Debt Conversions for Economic, Social and Environmental Projects – Jamaica's Experience

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BACKGROUND

Jamaica's debt equity conversion programme was launched in July 1987. The Programme aimed at satisfying two objectives. Firstly, it sought to attract and generate foreign investment in designated priority sectors in Jamaica and secondly, it targeted the reduction of the country's external debt and debt service burden.

The debt conversion programme was launched in a period of very weak economic activity. The bauxite and alumina industry, Jamaica's single largest earner of foreign exchange and principal engine of economic growth, had in 1984-85 virtually collapsed. Tourism had also stagnated following civil disturbances which had erupted in early 1985. Moreover, exploitation of the full potential of the industry was hampered by limited room capacity and the need for extensive refurbishing of hotels. Productive activity outside of these sectors was uneven but, in general, far below the full capacity level.

Jamaica's external accounts reflected the weak performance of its two leading sectors. On current account, an already intractable deficit widen to an annual average of 12% of GDP in the period 1980-1985, more than double the average of 5% recorded in the latter half of the 1970s. Financing of the current account deficit was achieved primarily by way of borrowing, and the external debt grew to unprecedented proportions over the period 1980-1985.

In value, Jamaica's medium and long term public and publicly guaranteed debt grew from US$1.5 billion at the beginning of 1980 to US$3.6 billion at the end of 1985. Between 1980 and 1985, the ratio of debt to GDP almost doubled from 89% to 161%, while the debt service ratio on an accrual basis increased from 24% to 58%. By the end of 1987, the year in which the debt conversion programme was established, Jamaica's external debt has increased to US$4.0 billion or 141% of GDP and the debt service ratio on an accruals basis had risen to 64%.

As Jamaica's debt burgeoned, foreign direct investment and other capital flows shrank to acutely low levels. From being close to balance in 1979, Jamaica's capital account recorded a surplus between 1980-1982 but reverted to a deficit in 1983, occasioned primarily by significant outflows of private capital. Improvements in the capital account thereafter were accounted for by official medium and long-term inflows, as other inflows remained at much reduced levels.

Jamaica's economic landscape in 1987 was one of scarce foreign exchange resources, a massing and unsustainable debt burden and a weak investment climate. Against this background, the Jamaican Government committed itself to significant economic reforms supported by a World Bank structural adjustment loan. The imperative was to transform the economy from one which favoured import-substitution to one which was export driven. This required comprehensive deregulation and liberalisation of the economy. Integral to the process was improving Jamaica's attractiveness as an investment destination to overseas interests. The debt conversion programme was therefore perceived as a creative means by which the Government could attract foreign investment especially since the 1987 package of economic reforms included the dismantling of a number of tax holidays and other incentives enjoyed by the overseas investor. Moreover, not only did the debt conversion programme provide a vehicle to pull foreign investment but it facilitated some reduction of Jamaica's external debt.

THE DEBT CONVERSION PROGRAMME

When instituted in 1987, the debt conversion programme aimed at converting US$185 million of commercial bank medium and long term debt, or approximately one half of the outstanding consolidated amount of US$365 million. The amount was not substantial as total commercial bank debt represented only 10% of Jamaica's total debt outstanding. Debt owed to official bilateral creditors and multilateral financial institutions accounted for 85% of the total external debt, the remaining 5% being owed to suppliers.

Initially, the debt conversion programme only targeted debts designated as Tranche A Advances under the terms of the 1987 Refinancing Package. Debts consolidated under this agreement were clubbed as either Tranche A or Tranche B debts depending on their maturity structure. Tranche A debts were those of relatively shorter maturity, repayable between October 1988 and October 1995, whereas Tranche B debts had a longer maturity and were repayable after 1995 in 16 quarterly installments. Tranche A debt amounted to US$185 million t the start of the programme.

The rationale for limiting conversions to Tranche A debt was to quickly ease the debt service burden associated with these early maturities. In addition, the view was held that difficulties would arise in raising long term funds locally for financing the conversion of Tranche B debts which enjoyed s long grace period before repayment. Modifications to the programme took place in June 1990 when a new refinancing package was negotiated with the commercial banks. At this time, restructured Tranche A and Tranche B debts both became eligible for conversion.

The original programme permitted only non-residents to qualify as eligible investors. The sanction against residents was lifted under the terms of the 1990 Refinancing Package following on continued efforts at deregulation and liberalization of the economy by the Jamaican authorities. A condition imposed on qualified investors resident in Jamaica was that they had to satisfy the administrators of the programme, the Bank of Jamaica, that they had sufficient foreign assets or were able to borrow overseas in order to finance the debt conversion.

Investments funded through the debt conversion programme were able to take the form of equity interest in any Jamaican public sector entity as well as in both listed or non-listed private sector companies. However, the purchase of capital assets in Jamaica funded by a debt conversion transaction had to be funded through a Jamaican investment vehicle. In addition, a qualified investment was not convertible into any instrument or security other than another qualified investment.

An objective of the programme was to provide and target investment into areas of high priority. Areas of economic activity assigned high prior were:

1. The construction of hotels in Jamaica or the expansion of existing hotels.
2. Investment in existing export processing zones (Free Zones).
3. The construction of factory space.
4. The production, manufacture or processing of export products.
5. Activities generating employment in Jamaica.

The Bank of Jamaica, the administrators of the programme on a case-by-case basis reserved the right to permit other investments outside of the priority areas if special circumstance warranted.

Restrictions applied to the remittance overseas of capital and dividends arising from investments under the debt conversion programme. Preferential treatment was accorded to investments in new facilities in priority sectors, in which case the repatriation of capital was restricted to a waiting period of three years. Other investments were restricted to a seven year waiting period. In all cases dividends had a waiting period of three years before repatriation was permissible.

Blocked deposit accounts were established for the deposit of local currency funds which the investor was not immediately permitted to remit overseas. These accounts could be held at any authorized Jamaican commercial bank, subject to the consent of the Bank of Jamaica, and attracted market rates of interest. In the event that an investor wished to re-invest local currency funds, approval could be obtained from the Bank of Jamaica for funds to flow into a "related qualified investment". Care was exercised by the administrators to ensure that such funds were re-channelled into bona-fide investments and not simply a means to speculate in the foreign exchange market. A further feature of the debt conversion programme was the approval given to investors to sell their interest in an investment within the restricted period provided the purchaser was an eligible

investor and the transaction did not involve foreign currency obtained through the domestic foreign exchange market.

Jamaica's debt conversion programme does not stipulate a fresh money requirement. However, since Jamaica dollar proceeds may not be used to fund capital imports, the Bank of Jamaica may at its discretion require the investor to put up fresh money (foreign currency) or its equivalent in tangible assets or technology.

The mechanics of the debt conversion programme started with an eligible investor apply to engage in a debt conversion transaction. On submission of his application, the investor was required to pay the Bank of Jamaica a non-refundable fee of US$250. Projects were approved on a case-by-case basis and not, as in some debt conversion programme, through an auction quota system. Upon approval of this project, the investor would purchase convertible debt from a bank party to the Refinancing Agreement. The investor would pay the value of the commercial paper in the secondary market. Having purchased the debt, the investor would cancel it on an agreed date and receive in exchange, shares in the company which he has established in Jamaica. The Bank of Jamaica, would, on the same date, pay over to that company local assets either in the form of shares in public sector entities, land, or a local currency debt instrument, an Equity Investment Bond, rediscountable by a Jamaican private sector financial institution. Redemption would not be in cash. The value of the local asset would be the Jamaica dollar equivalent of the face value of the cancelled debt less a conversion fee charged by the Bank of Jamaica. The conversion fee payable by the investor is variable and depends on the priority of the investment project. However, fees do not exceed 10% of the face value of cancelled Tranche A debt and 19% of Tranche B debt. In all cases, the applicable exchange rate is the Bank of Jamaica buying rate of U.S. dollars 15 days prior to conversion.

Equity Investment Bonds (EIBs) issued to the investor have the same tenor as the cancelled debt so as to minimize any inflationary effects arising from the conversion. However, the EIB carries a variable rate which is tied to the existing yield on six-month Government of Jamaica Treasury Bills with a 2% margin.

The Jamaica dollar proceeds generated from the discounting of EIBs are credited to Block deposit accounts. Disbursements from these accounts are made to the investor with the approval of the Bank of Jamaica against proof of expenditure.

PERFORMANCE OF THE DEBT CONVERSION PROGRAMME

The performance of Jamaica's debt conversion programme has been mixed. Over the period July 1987 to June 1989 only US$15 million had been cancelled under the programme, far from the US$30 million per annum targeted for conversion. The pace of conversion accelerated after 1989 and by end-March 1993, US$107 million or approximately one half of the consolidated debt outstanding at the start of the programme had been converted.

A number of factors contributed to the weak performance in the early phase of the programme. Firstly, commercial banks with large Jamaican exposure were reluctant to part with their loan assets as it was a performing one with interest payments being honoured on a timely basis. The problem became even more acute when principal payments commenced on Tranche 'A' debt under the terms of the 1987 arrangement. Trade in Jamaica's debt was largely confined to banks with smaller exposures and in 1989 approximately 66% of the 85 banks held less than US$2 million. Another factor was the initial delay in implementing the Equity Investment Bond which provided the Jamaica dollar funding of the programme. Perhaps however, the most dampening effect on the programme in its early phase was the inconsistent government policies which eroded investor confidence. Although within a year of its start, the programme had received applications in excess of US$185 million, the authorities effectively suspended the programme when they decided to tie it to their hotel divestment programme. Under this scheme, eligible investors could pay up to 25% of the purchase price of government-owed hotels with available debt. It is significant that with Jamaica's debt then trading a discount of 65% only US$15 million of convertible debt was cancelled in the two year period of July 1989.

The US$15 million in cancellation related to twelve projects and was accompanied with a total fresh money injection of US$7 million. Completed projects were concentrated in export manufacture and export agriculture. There were, however, two exceptions. Approval was given to a film company to use proceeds from a debt conversion to meet the local currency cost of a production. Debt conversion proceeds were also used to fund the purchase and renovation of low-income houses for rental to women working in the Free Zone.

After 1989, the pace of debt conversion accelerated because of modification which took place to the programme. The terms of the 1990 Refinancing Package allowed for the conversion of both Tranche A and Tranche B debt. In addition, the programme was expanded to included Jamaica residents. Most importantly, the debt capitalization scheme was de-linked from the hotel divestment programme.

By the end of 1992, debt amounting US$106 million had been cancelled under the programme. A further US$0.9 million was cancelled in the first quarter of 1993. Projects in the tourism sector accounted for 64% of the total debt converted. Export agriculture and export manufacture accounted for a further 20% while 10% was committed to the mining sector. In all, 35 projects have been approved through the debt conversion programme. At the end of March 1993 investors held approvals with a conversion component of US$63 million. Applications pending approval amounted to US$12 million.

Although most projects have been directed towards tourism and exported goods, a few projects have related to the social sector and the environment. One such project involves UNICEF which is to convert US$4 million over three years for special programmes related to women and development, primary health care and children in especially difficult circumstances (street-children, child abuse victims, teenage mothers.) A debt for nature swap was also approved. This involved the creation of a Trust Fund from which the interest derived has been used to maintain two national parks.

Some deceleration in the debt conversion programme has occurred since 1992. One reason is that the price of Jamaican debt in the Secondary market has risen substantially. Between 1987 and 1992, the price of Tranche A debt has risen from 35 cents to 75 cents and that of Tranche B from 19 cents to 68 cents. Another reason is that there remains little of Tranche A available for conversion as in addition to cancellations, principal repayments of Tranche A debt have begun. The remaining Tranche A debt, approximately US$80 million, is held by six large money centre banks that for tax or other regulatory reasons are reluctant to part with this debt.

Budgeting constraints have also hampered the programme. On average, the budget has provided for only US$30 million in debt conversions on an annual basis. Tighter demand management policies in 1992-1993 have resulted in the ceiling being lowered to US$25 million. Difficulties in raising funds on the domestic market during period of low interest rates have been an added impediment to the programme. Conversely, the effect of high interest rates on Equity Investment Bonds has been to impose an additional fiscal burden on the government. The differential between international and domestic interest rates (after tax) has been of the order of 12 per cent per annum.

THE FUTURE

Despite an uneven performance, Jamaica's debt conversion programme has been fairly successful. US$107 million or approximately 27% of the debt outstanding at the start of the programme has been converted.

Once more, however, there is uncertainty about the future of the programme. At the present time, concerns about the outlay from the fiscal budget to meet interest payments on Equity Investment Bonds have brought processing of applications to a halt. While no firm decision has yet been taken, it would be disappointing if the programme were to be dismantled. Although the debt converted amounts to a mere 5% of Jamaica's total debt outstanding, conversions still have contributed towards its reduction.

Especially import is that investment has been generated by the conversion programme and has contributed to additional employment and earning of foreign exchange.

In our view, the programme continues to have immense potential. The question is ‘where do we go from here?