

ABSTRACT

In any external debt swap, a country must surrender an asset in return for having a liability extinguished. Typically, the external liability is the government's, while the domestic assets available for swapping belong to the private sector. Hence, the government must gain control of these privately owned resources—whether by taxing them away, or purchasing them with money or bonds. This crucial aspect of debt conversion operations has so far been neglected in the literature.

Each one of these types of debt swap financing will have different macroeconomic effects. Under a dual exchange rate system, money-only swaps can lead to a depreciation of the parallel exchange rate and a temporary current account deficit. The effect of bond-financed swaps, on the other hand, will depend on the size of the secondary market discount and the differential between foreign and domestic real interest rates. For realistic parameter values, we show that debt-financed swaps can be a fiscally expensive proposition, increasing the total interest burden of the public sector. If the public expects that the growing stock of domestic debt will eventually be monetized, the domestic inflation rate will immediately begin to rise.

Hence, the simple model used lends some theoretical backing to commonly voiced fears concerning the macroeconomic effects of debt swaps.