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DEBT CONVERSION PROGRAM IN VENEZUELA

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Abstract:

This paper describes Venezuela's debt capitalization program and analyzes its general and sectoral impact. Especial emphasis is placed on the reasons as to why the program has been unsuccessful in reaching government's goals in therms of atracting new foreign capital.

I. Introduction

While debt capitalization programs already existed in most Latin countries, its wide use and evolution arised after the 1982 debt crisis. Since then, debt to equity schemes have been sought by most countries in the region as a way to ease debt burden and attract foreign investments. Within that general framework, the following paper examines the existing debt conversion program in Venezuela and its impact on the Country's overall debt reduction efforts.

This work will be structured as follows: First, we describe the Venezuelan capitalization and debt-to-equity schemes. Then, the impact that such programs have brought forth and a brief sector analysis is presented. Third, a critique to the scheme is presented based on the results shown to date; and finally, in section V a concluding comment regarding future viability of the conversion program for the short and medium term is discussed.

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II. Venezuela's Debt Conversion Program

In 1986, the Venezuelan Government made firm steps to revamp its foreign investment legislation by issuing the all-encomapassing Decree 1200 along with Exchange Agreement Nº 3[1]. This new regulation paved the way for future debt capitalization alternatives as an integral part of the Country's debt strategy. The following are the general guidelines introduced by this decree:

1. New foreign investments do not require previous Government authorization. Once capitalized, the investment will be registered in foreign currency at the Superintendency of Foreign Investments (SIEX).
2. New foreign investment will be treated at the controlled foreign exchange rate (2). Capital repatriation and remittance of dividends will also be converted at the controlled rate.
3. Dividend remittance will be limited to 20% plus LIBOR of registered capital, except for the following cases in which there is free dividend payout:
   a. Investments in the agri-industry, agriculture, construction, tourism, electronic, information systems and biotechnology sectors.
   b. Capitalization in state-owned industries.
   c. Companies exporting more than 50% of production.
   d. Companies in which local owners participation is more than 80%.
4. In case of liquidation and/or sale of equity the foreign entity will be able to repatriate proceeds at the controlled rate if the original investment was registered prior to December 1987. Otherwise at the free market rate.
5. Technical assistance services and foreign technology contracts will be paid at the controlled rate.
6. Companies will have access to internal credit and will be able to access the controlled rate for imported components and raw materials[3].
7. Companies incurring in external credit will sell proceeds at the controlled rate through the Central Bank. Debt repayment and interest servicing will be effected also at the controlled rate.

Further steps were taken in 1987 to define a debt conversion scheme which included debt to equity alternatives. Decree 1521 and Exchange Agreement Nº 4 were issued to this purpose with the following guidelines:

1. Debt to equity conversion do require Government approval via the 1521 Committee (comprised of the Minister of Finance, Development, the President of Central Bank and the Superintendent of Foreign Investments).
2. Debt to equity transactions only entail swap of Republic of Venezuela (ROV) debt and will only be auctioned to foreign investors. The foreign investor will capture the discount and redeem the ROV paper at par with the Venezuelan Central Bank at the controlled rate.
3. Dividend remittance is limited to 10% of registered investment during the first three years, and as per Decree 1200 thereafter. Capital repatriation will be allowed after the 5th year (maximum 12.5% of capital per year thereafter).
4. There is access to external credit, which along with foreign technology and export revenues, is treated at the controlled rate; both in securing funds and for repayment purposes.
5. Elegible companies will also have access to the internal credit system, the controlled rate for imports and export incentive mechanisms.

6. Any imported good must be financed by the investor.

In October of 1988, and as corollary to the existing debt conversion scheme (Decree 1521), the Government issued a new Decree (Nº 2485) where by special treatment was given to companies exporting over 80% of production. The purpose of this Decree was to incentivate exports utilizing the debt to equity route to attract foreign capital. Decree 2485 establishes the following guidelines:

1. Investments via this decree will be treated at the free market rate, as per Exchange Agreement Nº 6.
2. It applies to specific industry sectors, namely petrochemicals, mining, metalurgic, paper and paper pulp, tourism and agri-industry.
3. Export proceeds do not have to be brought to the Country. The imported component of the operation must be funded via own foreign currency generation and includes raw material, technology arrangements and capital expenditures.
4. Access to the internal credit system is not allowed.
5. There is no limit to dividends remittance, which are also converted at the free market rate.
6. Capital repatriaton will be allowed beginning the fifth year after registering the investment and will be limited to 12.57 of registered capital per year.
7. The amount to be invested via debt-to-equity is limited as follows:
   – 40% of total registered investment if same ranges from US$ 20MM to US$ 100MM.
   – 60% of total registered investment if same is greater than US$ 100MM.

   This point brings the fact that foreign investors who would like to capitalize through a swap must bring some "new" money.
8. There is also a discount involved redeeming the ROV paper at the Central Bank.

Decrees 1521 and 2485 are, in several instances, mutually exclusive something which obliges the foreign investor pursuing debt to equity alternatives to choose either route, as follows:

a) Debt capitalization via Decree 1521

Under this scheme there are three capitalization alternatives:

– Debt into equity of the same company (ruled by Decree 1200);
– Conversion of ROV debt into foreign investment; and
– Conversion of ROV debt into national investment (debt-to-debt).

The foreign investor submits its capitalization plan to SIEX, including dividend remittance, capital repatriation schedule and reinvestment alternatives, among others.

Then, Siex approves, through the 1521 Commission, the investment and grants a time period to formalize registration. However, SIEX may require additional external funding to cover imported component costs of the intial operation.

Once approved by Commission 1521, the foreign investor buys the Public Debt paper and effects the capitalization and redeems the paper at the Venezuelan Central Bank at face value. The investment is then registered at SIEX in foreign currency also at face value.

b) Capitalization of Debt via Decree 2485

Debt conversion mechanism utilizing Decree 2485 scheme is similar to that of 1521. In this case a new commission approves the initial investment through SIEX. Elegible companies must meet all conditions to opt to this Decree, i.e. at least 80% of production go to exports, financing alternatives through external sources, etc.).

III. Debt Conversion Program Results

The Government is reportedly studying approval of US$ 904MM in new investment through the debt conversion scheme. An additional US$ 450MM have been already approved totalling US$ 1,350MM in possible new equity. Broken down per major economic sectors such investments are the following:

Sectors	Projects Under Approval by Siex (US$ MM)	Already Approved (US$ MM)
Agri-Industry	–	5
Manufacturing	556	356
Commercial Activities	248	88
Transportation, Storage & Communication	90	–
Financial Activities	10	.70
TOTAL	904	450

Source: Superintendency of Foreign Investments.

Based on the volumes cf debt to equity conversions requested during 1987-1988, the industry sectors which seem to be have appealed most to investors are: manufacturing, especially paper and paper pulp, chemicals, aluminum, cement, fiber glass, electronic equipment and telecommunications and commercial activities, including tourism, restaurant and retail and wholesale concerns.

The underlying discount and hurdless rates set by the Government to approve any of the ongoing projects have, so far, been undisclosed. Official sources, however, reportedly state that an effective exchange rate of Bs. 55/US$1 for the overall debt conversion operation was sought in the case of the 2485 scheme. This parity was attained by setting the appropiate discount of the ROV paper when redeemed at BCV – given the exchange rate at the free market.

In the area of debt capitalization, SIEX approved during 1988 requests for to US$ 150MM, mainly in the cement area.

IV. Debt Conversion Scheme in Venezuela: A Critique

Debt to equity swaps have not had a significant impact in the Country's goals to achieve debt relief and promote capital inflow. Some of the objections that have impeded greater thrust on more active debt to equity investments are:

- The existence of a dual exchange rate system and the growing premium of the free market over the controlled rate discouraged the expected flow of investments into the Country given that foreign investments are converted at the controlled rate. As the Country moves towards a unified exchange rate this obstacle should be removed and a clear investment pattern should emerge based on risk/return grounds.

- Past uncertainty in the exchange rate trend, which will be removed with the new unification.
- Dividend remittance and capital repatriation are restricted to 10% and 12.5% of registered capital during the initial years of operation, besides the five year grace period for capital repatriation.
- Debt to equity swaps are limited to specific industry sectors (see Decrees 2485 and 1521 description) thereby restricting scope in eligible equity and return on investments.
- The mere existence of two schemes (Decrees 1521 and 2485) with mutually exclusive clauses tends to weaken the general investment framework. Investors will value the advantages of each scheme separately and not in a global manner since they can only opt to one route.
- Lack of long term regulatory guidelines, which translate in poor confidence for the short term. Continuous ammendments and changes introduce uncertainty to the investment equation. Just in the case of the Decree 2485, there were 3 different modifications during 1988.
- U.S. banks with significant public debt exposure are reluctant to trade underlying debt at current discounts (28% in March, 1989) since it would imply that the remaining Venezuelan loan portfolio be marked down to the market price at which the debt was sold.
- While Decree 2485 allows for a swap of discounted debt, it also entails the disbursment of cash. This prerequisite has significantly affected the program's results.

V. Final Comments

As a result of the fundamental economic changes recently introduced by the new administration – which lean toward a more market oriented ecnomy with a strong export driven component; the flow of new foreign investments should increase. Furthermore, the more important obstacle to attract external capital – the dual exchange rate system, has now been eliminated. Overall, these measures should bring more stability and confidence to the system.

Further activity in the debt to equity area will have the following policy implications:

- Debt conversions might pose a significant burden on monetary aggregates with its subsequent inflationary component. Therefore, monetary policy should contain adequate provisions to take into account for this activity so as to attenuate possible impact on inflation. Central Bank authorities are considering coupons and auction mechanisms to avoid abrupt monetary impacts.
- Fiscal policy should also be wary of debt conversion side effects. This is particularly true if debt to debt activity shows a rapid level of activity, implying issuance of additional Government bonds and the subsequent debt service burden derived from the expected growth in the interest rate differential.

Because most of the data on the conversion debt program is still undisclosed, it is difficult to evaluate its trends and expected impact. Furthermore, with the recently implemented economic measures the basic features of existing decrees will have to be modified (e.g. exchange rate treatment). Further research should be done on the following debt conversion issues:

1. Program goals in converting debt via capitalization and debt swaps. This plan should include expected portions of total public and private debt to be capitalized.
2. Monetary and fiscal policies to undertake the new volumes of investments generated through the conversion programs. Such programs should ensure minimum distorsion in monetary aggregates and fiscal spending.
3. The new unified exchange rate will be a key variable to attract new investments and determine return viability.
4. Expected inflow of "new" money generated through the conversion programs. So far, Decree 2485 requires that part of the investment be made partially in cash.
5. Inclusion of new sectors into the program to cover industries with adequate risk/return parameters.

AN ADDENDUM

As expected, Venezuelan authorities laid the grounds for future investments through the debt conversion based on the new economic realities. Decree 86 was issued on March 15, 1989 with the following modifications in place:

– Incoming foreign investments will be converted at the prevailing rate under the unified market, since the former dual exchange rate system was removed.
– An auction mechanism to redeem Public Paper Debt with the Central Bank is introduced. Thus, both the investor and the Government will capture part of the discount. In these auctions, investors will bid taking as reference value an initial discount established by the Government.
– Debt conversion proceeds will only be used to finance the local component of the investment. This implies the injection of "fresh" funds to the operation.
– Local investors are now allowed to opt to the debt conversion mechanism. Dividend remmittance will be limited to 10% of capital during the first three years. Capital repatriation schedule does not vary from previous decrees.
– The creation of an investment fund will allow the investors to securely park its debt conversion proceeds, prior to effecting the capital registration and subsequent disbursement schedule. This sinking fund will be deposited with the Central Bank, allowing it to easen the monetary impact while smoothing the time lags that arise in the registration process.

Undoubtedly, there are many improvements in the new investment framework which will, should allow greater flows of funds to the country. There are, however, clear issues regarding the auction mechanism as well as the initial discounts to be established by the Government on the redeemable paper. A second issue pertains to the the fact that "new" money is required to fund the external component of investment.

Notes:

1 Decree 1200 modified Decision 24 of the Andean Pact, which regulated foreign investment for member countries.

2 In Febreary 16, 1989 the Venezuelan Government, among many other economic measures, unified the exchange rate, allowing it to fleat. The former controlled foreign exchange rate will presumably become from now on the floating parity existing at any one time. For purpose of this study, we describe the existing legislation as the Government is yet to address new foreign investment regulation based on the new economic realities.

3 As a result of the exchange rate unification, the Government's system to provide preferential dollar for imports was eliminated.

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EXCHANGE RATE DETERMINATION IN NATURAL RESOURCES–RICH ECONOMIES*

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Abstract:

This paper deals with the role of natural resources in the process of determination of the real exchange rate within the context of a resource-based sector that is important within the economy and heavily integrated with other sectors. In so doing, the article tries to shed some ligth on questions like: How does the effectiveness of nominal devaluation in promoting real devaluation in a resource-rich economy compare with that in resource-poor economies? What are the implications for the responsiveness of trade flows to devaluation of explicitly considering a natural resource-based sector? Is devaluation more likely to be contractionary in a resource-rich economy rather than in a economy that does not depend on natural resources? How do changes in resource management policies (i.e., extraction taxes) affect the real exchange rate, trade balance and real income in the short run and long run? How have these results been affected by whether the resource is exploited under private property or under common property?

1. Introduction

In a large number of developing countries, natural resources constitute an important component of the economy. The performance of industries based on natural resource

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