PRIVATISATION THROUGH THE USE OF BULGARIA'S EXTERNAL DEBT BONDS

by Rossen Rozenov

Bulgaria is lagging far behind the other Central and East European countries with regard to the privatised state property. Five years after the Law on Privatisation was passed by the Parliament, only 5% of the state assets have been privatised. After the last auction of the voucher privatisation this share is expected to rise to some 20% but still the majority of the enterprises will be state-owned.

The reasons for the poor performance will not be discussed here since there has been considerable debate on this topic recently. The purpose of this paper is rather to propose specific policy actions to accelerate the privatisation process. One of the means to achieve a faster change of ownership is to use external debt bonds.

I. Development of the Debt-Equity Swaps

Privatisation through Brady bonds is a sub-set of a broader set that encompasses various forms of debt-equity swaps. In the general case of debt-equity swaps the procedure is the following: A bank sells at a discount an outstanding loan extended to a country that has problems in servicing its liabilities. A private investor buys the debt paper and presents it later to the central bank of the indebted country. The central bank redeems the paper at certain exchange rate and the investor uses the money to purchase equity.

Historically the development of the debt-equity swaps began after the debt crisis of 1982 although several cases of similar transactions were recorded earlier. Many Latin American countries recognised the opportunity to deal with the debt problem and adopted relevant legislation. Brazil was the first to implement a conversion scheme, followed by Argentina, Chile, Philippines, Venezuela, Mexico and others.

The fast development of a secondary debt market facilitated to a large extent the process since loans had market value and the creditor banks could use the secondary market value to determine the discount at which to sell the loan. With the growing number of debt-equity swaps the rules and the regulations underwent major changes. The practice to allocate conversion rights and to set redemption prices through government decrees was gradually replaced by a more competitive approach based on auction systems. Some financial innovations were introduced in the late eighties like debt for trade swaps (Yugoslavia) and debt for conservation swaps (Costa Rica).

According to the definition provided above debt-equity swaps involve the participation of at least three parties: a creditor, a debtor and an investor. These parties have different interests and therefore each of them tries to obtain as much concession as possible from the others.

II. Advantages and Disadvantages for the Participants

The benefits for the creditor bank are usually associated with an improvement of the liquidity position. The outstanding loans to highly indebted countries are provisioned against losses and thus by selling a loan, the bank can invest the freed resources in more profitable assets. Banks also would prefer to diversify their loan portfolios and reduce the credit exposure that could become very high later. This is because many rescheduling agreements required new loans to finance the adjustment programs of the debtors. Since those new loans were usually extended by the creditor banks their country exposure increased. For the same reason banks often engaged in asset trading which sometimes preceded debt-equity swaps.

It is generally believed that the gains for the debtor country arise from the reduction of the debt stock. In order to avoid confusion it is essential to point out that what really matters for the debtor country is the net impact of the debt-equity swap on the domestic economy. For that purpose the most convenient tool to evaluate the effects of a swap appears to be the balance of payments analytical framework.

In the simple case where the redemption value is equal to the face value of the loan, the decrease in external liabilities is matched exactly by an increase in the foreign direct investment so that the foreign assets remain unchanged. The analysis becomes a little bit more complicated when the redemption price differs from the face value. The difference between the decrease in foreign liabilities and the increase in the foreign direct investment is recorded as realised capital gain. The above examples are based on the assumption that the discount value of the debt is at least equal to the redemption value. (If the reverse holds true, the investor will refuse to engage in the transaction.) Thus from the viewpoint of the net external position of a country the debt-equity swap is nothing but an exchange of one type of obligation for another. However, an important difference occurs when we consider the problem in dynamics, that is how the transaction will influence the current account of the balance of payments. In order to determine the net effect we have to compare the scheduled debt service with the factor payments associated with the investment. If the income transferred abroad is greater than the interest payments on the loan the outcome will be a deterioration of the current account and ultimately a decline in the foreign exchange reserves. In the long run there are some important benefits that can arise from positive externalities. Since the investors that buy the equity are often multinational companies, the economy benefits from the technological innovation. The purchase of equity is usually associated with additional investments which have a positive influence on the capital account of the balance of payments and increase the availability of foreign exchange.

The advantages for the investing company derive from the opportunity to buy property at terms more favourable than the company would get if it proceeds in the traditional way. Depending on the specific legislation of the debtor country, and the secondary debt market dynamics, the discounts can be quite significant.

Although debt-equity swaps can be beneficial in some respects to all the parties involved, certain problems can occur as well.

Banks might face difficulties in complying with accounting standards and local regulations.

The impact of the debt-equity swaps on the economy of the debtor country is often being assessed in relation to monetary policy. If the government and the central bank as its agent issue money when redeeming the paper, inflation may accelerate.

From the investor's perspective, the gains from the transaction may be offset by the restrictions on debt conversion operations that some of the countries introduce. Although these restrictions differ in the details they can be classified in three main groups: (1) control on repatriation of income and capital, (2) ceilings for payments with debt instruments, and (3) industry requirements. The majority of countries that engage in debt-equity swaps transactions impose some of the above mentioned limitations.

III. Country Experience

Argentina was among those countries that first passed regulations for debt conversion operations as part of a rescheduling package. According to the scheme adopted in 1984 the eligible debt was transformed into promissory notes which could be used for purchasing equity. Later the regulation was changed in a way that reduced the benefit to the investor. He was not allowed to pay with debt instruments more than 50% of the value of the investment. This requirement reflected the rising concerns of the local authorities that debt-equity swaps displace the inflows of fresh money that would have occurred otherwise.

In 1987 again the scheme was revised and the proportion of debt to fresh money was increased to 70/30 percent. Argentine's legislation imposed also limitations on repatriation of income (4 years) and capital (10 years).

Similar to the Argentinean case, in Brazil the repatriation of capital was banned for 12 years while dividends generated by the investment could be transferred freely abroad but only if they did not exceed 12% of the registered capital. In addition, foreign investors were not allowed to take control over local firms through debt equity swaps.

Jamaica's approach to debt-equity swaps provides an example of sector specific conversion scheme. In compliance with the debt capitalisation program of

1987 the Bank of Jamaica determined the “priority areas” for which investors could apply. Some of the preferred activities were construction of hotels and factories, and production or processing of export goods. The amount of the eligible debt under this program was 500 mln US dollars and the government’s intention was to achieve 50% reduction of the debt stock in five years. In order to provide additional incentives to investors to engage in particular businesses, the Central bank charged different commission fees for the different projects.

The last case that will be reviewed is Mexico’s debt conversion program. The experience of Mexico is relevant to our discussion because it is the first country that accomplished debt restructuring under the Brady initiative. In the general case of a debt-equity swap we assume that the creditor bank wants for some reason to dispose of a loan by selling it to an investor. Though the analytical framework presented above did not envisage explicitly the conversion of Brady bonds into equity, the same consideration is valid.

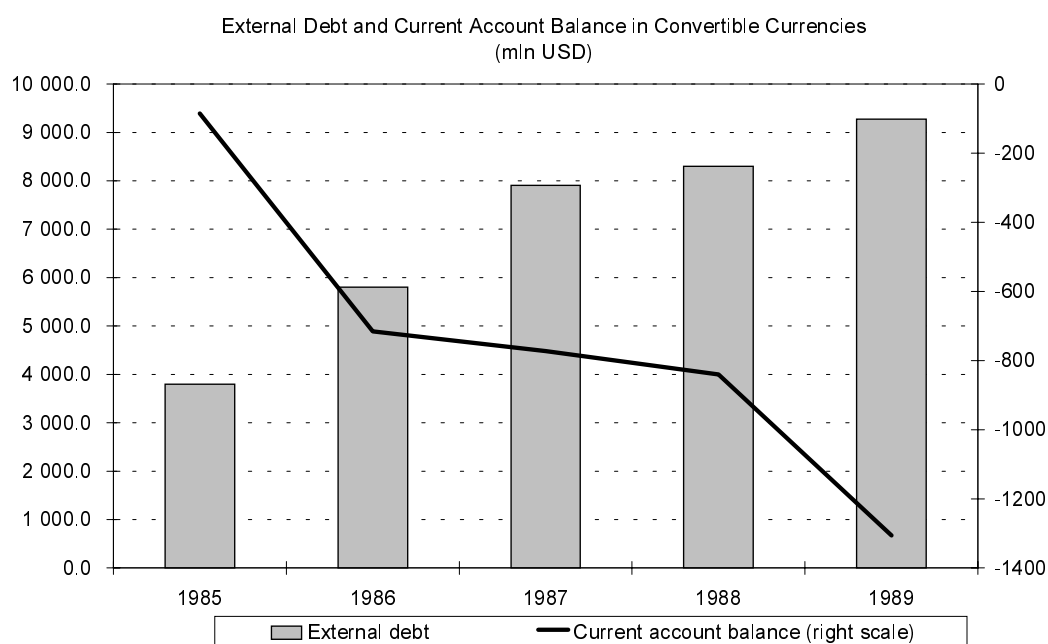
The new conversion program of Mexico, enforced after the Brady deal, limited the scope of the debt-equity swaps only to purchase of state-owned companies and participation in infrastructure projects. The debt instruments that could be used in privatisation were discount bonds and par bonds. Up to 50% of the value of the investment could be paid with Brady bonds. The swap mechanism was based on auctions. Discount bonds could be converted at face value while the conversion rate for the PAR bonds was no more than 65% of the face value.

IV. Restructuring of Bulgaria’s External Debt

In the period 1985-1989 Bulgaria recorded a growing deficit in its convertible currency trade. Two factors contributed most to the deterioration of the trade balance in the second half of the eighties. These are the decreased supply of Soviet oil which was previously re-exported to the OECD and developing countries, and the loss of competitiveness in the manufacturing sector.

The serious current account problems coupled with an ambitious investment program forced Bulgaria to borrow heavily from the international markets. As a result the external debt rose to 9.2 billion USD in 1989, or 272% of all exports of GNFS¹.

Chart 1.



Source: World Bank Tables, IMF and World Bank staff estimates

¹IMF and World Bank staff estimates.

In March 1990 the Bulgarian government announced a moratorium on the principal repayment after the foreign exchange reserves were depleted. It took more than three years of negotiations to come to an agreement with the foreign creditors. The deal with the London Club was finalised in July 1994 and Bulgaria resumed the debt service in accordance with the adopted plan.

The Bulgarian Brady deal covers the total amount of 8.13 billion of US dollars outstanding debt of which 6.11 bln USD principal and 2.02 bln USD interest overdue. About 300 foreign creditor banks joined the London Club. Russian banks and the National Bank of Poland which together held some 540 mln. USD of Bulgarian debt decided to arrange their claims on a bilateral basis and did not participate in the restructuring agreement.

The total debt and debt service reduction operation costs are estimated at 740 mln. USD. These include:

- 257 mln. USD for the buyback of 1.02 bln USD of debt at price 25.19% of the face value
- 219 mln. USD for the purchase of 30-year US Treasury bonds that serve as a collateral of the newly issued bonds
- 170 mln. USD for the purchase of US Treasury bonds maturing in 1995 which cover the interest payments for 1995.

The overall debt reduction of 36.8% placed the Bulgarian Brady deal among the most favourable ones achieved by debtor countries. After the restructuring the amount of the outstanding debt is 9.1 bln USD of which 5.1 bln USD to holders of Brady bonds.

Three debt instruments were issued under the agreement with the private creditors: (1) collateralised discount bonds (DISCs), (2) front loaded interest reduction bonds (FLIRBs), and (3) interest arrears bonds (IABs). Table 1 summarises the main characteristics of these bonds.

Table 1.

	Discount Bonds	FLIRBs	IABs
Date of the issue	July 28, 1994	July 28, 1994	July 28, 1994
Maturity date	July 28, 2024	July 28, 2012	July 28, 2011
Nominal value of the issue:	1 865 mln.USD	1 658 mln. USD	1 615 mln. USD
Interest rate			6-month LIBOR + 13/16%
Issue A*	6-month LIBOR + 13/16%	Years 1-2 -- 2% 3-4 -- 2.25% 5 --2.5% 6 -- 2.75% 7 -- 3% 8- 18 --6-	
Issue B**	6-month LIBOR +15/16%	month LIBOR + 13/16 the rate for issue A + 0.5%	
Interest payments	Semi-annual	Semi-annual	Semi-annual
Collateral of the principal	Zero coupon US Treasury bonds	Zero coupon US Treasury bonds	-
Amortisation	One time repayment at maturity	8 years grace period followed by 21 semi-annual installments	7 years grace period followed by 21 semi-annual installments
Face value of a single bond	250 Th. USD	250 Th. USD	250 Th. USD

* Includes bonds that replaced medium and long-term debt and 70% of the short-term debt

** Includes bonds that replaced the remaining 30% of the short-term debt

V. Debt Conversion Activities in Bulgaria

The legal foundations of the debt-equity swaps in Bulgaria were laid by Regulation No. 278 of the Council of Ministers approved on November 26, 1994. This government's act practically enforced what already had been agreed in principle with the creditors under the terms of the London Club deal. The regulation respects the important principle of non-discrimination so that any holder of eligible bonds, irrespective of nationality, can participate in the privatisation through debt conversion.

Only two out of the three instruments issued after the restructuring of Bulgaria's foreign debt can be used in privatisation. These are the discount bonds and the front loaded interest reduction bonds. Discount bonds are exchanged for equity at face value and FLIRBs at 50% of their face value. (The different treatment creates a strong bias in favour of the DISCs since their current market price is about 60c per dollar while the price of the FLIRBs is 43c per dollar par value. A possible explanation for such an approach, which violates the principle of neutrality between the different instruments, is connected with the fact that at the time when Regulation 278 was prepared the FLIRBs were twice less expensive than the DISCs. The authorities did not take into account the fact that the relative price of the FLIRBs was likely to rise with the increase of the interest rate in compliance with the debt servicing schedule.)

The leva value of the bonds is determined by multiplying the dollar value by the average central bank exchange rate for the six month period preceding the date of the privatisation contract. The backward looking approach was adopted because of the high volatility of the Bulgarian foreign exchange market. Clearly, when the exchange rate is appreciating investors lose value in leva compared to the situation when the bond is converted at the prevailing rate when the deal is made.

Regulation 278 in its initial form did not contain clauses imposing restrictions of the kind that is often encountered in other countries' debt conversion programs. There were only several cases where Brady bonds could not be used: (1) in privatisation of municipal property, (2) as a means of payment when there is a direct sale of shares, and (3) to cover penalties for breach of privatisation contracts, taxes, fees and other claims of the state.

Later however, when the socialist government that took office in the beginning of 1995, the conversion regime was revised in a way that discouraged investors to engage in debt-equity swap transactions. According to the amendments in Regulation 278 the investor must take the obligation not to repatriate income generated by the investment for 4 years and capital for 10 years and the privatisation authority cannot accept payments with Brady bonds exceeding 50% of the value of the transaction.

There is enough evidence that the introduction of a debt-equity swaps program gave an impetus to the privatisation process at the beginning. Some of the biggest privatisation deals were paid for with Brady bonds. It should be stressed that the most significant transactions took place before the restrictions on repatriation and payments were imposed.

VI. Policy Recommendations

Bulgaria is preparing for the introduction of a currency board by the middle of 1997. The currency board is expected to ensure a stable macroeconomic environment which is essential for the revival of economic activities. However, no stabilisation program, no matter how strong it may be, is likely to be successful unless it is accompanied by fiscal and real sector restructuring. The Bulgarian experience of the last two years is an outstanding example in this respect.

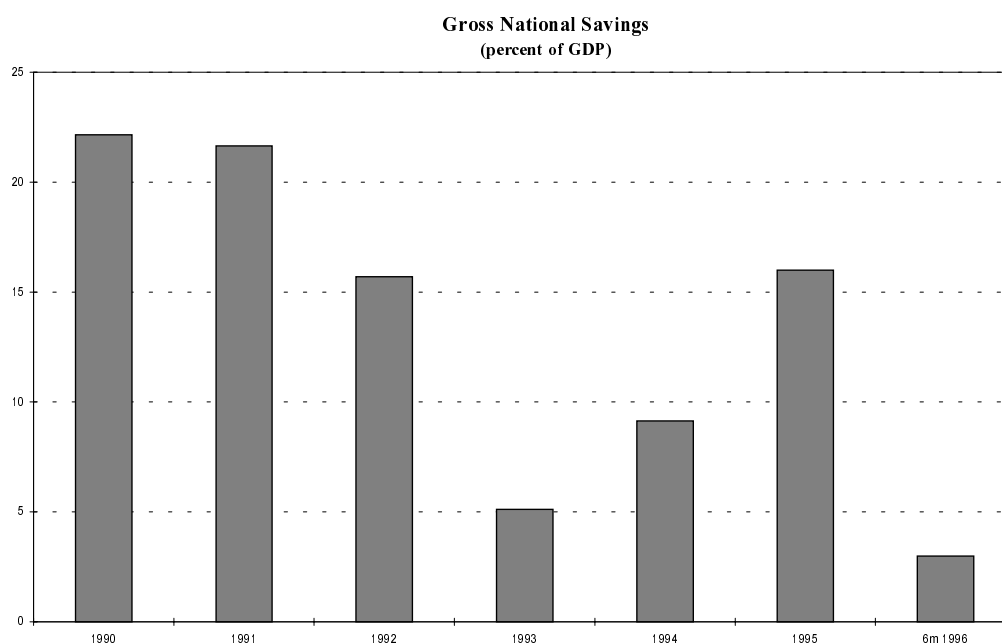
The approach to economic reforms of the former socialist countries has shown that restructuring should follow privatisation. Restructuring will hardly occur under state control of the property, or if it does, it will not be market based and could increase distortions and inefficiencies instead of abolishing them. Therefore, in order to ensure the sustainability of the currency board a massive transformation of ownership must be accomplished.

The interim government that was appointed in February declared its strong commitment to fast and transparent privatisation.

There is no doubt that supply is important but it is only one side of the market. It is equally important to have sufficient demand to match the supply. This is the key point that must be stressed upon. While the supply is entirely under the control of the authorities, the government can do very little about demand. Still it can facilitate the access to privatisation by implementing the proper policies.

The first thing that needs to be achieved is to regain the confidence of the economic agents through a strong stabilisation program. Investors, both domestic and foreign, should be convinced not to exercise the so-called "waiting option" but rather to invest their money in productive capital. But this is only the "macro" part of the story. On micro level, even though many Bulgarian investors are willing to take part in privatisation they may not be able to do so because of the shortage of resources. The recent economic developments have led to a severe reduction of the savings.

Chart 2



Source: NSI, BNB, Author's calculations

The debt-equity swaps provide a good opportunity to acquire equity cheaper as compared to a 100% cash payment. If the low level of gross national savings is taken into consideration, the clause which limits payments in Brady bonds to 50% of the value of the investment is irrelevant to the current economic situation and should be discontinued. It has to be mentioned that the legislation allows the remaining 50% to be paid in domestic debt bonds. The Privatisation Agency however has the authority to require cash payment. (This was done in 1996 but later was abandoned.) The best approach to the issue would be to restore the previous regime and leave investors to decide what combination of instruments to choose. If there are a lot of bids for a particular enterprise, the Privatisation Agency can organise auctions and choose the best terms. This will make the process transparent.

The restrictions on repatriation of income and capital are not unusual in the practice of the developing countries. Unlike the Latin America countries which enjoy enough interest from the part of foreign investors, Bulgaria faces difficulties in attracting capital from abroad. Maintaining the present regulations is counterproductive since the country risk is still high and investors require trustworthy guarantees that they will be able to get their money back.

Direct investments are essential in the restructuring period especially when the internal sources of the economy are insufficient to carry out the necessary reforms. Foreign investors often choose export-oriented industries which helps the country to improve the trade balance. The gains from the enhanced export performance can

offset the outflow of income and thus the overall effect for the balance of payments will be positive.

There are a number of indirect benefits to the economy arising from the direct foreign investment like increase in employment and in the tax base. The technological innovation and better management practices that are usually associated with new investments can significantly increase the factor productivity and restore economic growth.

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Debt-equity swaps

by Valentin Chavdarov

Government debt

The most important problem for the Bulgarian economy is the debt issue. Debt servicing absorbed almost 80% of the total budget expenditures. Large interest payments contribute to the huge budget deficit. The Bulgarian economy maintained a considerable primary surplus (deficit net of interest payments) since 1994. This indicates that non-interest expenditures are very restricted. There is no room to increase the primary surplus in order to reduce the total deficit. The only way to reduce budget deficit and inflationary pressure. is through more effective debt management

Table 1

Government debt at the end of period
/bln BGL/

	31.12.95	31.12.96	28.02.97
Long-term component	260.2	828.1	2427.2
Short term component	85.2	224.7	350.3
Total	345.4	1052.8	2777.5

The debt burden increased more than eight times since the end of 1995. There were two important factors which contributed to this fact. First, the budget deficit financing practice. About 90% of the budget deficit has been financed by means of government bonds. The State Savings Bank and commercial banks bought the bigger part of the bonds. The balance sheets of the banks consisted primarily of short term liabilities and a lot of non-performing assets. For that reason banks demanded short term bonds with high yield. 90% of the government securities, issued in 1996, were short term. The second factor for debt increase was the soft budget constraints. The banks and non-financial enterprises continued operating under soft budget constraints and accumulated losses. In order to reduce quasi-fiscal deficits in the economy the government issued the so called ZUNK bonds which covered non-performing bank credits granted up to 1990.

The operation improved balance sheets of the enterprises and induced a higher level economic activity. The economy registered a small real growth in 1994. But the situation of the banks did not improved. They received assets which, according to the Bulgarian accounting standards, were recording in their balance sheets at nominal value. The banking system registered an "accounting profit" and paid real money as profit tax to the budget. The net result for the budget was positive. But households suffered most of all. The ZUNKs did not improved the liquidity of the banking system and did not protect their savings through establishing sound financial discipline. In the second half of 1995 the banking crisis became evident. First Private Bank was declared insolvent and a lot of people lost their savings. In its effort to calm down depositors, the Parliament passed the State Protection of Deposits & Accounts Act. According to the Law the budget accepted the liabilities of non-viable banks to the depositors.

In other words, the economic policy after 1994 was a story of shifting liabilities from enterprises and banks to the budget and increasing government debt. Now it is obvious that monetisation is the only way to service government debt. The huge monetisation at the end of 1996 was one of the reasons for the high inflation rate in 1997. The debt-equity swaps are the only way to service government debt in a non-inflationary way.

ZUNK bonds

The ZUNK bonds are 25 years government securities, issued to cover non-performing credits, granted by banks to enterprises up to the 1990. There are two types of ZUNK bonds: denominated in BGL and denominated in USD. The Bulgarian leva ZUNKs amounted to 23 bln Dollar ZUNKs amounted to 1.8 bln USD.

ZUNKs pay interest twice a year. The yield of the BGL denominated ones is equal to 1/3 of the primary interest rate in the first two years, 1/2 of primary interest in the third and fourth years, 2/3 of primary interest in the fifth and sixth years, and primary interest rate during the remaining years up to the maturity date. ZUNKs, denominated in USD pay six months LIBOR. Both kinds of ZUNKs pay principal after fifth year in twenty equal installments and are eligible for privatisation.

The Government tried to regulate ZUNK prices through restrictions on both minimal price level and privatization eligibility of the bonds. The result was a very underdeveloped ZUNK market. There are no daily bid and ask quotations and many foreign investors have no information about the possibilities that they offer.

There is no need to impose administrative restrictions on ZUNKs. The return on ZUNKs closely correlates with the return on BRADYs. No portfolio investor will buy ZUNKs at a price which give him a lower return than BRADY bonds. No strategic investor will use ZUNKs in privatisation deals if BRADYs are more favorable.

The other important factor for the underdeveloped ZUNK market is the lack of stock exchange for SOEs. The Privatisation Agency and branch ministries are authorized to sell state owned assets. The privatization process is rather unclear and the price of the capital is determined by a very limited number of sellers and buyers.

Recently the Government used ZUNK bonds to recapitalise the banking system. There were several schemes for banks' recapitalisation by means of redistributing the outstanding ZUNKs among state-owned banks. These schemes proved very inefficient. The banking system is not healthier than before the schemes' utilization. The effect on the budget was negative because of the decreased profit tax revenue from Bulbank and the transformation of long term debt into short term. The most badly affected were the households again because higher inflation tax reduced the purchasing power of their savings.

The point is to reduce the debt burden rather than to redistribute it. A modern stock exchange and simple privatization procedures are more relevant steps toward non-inflationary debt servicing rather than debt redistribution among state-owned banks. This is not recapitalisation but decapitalisation because the high inflation rate sharply decreased the value of capital stock in the economy.