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Debt Swap Mechanisms Revisited: Lessons from the Chilean Experience of the 1980s

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In the aftermath of the debt crisis of the early 1980s, and after a very severe recession in which aggregate output fell by about 15 percent in real terms in two consecutive years, the Chilean economy was in a critical situation. The country was in debt; a severe shortage of foreign exchange meant that it could not finance its current account deficit; banks as well as many corporations were undercapitalized; and the corporate and household sectors were highly indebted.

To help resolve the debt overhang and ease the foreign exchange shortage, the economic authorities introduced two mechanisms that allowed residents to swap Chilean foreign debt – which was being sold at a significant discount in the secondary market – for newly issued debt or equity instruments payable at par (or near par) in local currency. One of the mechanisms, applicable only to foreign residents, granted investors access to the official foreign exchange market for future repatriation of principal and profits. These swap operations, which were granted FDI status, were subject to minimum stay requirements for repatriation – ten years for capital and four years for profits. This mechanism required each debt swap operation to be approved individually after severe scrutiny. The second mechanism, applicable to domestic residents, did not grant access to the official foreign exchange market, and did not require approval on a case-by-case basis, but required participation in a bidding process where the Central Bank auctioned swap quotas. All operations were subject to tight monitoring and scrutiny to make sure that they would not result in capital flight, which would have exacerbated rather than ameliorated the shortage of foreign exchange. All the debt swap operations occurred in an environment where all international transactions were subject to restrictions that applied to both the current and capital account.

Our analysis of the Chilean experience concludes that the two Central Bank supported mechanisms used in Chile were effective and important in helping to resolve the debt overhang problem and ease the shortage of foreign exchange faced by the Chilean economy in 1984-85. The swap mechanisms allowed for a conversion of debt that amounted to about one third of the total outstanding debt at the time of their inception. And it is unlikely that they had just substituted for other potential private arrangements, crowding out other sources of foreign exchange, because the mechanisms helped to overcome important problems – to do with asymmetric information, difficulties of coordination and other market imperfections – that were impeding the emergence of alternative private solutions.

How applicable is the Chilean experience to other countries? Does the positive outcome for Chile imply that similar debt swap mechanisms could be implemented successfully elsewhere? Our conclusion is that the mechanisms were effective in the case of Chile only because some important prerequisites were met, principally:

1. There was an adequate institutional setting – comprising a legal, regulatory and supervisory framework – and tight restrictions, effectively enforced by the Central Bank and other public entities, that prevented the swaps from occasioning major fraud;

2. The economic authorities were fully committed to strictly applying an adjustment program aimed at attaining macro stability and sustained high economic growth;

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3. Redistribution aspects were taken into account to avoid an erosion of public support that would have jeopardized the success of the program's macro stabilization and debt conversion objectives;

4. The domestic capital market was deep enough to be able to intermediate the necessary savings to finance the debt swap program.

Without these preconditions the debt swap mechanisms supported by the Central Bank, far from resulting in a positive outcome, would likely have brought on fraud, undesirable redistribution effects, high interest rates and inflation – in fact, a recurrent crisis.

Further, since one important objective of debt swaps is to ease the shortage of foreign exchange, in addition to enforcing compliance with capital controls, it may be necessary to create conditions that will attract long-term investors and postpone outflows – via restrictions (such as minimum stay requirements on FDI, or requiring additional, new, investments for the approval of the swap operation), or incentives (such as giving investors a larger share of the swap benefits if they are committed to a longer term investment). Finally, it is important to design market-friendly swap mechanisms that reduce the risk of unfairness or uncompetitive practices that could deter potential investors.