Debt swaps for sustainable development

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A practical guide for NGOs

produced by

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PREFACE : Debt swaps for sustainable development: from theory to action

Many managers in non-governmental organizations wonder whether debt conversion for sustainable development purposes is technically feasible without the very expensive support of highly specialized lawyers or financial experts. This handbook shows that debt swaps do not need such expensive props. The way forward is to `learn by doing'. The purpose of this handbook is to make this process as inexpensive and rewarding as possible.

In the past few years academic writing on debt swaps for development and their political and economic implications have by far exceeded in volume the work of practitioners. The NGO practitioners who have efficiently and successfully negotiated debt-for-development swaps have had little time to write about their work.

There is thus a world of difference between academic writing and `field' practice. This handbook tries to bridge this gap by demystifying debt conversion or debt swaps, using a series of concrete examples and providing practical advice on how to do it. It draws on the experience of various kinds of swaps: debt for child survival programmes, debt for conservation, debt for education, debt for counterpart funds, debt for micro-enterprises, not forgetting more exotic swaps such as debt for soccer stars[5]. This practical guide deals particularly with debt swaps designed for sustainable development, particularly as developed by WWF, The Nature Conservancy, and Conservation International as well as by IUCN—The World Conservation Union.

This handbook also reflects the past experiences of NGOs such as the Swiss Coalition of Development Organizations and not-for-profits like the US Debt for Development Coalition/Finance for Development — excellent examples of pioneers in the area of debt for development conversion and the various ways to set up counterpart funds and to give ownership of this process to the people and their organizations in the developing world themselves.

One of the main constraints in practising debt conversion is the difficulty of understanding the very peculiar terminology that is often used: round-tripping effects, financial market volatility, secondary market price, redemption rate, face value, triple-A rating, etc. A real effort has therefore been made in this handbook to explain the jargon. Rest assured, however, that the language is often more off-putting than the basic economic or financial concepts behind such terms.

Several of these apparently complicated concepts were developed by macro-economists and financial engineers in debt-for-equity swaps. These procedures are often not relevant for debt-for-development swaps and have mainly been used by transnational corporations considering how to invest in a developing country (mostly middle-income countries).

Another important lesson from experience is that a debt-for-development swap is much more than a financial operation; it is a process which includes the use of the product of the conversion. Using the funds is often more complicated than the financial operation itself.

The proceeds of debt swaps are frequently larger than NGOs' financial absorption capacity. In countries where the inflation rate is high and the banking system weak, the proceeds of the conversion have to be spent or secured very fast or they may be eaten up by inflation. It is therefore of fundamental importance to deal with the spending aspect of the swap at the earliest stage. This handbook suggests some ways of avoiding losses.

Three main conclusions are agreed by most practitioners:

1) Swapping debt is less complicated in practice than it appears in theory.

[5] Van Kesteren has shown how little swaps may have to do with development by pointing to the swap-financed transfer of Brazilian soccer star Romario to the Dutch team PSV Eindhoven; see: Van Kesteren, K.(1994) p.245.

2) Although there are general financial and economic principles applicable to all debt conversion operations, there is no single recipe applicable to all swaps, every swap having its own peculiarities.

3) Debt swaps often require a joint initiative of NGOs in both the creditor and the debtor country.

We thank all those inside and outside the NGO community who have helped us to learn such lessons. By sharing our experience we hope to encourage you to explore an exciting, additional source of financing for sustainable development. Finally, we invite all readers to comment and contribute their own experiences to help us improve this handbook in future editions.

Ted van Hees, Coordinator of the European Network on Debt and Development — EURODAD

Frank Vorhies, Environmental Economist IUCN—The World Conservation Union

CHAPTER 1 : What is debt conversion for development?

Why should an NGO be interested in carrying out such a relatively complicated operation as a debt-for-development swap? There are two possible motives, each distinct from the other. But both lead to the same conclusion:

- The NGO may find that a debt-for-development swap will provide it with more in local money for its foreign currency than it would get across the bank counter. A swap may thus be good business.
- The NGO may be concerned with the devastating effects the foreign debt is having on the economy of the country where it works. Therefore its interest may be in helping to bring about debt reduction.

This booklet tries to show how and to what extent converting debt into local currency for development purposes can serve both ends. So we shall start with a broad definition of what we are talking about:

The term `debt for development' encompasses any financial transaction under which an NGO converts debt or currency claims against a developing country into additional funding for its local programmes. (…)

An NGO can obtain more local currency by converting its foreign currency resources into local currency through a debt-for-development swap rather than a conventional foreign exchange transaction. Because many external debt instruments of developing countries have little chance of being fully repaid, they can be purchased on the secondary market for a price substantially below their face value. The NGO uses its foreign currency resources to purchase such discounted debt and the debtor country agrees to redeem the debt for local currency in an amount exceeding the discounted price the NGO paid for the debt. The NGO agrees to spend the local currency on an approved local development, environmental or social welfare project[1].

Figure 1 from the US-based former Finance for Development, Inc.[*] shows the typical course for a debt-for-development swap.

WHO GAINS?

A debt-for-development conversion or swap regularly involves three actors who all benefit from the difference between the nominal value and the real value (defined by the secondary market or some other mechanism) of a country's foreign debt. Figure 2 (over) shows the three values involved.

[1] Debt for Development Coalition Inc.: *How the international debt crisis can work for development*; Washington (flyer)

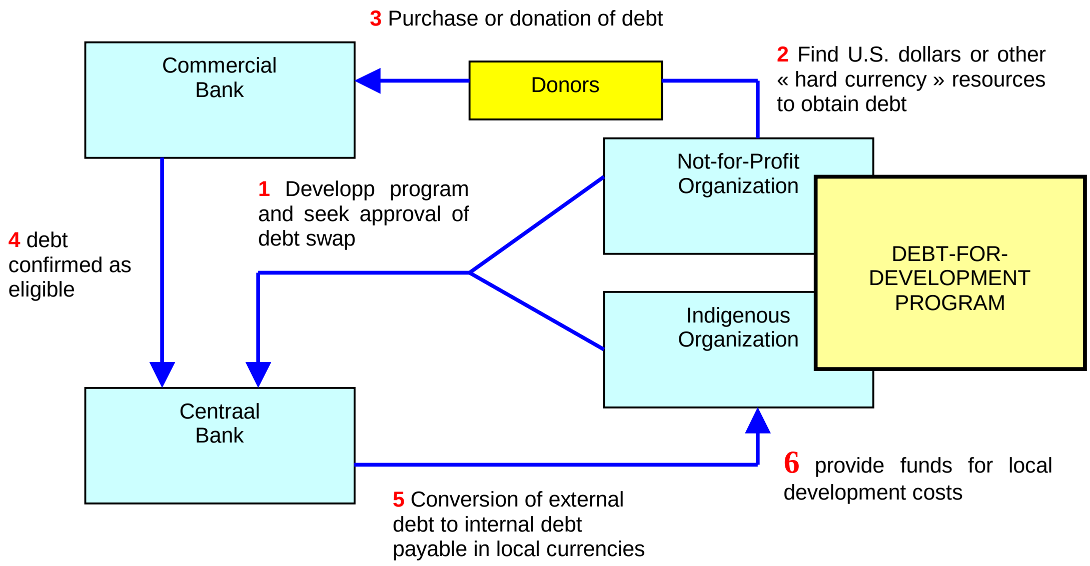
[*] Finance for Development, Inc, a USAID-supported NGO, no longer exists. Some of its staff now work for New York Bay (see page 56).

Who will gain, and how much, by a conversion?

The **creditor's** gain is equal to (b), provided the original debt is considered uncollectable. Through the conversion the creditor realizes a percentage of the original claim (a). Otherwise this claim would only have caused more and more arrears to build up which the creditor would never be able to collect. The creditor will make the decision to sell at a given price dependent on an analysis of the debtor's future ability to pay in full or at a higher rate than the actual offer.

The **debtor government** gains the difference between prices (a) and (c) or between (a) and (d). It will make its decision on the deal dependent on various factors which are discussed more in detail below: the rate of other kinds of debt cancellation available from its international creditors, the priority it gives to the NGO's proposed programme or project, its own capacity and willingness to service its debts in the future, etc.

Figure 1. How do debt swaps work?



Source : The Debt for Development Coalition Inc. : How the International Debt Problem can work for Development (flyer) September 1993

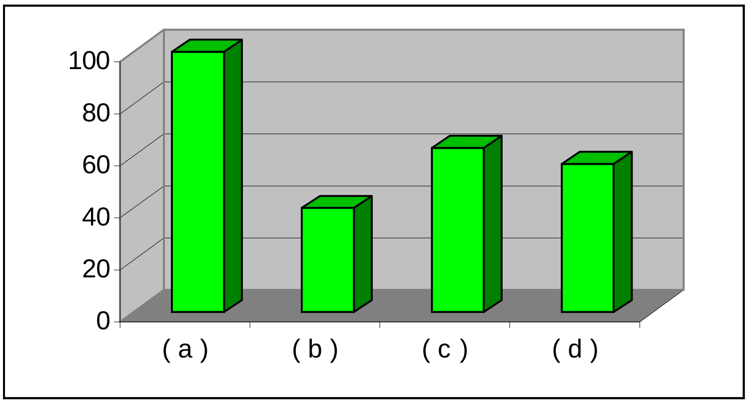
Figure 2. Prices during a debt-for-development swap.

The purchasing NGO gains the difference between prices (b) and (c) or between (b) and (d). It will enter the transaction provided:

- it can ensure payment by the debtor government with a sufficient degree of certainty;
- the price differences are high enough to offset the additional effort as compared to a simple currency exchange and possible risks caused by the debtor government's eventual inability to fulfil its payment obligations over time.

Figure 2 also introduces a fourth actor on the conversion stage who will play a central role in the forthcoming chapters: the indigeneous NGO, which together with the international or Northern one will set up the project or programme which is to be funded by the conversion operation.

Figure 2. Prices during a debt-for-development swap



(a) Is the nominal or face value of the original debt owed to the creditor (whether official or private).

(b) Is the secondary market price at which the interested NGO is able to purchase the original uncollectable debt (purchase price) ;

(c) Is the redemption price, denominated in local currency which the debtor government is willing to pay to the NGO for an approved development project or programme, against the complete cancellation of the original debt denominated in foreign currency.

(d) Is a fourth pricing element which may be applied in some cases : a set of taxes and fees, which the debtor country's government may levy in order to capture an additional share of the overall profit for itself. Price (d) is equal to (c) minus a small amount.

The conversion instrument commonly called the `counterpart fund' or `CPF'

One can distinguish between six different types of CPF, but only three are of interest to the NGO community. It should be noted, however, that the instrument of counterpart funds can be used through a broader range of instruments than is discussed in this handbook (For an extensive review of 21 existing National Environmental Funds, see the *Report of the First Global Forum on Environmental Funds*, Santa Cruz, Bolivia, 30 May-2 June 1994. IUCN).

A CPF can be used for[3]:

- setting up an autonomous fund administered by national NGOs
- making payments to a parastatal social fund, which for its part funds NGO projects
- direct payments to current or immediately implementable projects of local NGOs or specialized international organizations (e.g. UNICEF)
- budget aid assigned to a specific ministry (in most cases health or education) for the implementation of a priority programme
- general budget aid; the counterpart funds remain part of the official budget and serve to finance overall state expenses
- servicing government debt towards the national banking system.

The first three are of interest to NGOs considering a debt-for-development conversion.

[3] See: Fues (1992), p. 16.

A standard CPF agreement

A standard CPF agreement between the debtor country and its creditors, mediated by the Swiss Coalition, includes the following elements:

1. Redemption rate
2. Disbursement modalities
3. Priority sectors
4. CPF management structures
5. Accountability and reporting requirements.

These standard elements will be discussed at various stages of this booklet.

Debt conversion is a means to provide development financing in an innovative manner, which implicitly includes some kind of debt relief. It should, however, by no means be considered as a way to `solve' the debt crisis[4]. Unless the redemption price of such debt come close to zero, e.g. by selling at an explicitly symbolic price, it does not abolish the pressure of repayments from the debtor country's budget. Some of the conversion schemes discussed below may even cause short-term obligations to rise because they compress payments into one or two years. This clearly runs counter to the policy of many debtors, who seek to postpone payments into the future.

Debt-for-development swaps: recent examples

PERU, 1994 (C$22.7mn/C$5.69mn)

> **Canada forgave 75% of the C$22.7mn face value of bilateral debt, and as part of the forgiveness the Peruvian Ministry of Economics and Finance paid 25% of the debt amount in local currency (C$5.69mn) for social and environmental purposes. The local currency amount was divided between FONCODES (the fund for poverty) — C$1.5mn, UNICEF — C$3.69mn and PROFONANPE (the fund for nature) — C$.5mn. The debt conversion was funded in 1995. This was the first debt for nature conversion to be approved in Peru.**
>
> **The Peruvian environmental trust fund, PROFONANPE, is governed by three members from local NGOs, three from government and one from an international agency (such as the German Cooperation Agency).**

PERU, 1995 (US$27mn/$8.1mn)

> **The Finnish Ministry of Foreign Affairs forgave 70% of Peru's official bilateral debt. In exchange the Peruvian Minister of Economics and Finance will pay 30% ($8.1mn) in local currency to be divided between the fund for nature PROFONANPE ($4.86mn/60%) and the poverty fund FONCODES ($3.24mn/40%). This was arranged to be funded in March 1996.**

PERU, 1994 (DM30mn/$6.89mn)

> **Germany renegotiated debt with a face value of DM30mn and forgave 70%. In exchange the Peruvian Ministry of Economics and Finance agreed to spend the remaining 30% (DM9mn or US$6.89mn) on the environment. The funds were paid in 1995 into a sinking fund for PROFONANPE.**
>
> **The transaction was carried out under a German programme that is intended to convert all remaining debt, particularly in Latin America, into local funds for the environment within the next few years. Terms are negotiated on a case-by-case basis under the Paris Club criteria.**

BULGARIA, 1995 (US$83.5mn/$16.7mn)

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[4] The World Bank puts it even more generally: “There is no market solution to the debt crises,” conclude Claessens *et al.* (1991), p. 44.

> **Switzerland forgave 20% or Sfr20mn of approximately $83.5mn of Bulgaria's official debt. In exchange Bulgaria agreed to spend the equivalent amount on the environment and on an environmental cleanup. The payments in eight semi-annual installments are deposited in an earmarked environmental fund. The fund has provided grants to viable non-commercial environmental projects with project technical assistance from the World Bank under the guidelines of the Environmental Action Programme for Central and Eastern Europe.**

PHILIPPINES, 1995 (US$32.3mn/$16.1mn)

> **This bilateral debt was converted at a 50% redemption rate so that half the debt was forgiven in exchange for the Philippines paying $16.1mn in local currency. Funds went to a private foundation established to finance environmental and social projects in priority sectors. Grants were paid to NGOs and small enterprises for sustainable production projects in fishing, agriculture and small industry.**

Debt swaps for sustainable development have a qualitative character

For this reason it would be naive to suppose that an enormous extension of the size and number of conversions could lead to an eradication of the international debt problem. Even if sufficient NGO funds were available, they would in the first place bail out current creditors. Therefore they are a means of influencing post-structural-adjustment or counter-structural-adjustment development policies. But they do not solve the debt problem. So their qualitative character of serving two purposes in one operation (debt reduction and development financing) has clear quantitative limitations and does not make swaps a higher form of development aid. They are a resource which balances opportunities against new risks and drawbacks[5]. One needs to remember, however, that conversion, like any form of debt and debt service reduction, tends to be a positive-sum rather than a zero-sum game. This is due to the manifold effects that debt reduction has on the value of debt titles in the secondary market, to the country's enhanced attractiveness for foreign direct investors, domestic savings, etc[6]. This is more so, when the funds which finance the operation are truly additional and not taken out of existing aid budgets[7].

The Mexican debt conversion programme: how does it work?

The Mexican Debt Conversion programme has been open to any NGO since June 1994. As this is a securities repurchase operation (NGOs have to buy debt securities on the secondary market and redeem it with the Mexican Government), we recommend that any interested small and inexperienced NGO contract the services of a professional organization. New York Bay (NYB) suggest the following steps:

> **1) The NGO or its representative asks for a Debt Conversion Application from the Mexican Ministry of Finance. This application is filed with the Government jointly by the NGO and NYB. NYB can provide drafts of the application letter to be completed by the applicant. In the Mexican case, NGOs may apply for as much as three years' funding. The debt can be redeemed as often as is desirable but the minimum is US$250,000. There is no obligation to redeem the total debt amount approved. Therefore, the application should be realistic but not too small, as there will obviously be no financial absorption problem for the NGO.**

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[5] Van Kesteren has shown how little swaps may have to do with development by pointing to the swap-financed transfer of Brazilian soccer star Romario to the Dutch team PSV Eindhoven; see: Van Kesteren, K.(1994) p.245.

[6] Griffith-Jones and Mistry (1994), p.32.

[7] A clear case in point is the IDA-financed buy-back of Zambian commercial debt described on pp44–5 in Chapter 6: resources have been clearly additional, the operation was soundly planned and well managed, and due to its large size it did cancel a considerable amount (45%) of the country's total commercial debt.

2) After the application is approved, the NGO opens a trust account at a bank of its choice. The purpose of this account is to hold the pesos until the NGO is ready to expend the funds as outlined in the approved application. A standard report format for the Bank can be filed as often as is desirable. The report could also simply be a list of grants to be paid to projects.

3) The NGO will also need to sign an agreement with the Government of Mexico stating the debt's redemption rates, amounts, etc.

4) When the bank account is opened and the agreement signed, Mexican debt is purchased on the open debt market at the best available price (taking into account the redemption rate), and later repatriated to Mexico and redeemed in pesos, with the Government of Mexico, at the agreed redemption rate.

5) The pesos are deposited into the trust account and the NGOs can use the money as stated in the agreement, i.e. to finance a specified project.

Note that if you contract NYB, this company charges two percent of the debt purchased and redeemed, in US$. NYB is paid only after the debt is redeemed and pesos are in the trust account.

What will NYB do for the fee?

1) Prepare, in collaboration with the applicant, all the necessary documentation for submission to the Ministry of Finance

2) Discuss and arrange all formalities for the opening of the trust account and the agreement with the Government

3) Identify and purchase the appropriate debt (this is the most complicated and important activity which requires professional banking and financial services)

4) Secure all necessary approvals

5) Execute the conversion into pesos and deposit them into the trust account

6) Cover all legal fees for the operation.

MEXICAN AND NEW YORK BAY

What does that mean in figures?

The following example shows the transaction costs and profits on a US$1 million operation. As the secondary debt market fluctuates, these figures are of course only indicative but they give a good idea and order of magnitude.

	US$	Pesos
Purchase of US$ 1 million of par debt at 55 cents to the $	550,000	
New York Bay fee	20,000	
Central Bank fee (0.4%)	4,000	
Total cost for the NGO	574,000	
Debt redeemed at 75% in pesos (20% above purchased price) at official exchange rate of P. 6.685/$ at October 1995 rate)	750,000	5,013,750
Total profit for the NGO: 750,000-574,000=	176,000	1,176,650

Examples of debt conversion facilitated by New York Bay

Where	With whom	Amount
Nigeria	International Planned Parenthood Federation	US$1,390,663
Ecuador	Children International	US$5,000,000
Mexico	Conservation International	FRF 2,200,000
Mexico	Fundación Aloysius	US$4,500,000
South Africa	World Vision	US$3,500,000

CHAPTER 2 : A history

How did we get from `market-based debt relief' to `debt for development conversion'?

Converting debt into locally available funds for investment, nature conservation or development has appealed to at least two ideologically very different kinds of actors: conservative apologists for a doctrinaire market system and development politicians. The former have appreciated it as a solution to an over-indebtedness problem, a solution which conforms to the fundamental principles of a market-driven economy. This approach puts the emphasis especially on the pricing mechanism insofar as it is determined largely by the secondary debt market. Development politicians, on the other hand, especially those with a practitioner's background, have welcomed it as a `creative' form of development finance, which as a side-effect also contributes to a medium-term reduction of a country's external debt.

In fact debt conversion as outlined here satisfies both groups.

The first conversion

Conversion has been used to reduce Third World countries' debts since 1985, when Chile established its first debt-for-equity swap programme in May of that year. Since then, debt swaps have grown in volume until in 1990, in the course of the Brady plan, they peaked at US$27 billion for that year. In the following years they have not gone into double figures in billion-dollar terms, and have fluctuated considerably from year to year. For some Latin American countries in particular, such as Chile and Argentina in the early 1990s, debt-for-equity swaps have become important instruments in their debt reduction strategies[8]. Since then the relative importance of swaps has declined due to rising secondary market prices.

Swaps for nature

Compared to the volume of equity swaps, swaps for nature conservation and development purposes have been relatively small. From 1987 to 1994 US$177.56m in Third World foreign debt was eliminated through swaps which provided funds for nature conservation projects.

Some of those deals have been accompanied by fierce discussions in both donor and creditor countries about the approach's legitimacy. Especially in the late 1980s, when foreign debt was widely considered as illegitimate as such by some NGOs and POs (people's organizations), debt-for-nature swaps were being criticised for implicitly acknowledging the legitimacy of the debt titles purchased.

[8] It is not possible to discuss here the far-reaching transformations brought about by this new and specific style of money inflow into a severely indebted economy with its strong emphasis on sectors with traditional comparative advantages and nearly exclusively on serving foreign markets. But see Balbontín's investigation into the Chilean equity-swaps in the eighties: Balbontín (1993). Also see Willam R. Sline: *International Debt Re-examined*; Institute for International Economics, Washington DC February 1995. We particularly recommend the chapter on `The Economics of Debt Forgiveness' and `The International Transfer Problem'.

Ecological organizations involved in those deals were criticised for undermining the broad front rejecting debt collection from impoverished nations and harming the countries they pretended to support with their projects. This debate has today largely died down, due to a more realistic view of the limited contribution swaps can bring towards a solution of the overall debt problem (see Chapter 1) and a growing awareness of the important effect they can have for nature conservation and poverty alleviation.

Table 1. Debt-for-nature swaps, 1987–94

Table A6.2 Debt-for-nature swap, 1987–94

(US$ millions)

Country	*Year*	*Cost*	*Face value*	*Conser-vation funds*	*Purchase price (percent)*	*Redemption price (percent)*	*Leverage*	*Organization/country*
Bolivia	1987	0.10	0.65	0.25	15.4	38.5	2.5	Conservation International
Ecuador	1987	0.35	1.00	1.00	35.4	100.0	2.8	World Wildlife Fund
Costa Rica[a]	1988	5.00	33.00	9.90	15.2	30.0	2.0	The Netherlands
Costa Rica	1988	0.92	5.40	4.05	17.0	75.0	4.4	National Park Foundation of Costa Rica
Costa Rica	1989	3.50	24.50	17.10	14.3	69.8	4.9	Sweden
Costa Rica	1989	0.78	5.60	1.68	14.0	30.0	2.1	The Nature Conservancy
Ecuador	1989	1.07	9.00	9.00	11.9	100.0	8.4	World Wildlife Fund/The Nature Conservancy/Missouri Botanical Gardens
Madagascar	1989	0.95	2.11	2.11	45.0	100.0	2.2	World Wildlife Fund/U.S. Agency for International Development
Philippines[b]	1989	0.20	0.39	0.39	51.3	100.0	2.0	World Wildlife Fund
Zambia	1989	0.45	2.27	2.27	20.0	100.0	5.0	World Wildlife Fund
Costa Rica	1990	1.95	10.75	9.60	18.2	89.3	4.9	Sweden/World Wildlife Fund/The Nature Conservancy
Dominican Rep.	1990	0.12	0.58	0.58	19.9	100.0	5.0	Conservation Trust of Puerto Rico/The Nature Conservancy
Madagascar	1990	0.45	0.92	0.92	48.5	100.0	2.1	World Wildlife Fund
Poland	1990	0.01	0.05	0.05	24.0	100.0	4.2	World Wildlife Fund
Philippines	1990	0.44	0.90	0.90	48.8	100.0	2.1	World Wildlife Fund
Costa Rica[c,d]	1991	0.36	0.60	0.54	60.0	90.0	1.5	Rainforest Alliance/Monteverde Conservation League/The Nature Conservancy
Madagascar[e]	1991	0.06	0.12	0.12	49.6	100.0	2.0	Conservation International
Mexico[f]	1991	0.18	0.25	0.25	72.0	100.0	1.4	Conservation International

[a] Includes $250,000 donation from Fleet National Bank of Rhode Island.

[b] Total amount of agreement is $3 million.

[c] World Wildlife Fund contributed $1.5 million to this deal on top of the swap.

[d] Purchase of CABEI debt.

[e] Total amount of program is $5 million.

Country	Year	Cost	Face value	Conser-vation funds	Purchase price (percent)	Redemption price (percent)	Leverage	Organization/country
Mexico[f,g]	1991	0.00	0.25	0.25	0.0	100.0	n.a.	Conservation International
Ghana[h]	1991	0.25	1.00	1.00	25.0	100.0	4.0	Debt for Development Coalition/Conservation International/Smithsonian Institution
Nigeria	1991	0.07	0.15	0.09	43.3	62.0	1.4	Nigerian Conservation Foundation
Jamaica	1991	0.30	0.44	0.44	68.6	100.0	1.5	The Nature Conservancy
Guatemala[d]	1991	0.08	0.10	0.09	75.0	90.0	1.2	The Nature Conservancy
Mexico	1992	0.36	0.44	0.44	80.5	100.0	1.2	Conservation International/U.S. Agency for International Development
Philippines[i]	1992	5.00	9.85	8.82	50.8	89.5	1.8	World Wildlife Fund
Guatemala	1992	1.20	1.33	1.33	90.0	100.0	1.1	Conservation International/U.S. Agency for International Development
Brazil	1992	0.75	2.20	2.20	34.0	100.0	2.9	Conservation International
Panama	1992	7.50	30.00	30.00	25.0	100.0	4.0	Conservation International
Bolivia[j]	1992	0.00	11.50	2.76	0.0	24.0	n.a.	World Wildlife Fund/Conservation International
Philippines	1993	13.00	19.00	17.70	68.4	93.2	1.4	World Wildlife Fund
Madagascar	1993	0.91	1.87	1.87	48.7	99.9	2.1	World Wildlife Fund
Madagascar[j]	1994	0.00	1.34	1.07	0.0	79.9	n.a.	World Wildlife Fund
Total/average		46.30	177.56	128.77	37.2	86.3	2.3	

n.a. Not applicable.

Note: Cost = Expenditures by environmental agency to acquire the sovereign debt. *Face value* = Face value of the sovereign debt acquired by the environmental agency. *Conservation funds* = Value in dollars equivalent to the local currency part of the swap (either face value of the environmental bond or local currency equivalent). For bonds, the figure does not include interest earned over the life of the bonds. Overhead fees charged by government are not deducted. *Purchase price* = Price at which the debt was acquired (cost or face value). *Redemption price* = Conversion rate from foreign debt to local debt (conservation funds or face value). *Leverage* = Redemption price or purchase price.

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[f] Total amount of program is $4 million.

[f] Total amount of program is $4 million.

[g] Debt donated by Bank of America.

[h] Involves buying blocked local currency funds from multinational. Also includes Midwest Universities Consortium for International Activities and U.S. Committee of the International Council on Monuments and Sites.

[d] Purchase of CABEI debt.

[i] Face value of debt includes $200,000 debt donation by Bank of Tokyo.

[j] Debt donated by JP Morgan.

[j] Debt donated by JP Morgan.

Source: World Wildlife Fund, The Nature Conservancy, and World Bank data.

Source: World Debt Tables 1995, page 165.

Maximal vs optimal conversion

From a development point of view it may be helpful to distinguish between a maximal and an optimal conversion. The former obtains a maximum amount of local currency for a development project or programme in exchange for a given amount of foreign debt. An optimal conversion would balance obtainable funds against macro-economic factors that tend to diminish the local currency proceeds: there should be no unsustainable burden on the national budget, the danger of inflation should be minimized, etc. UNICEF's debt-for-child-survival programme (see below) is a clear case of a big organization passing on any inflationary risk onto the shoulders of the debtor government. In Madagascar UNICEF did not receive cash or local currency-denominated bonds, but eight US$-denominated promissory notes with a value of US$500,000 each. They were converted into local currency at periods during the whole duration of the programme.

Nature and development

As nature conservation and development are strongly interlinked, debt-for-development swaps are not always easy to distinguish from debt-for-nature swaps. While the first `pioneering' debt-for-nature swaps were normally used to purchase land which was then exempted from commercial use, conservationists nowadays favour a more `holistic' approach. This implies financing traditional development activities, e.g. providing the landless with alternative employment in order to relieve pressure on the biosphere. IUCN-The World Conservation Union has focused particularly on promoting debt conversion that would alleviate over-exploitation of natural resources.

Debt-for-development programmes

It is estimated that up to 1994, US$750m-1bn was cancelled in foreign debt to fund development projects or programmes in local currency[9]. Initially debt-for-development swaps were exclusively undertaken with commercial debt, i.e. debts were purchased from or donated by commercial banks. Since March 1991 an important source of funding for the buy-back and, sometimes, conversion of commercial debt has been the IDA debt reduction facility (see Chapter 6). The most important actor in swapping commercial debt for development is UNICEF with its debt-for-child-survival programme. US$188.771m of debt has been cancelled through this programme since 1989 (see table 2, page 16).

SILMICs SILICs AND TERMs

SILMICs and SILICs, Toronto and Naples Terms

In September 1990 the Paris Club (the consortium of big Western creditor governments) included a swap option into its standard proceedings for Severely Indebted Lower Middle Income Countries (SILMICs): 10% of a creditor's claims or US$10m (whichever is higher) may be sold for investment, nature conservation, social development or any other similar purposes. In late 1991 the Paris Club extended this clause to the poorest countries (SILICs) in its `Enhanced Toronto Terms' (ETT). Most recently the clause has also been integrated into ETT's successor, the `Naples Terms' with a slight improvement in conditions, bringing the maximum amount up to US$20m. The inclusion of a swap option for official bilateral debt must be considered an important step for development financing in general. The scheme suffers, however, from the lack of an adequate and recognised pricing mechanism. Creditors who sell debts under the 10%-clause do so mostly at a price fixed in line with the conditions the country has received for its bilateral official debt in the Paris Club. This means that an official creditor who has granted a 50% debt service reduction under Enhanced Toronto Terms will expect any investor or NGO wanting to buy another 10% of its claims to pay at least 50% of face value, even if the secondary market price for this debt is considerably lower. This expectation makes it difficult for countries with a low secondary market price for their debts to have a chance to get the additional 10% swapped (because possible investors can eventually get their local currency cheaper

[9] *World Debt Tables 1994/5*; p.164.

on the secondary market). Therefore some actors strongly argue for the establishment of a secondary market for official bilateral debts[10].

Table 2. UNICEF debt-for-development swaps.

UNICEF has done much to show how far forward debt swaps can be taken. Since 1989, 21 swaps in countries as diverse as Sudan, Madagascar and Zambia have retired $193 million of debt at a cost of $25 million and generating $48 million of project funds. These swaps were financed in addition to regular country programs, through special fundraising campaigns or the donation of debt (as seen in the table where purchase price in $0), and therefore represent new money. UNICEF's success has involved three critical factors: projects are always formulated in partnership with government to address national priorities, projects are chosen for their sustainability and high local-cost content; and projects are chosen with a life-span of 3–4 years to guard against inflation or currency devaluation.

Swap	*Face Value*	*Purchase price (PP)*		*Redemption price (RP)*		*Leverage*
	in US$ of Debt	*in US$ on Secondary Market*	*(as % of face value)*	*in US$ — Local Funds Generated*	*(as % of face value)*	*(RP/PP)*
Sudan 1989–1992[a]	59,355,000	0	0%	3,285,000	5.5%	n/a
Jamaica 1992[b]	4,000,000	2,877,000	71.9%	4,000,000	100%	1.4
Madagascar 1992[c]	4,000,000	2,000,000	50%	4,000,000	100%	2
Phillipines 1992[d]	486,000	245,000	50.4%	329,000	67.7%	1.3
Phillipines 1993[e]	250,000	0	0%	180,000	72%	n/a
Bolivia 1993[f]	15,000,000	2,400,000	16%	3,600,000	24%	1.5
Phillipines 1993[f]	1,226,000	864,000	70%	1,000,000	82%	1.2
Madagascar 1993[g]	2,000,000	940,000	47%	2,000,000	100%	2.1
Senegal 1993[h]	24,000,000	6,000,000	25%	11,000,000	46%	1.8
Madagascar 1994[h]	1,200,000	576,000	48%	950,000	79%	1.6
Madagascar 1994[i]	2,000,000	1,000,000	50%	2,000,000	100%	2

[10] See e.g. Frans van Loon: Debt conversion for financing sustainable development; in: *Debt Conversion for Financing Sustainable Development. Highlights from a EURODAD workshop, March 23rd–25th 1994*. Brussels 1996; van Loon also shows that the unclear pricing mechanism goes along with a very arbitrary setting of the redemption price; i.e. some investors or NGOs get considerably more local currency for the same amount of foreign debt than others. Griffith-Jones and Mistry (*op.cit.* p.32) argue for a key role of the Paris Club in standardizing exchange instruments in the event of official debt sales in secondary markets, in order to do away with the present excessive complexity of official debt sales.

[a] **seven swaps in water, health and sanitation sectors**

[b] **primary health care, women and street children sectors**

[c] **education, health and nutrition sectors**

[d] **children in armed conflict**

[e] **primary education sector**

[f] **education sector**

[f] **education sector**

[g] **two swaps in water, health and sanitation sectors**

Swap	Face Value	Purchase price (PP)		Redemption price (RP)		Leverage
Peru 1994[j]	10,880,000	0	0%	2,720,000	25%	n/a
Zambia 1994[j]	66,614,000	7,328,000	11%	10,990,000	16.5%	1.5
Mexico 1994[k]	1,870,000	1,015,000	54%	1,658,000	88.7%	1.6
Total	192,881,000	25,445,000	13.2%	47,713,000	24.7%	1.9

From: Saravannamuttoo, N. & Christopher Shaw: Making Debt Work for Education;
Association for the Development of African Education; Paris 1995; p.10

CHAPTER 3 : Which debts can be converted?

In principle any debt can be converted — provided there is an agreement between seller, buyer and debtor on the conditions of the arrangement. No debt is exempted from conversion by character or definition. Some are excluded, however, by political decision, mostly on the part of the creditor (e.g. debts on military expenditure).

Multilateral debt

So **multilateral debt** is not available for conversion just as it is exempt from cancellation, because the International Financial Institutions (IFIs) have so decided and — at least so far — have the power and political backing of creditor governments to hold to that position. This does not mean that the IFIs are against conversion as such. Time and again they have expressed their moral support for a `market-based solution' and the World Bank's soft-loan window IDA has even provided considerable amounts for debt buy-backs which sometimes have been associated with debt-for-equity swaps (see Chapter 6). It is just their own claims which they don't want to see converted. In the course of the international debate on a possible future `Multilateral Debt Relief Facility', the option to convert the claims of multilateral institutions into local currency funds has been introduced for the first time. The discussion has remained on a theoretical level so far, but international pressure may force the IFIs to accept multilateral debt conversion.

Commercial private debt

An opposite case in point is **commercial private debt,** i.e. debt owed to mostly Western private banks. There is an extensive secondary market for these debts, which functions more or less according to market principles. As soon as banks understand that a claim towards a specific country may not be recoverable, they may be willing to sell it below face value. Investors, environmentalists and development NGOs among others are invited to come in and buy the banks' claims. Normally there are no restrictions on the sale. Everything depends on finding an agreeable price for buyer and seller and on whether a convenient procedure for the conversion can be established with the debtor government on behalf of the buyer.

Official bilateral debt

Opportunities to swap **official bilateral debt** vary from country to country. The regulations of the Paris Club (see Chapter 2) state two fundamental principles:

- Official Development Aid (ODA) can be converted — as it can be reduced — without any limitation. It depends only on the creditors' will to do so.
- Non-concessional debt conversions, on the other hand, are regulated by the frameworks set up by the Paris Club in September 1990 for SILMICs (severely indebted lower-middle income countries) and in late 1991 for SILICs (severely indebted lower income countries) (see Chapter 2). These conversion terms largely depend on the category the debtor country belongs to: is it a severely or a moderately indebted country and is its per capita income low, lower-middle or middle according to World Bank terms? SILICs and SILMICs can have 10% (or US$10m, whichever is greater) of non-concessional claims of a particular creditor converted in any kind of swap. Very recently the `Naples Terms' for

countries of the SILIC category have elevated the minimum amount to US$20m. For `moderately' or `less' indebted countries Paris Club regulations (`Standard Terms') foresee no debt conversion option.

Debt structure of Severely Indebted Low Income Countries (SILICs)	
Bilateral:	61%
Multilateral:	21%
IMF:	4%
Private:	8%
Short term:	6%

Source: World Bank Debt Tables — 1996

List of SILICs and SILMICs: see Annex 2

Who holds the debt?

Conversion of non-concessional debt is still further complicated by the various possible holders of that debt: the creditor government, its national Export Credit Agency (ECA) and/or the original provider/exporter, which under most export insurance systems is likely to still hold a `tail end' of its claim exempt from compensation. National law normally gives governments a mandate to include these claims into Paris Club agreements. But, of course, they are under pressure to minimize concessions. The key factor regarding the sale of these claims is the legal construction and market position of the ECA. There is an often confusing, and in itself contradictory, mixture — of governments' political interest to be concessional towards some countries and less so towards others — and an ECA's commercial interests. Such aspects cannot be examined comprehensively in an introductory handbook[11].

As reported in the previous chapter, some member countries of the Paris Club have granted debt reductions or debt conversions beyond the limits established in the Club. They have done so for reasons of internal national politics, as in the case of the Swiss debt reduction facility, or because they have a special interest in benefiting, for example, former colonies, among them France and Spain. Therefore **the formally binding agreements made in Paris should not deter NGOs from asking their governments to consider swap options for bilateral official debt.**

Convention on Biological Diversity

Some international conventions have binding articles promoting the use of new and additional funding to implement them. This is particularly the case of the Convention on Biological Diversity. In Article 20 on Financial Resources it stipulates:

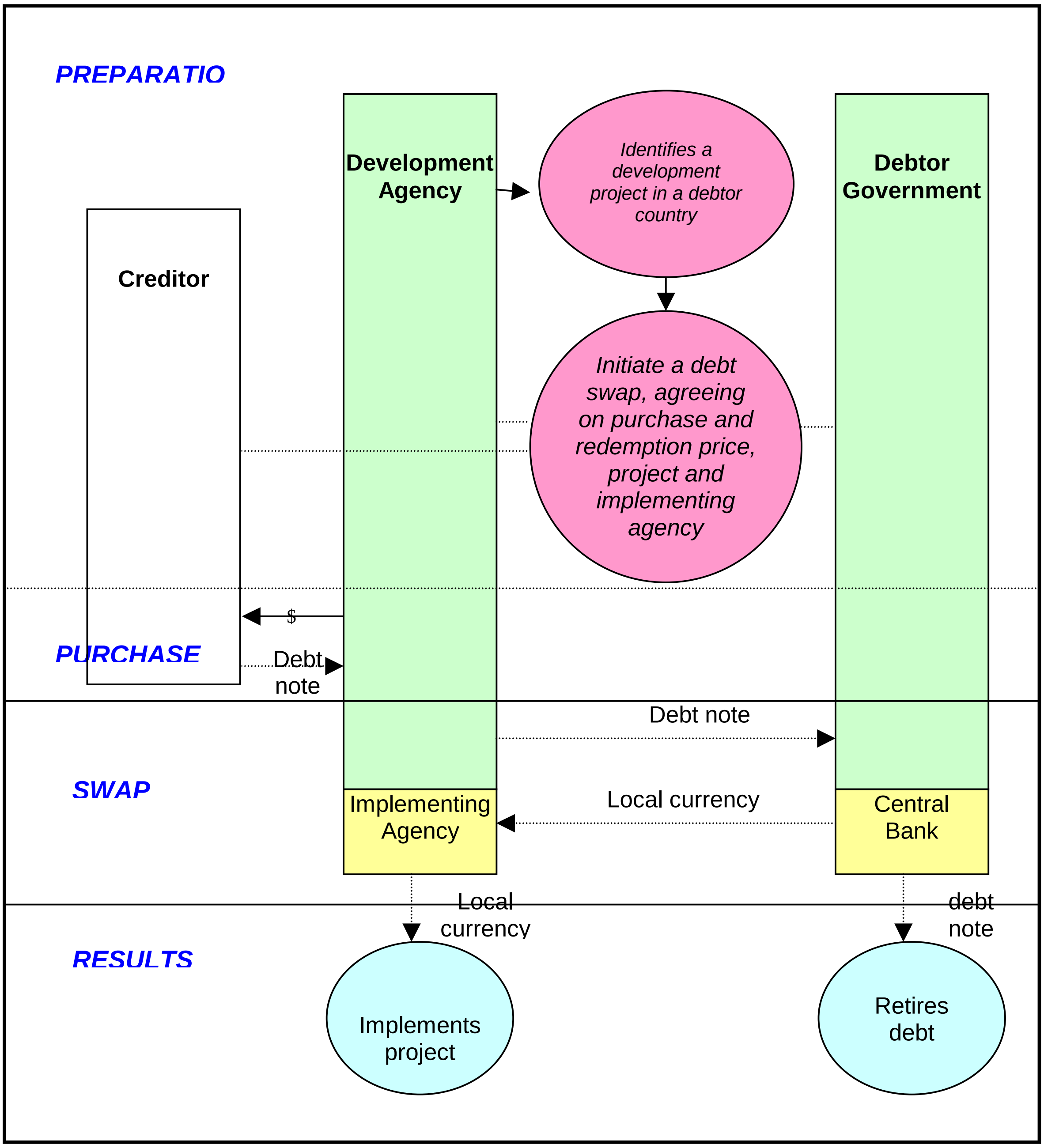
“The Developed country Parties shall provide new and additional financial resources to enable Developing country Parties to meet the agreed full incremental costs to them of implementing measures which fulfil the obligations of this Convention…”

IUCN is asking its own State members which are at the same time Parties to the Convention to activity promote debt-for-nature swaps, in accordance with Article 20 and as a way to implement the Convention.

NGOs may approach their national authorities and ask them to fulfil their international commitments assigning them bilateral debt that they can redeem in developing countries for their activities related to the implementation of this Convention or any other relevant ones.

[11] For an overview, see Griffith-Jones *op.cit.* p.97–104.

Figure 3. A simplified model of a debt-for-development swap



Nonetheless NGOs should also take the lead in pressing their governments to increase the opportunities to convert official bilateral debt beyond the present limits. In particular, the Paris Club's 10% clause is an all too arbitrary ceiling, limiting what could be an innovative instrument from a development point of view. Given the capacity of conversions to provide substantial relief in terms of foreign currency debt and at the same time to pass relief effects on to target groups, the 10% clause should either be abolished altogether or elevated to a level which provides 100% foreign currency relief in combination with an implementable level of debt reduction. In addition, the cut-off-date should be deferred for debt conversions, and previously rescheduled debt should be made eligible for conversion (When general reduction schemes are agreed, the partners usually stipulate that these measures apply only for debts contracted before a specific `cut-off date'). Even if post-cut-off-date debt continues to be exempt from cancellation, it should be made tradable, especially for some African countries, because such debt represents a considerable amount of their overall external debt.

Selling and converting debts which are already considered below their face value is not likely to have any negative effect on creditor-debtor-relations in the future[12].

How to find convertible debts

From a development point of view there is a clear priority to convert debts which are (a)non-concessional and (b)being serviced, as against those which are concessional and in arrears[13]. As we have seen, however, the latter are `softer' targets because creditors are more likely to give them away. Therefore development NGOs wishing to engage in conversion need to balance the desirable against the practicable. An additional incentive for private banks may be the disproportion between a claim's size and its probability of being serviced or the administrative effort needed to maintain it. So, once they have a project in a particular country which they want to finance through a conversion, NGOs should also investigate whether a bank is holding small, unserviced claims.

There are three fundamental options to obtain convertible debt:

THE FIRST STEP

(a) An NGO can have it donated by a commercial creditor which considers the gains from donating it, in terms of tax-benefit or publicity effect, to be superior to the chance of recovering part of that debt. A variant would be the inclusion of the NGO and its programme in an official debt conversion scheme financed from the creditor country's aid budget or from a national or multilateral debt reduction facility.

(b) The NGO purchases commercial private debt on the secondary market. Generally that market is accessible through any internationally operating commercial bank or a highly specialized NGO. You need to consider that restrictions may be tied to particular portions of such foreign debt. Among these may be prepayments to one as opposed to all creditors, or factors in the relation between government and the Central Bank[14]. We discuss some of the potentially negative side-effects of debt conversion in Chapter 7.

(c) The NGO agrees with its own or any other creditor government to purchase official bilateral debt at a discount or have it donated, and at the same time reaches agreement with the debtor government on a conversion scheme.

The first step

In practice the first step in any of the three options is to contact the financial authorities (Ministry of Finance, Export Credit Agency, Development Co-operation Agency) to inform yourself about their policy regarding debt swaps. Some Development Co-operation Agencies have earmarked funds specifically for debt relief activities. Most of the Export Guarantee Institutions are public bodies; others have public funds for debt relief activities. Every government institution dealing with the debt has its own policy and those are changing very fast. The best way to find out is therefore to ask!

If you seek donation of private bank debt, the approach is quite similar: regardless of the amount, managing a debt is a very expensive activity, with travel costs, lawyers' fees, accounting expenses, etc. Some banks therefore wish to get rid of some (for them) small debts because the likelihood of getting them paid is extremely low and the management costs are too high. They may also wish to unload these debts because the local legislation provides a tax rebate for such operations. Or they may want to strengthen their operating balances in order to be better rated on international financial markets: if the bank is seen as a very well managed, safe and reliable financial institution, and therefore rated highly (AAA), it has easy and cheap access to the international financial market to borrow money. The only way to know if banks are interested in divesting itself of any of its claims is to visit them and ask. Of course, not every bank is holding claims on the country you may be interested

[12] For a comprehensive NGO agenda on conversion-ceilings and eligibility, see Martin(1994), p. 36.

[13] See: Debt for Development Coalition: *Debt for development conversions in the context of the debt-reduction facility for IDA-only countries*; Oct.1993, p.10

[14] *ibid.* p.10/11

in. So you can either go from door to door starting with the major players or try to get advice from your national banking association.

Multilaterized operations

One more innovative means to `multilateralize' development swap operations has been to leverage the large amounts of debt owed by Third World nations to countries of the former Socialist bloc through comparatively small amounts of debt relief for the latter by Western creditors. As most of the ex-Communist countries do not provide aid any longer for their old allies, their chances of recovering any considerable part of their money are very slim.

As an example, Nicaragua owes more than US$3.2bn to Russia as the successor to the former Soviet Union. Nicaragua is, per capita, the most indebted country in the Third World; it is unable to service its obligations towards multilateral creditors other than through new aid money; it obtained a 67% debt service reduction from the Paris Club in March 1995, but will clearly be unable to service the remaining part of Paris Club debt. Therefore Russia knows that it won't see a ruble from Nicaragua for a very long time. It has offered to cancel 90% of the debt, if it has the remaining 10% guaranteed and repaid over a relatively short period. Nicaragua, in turn, has suggested a 95% reduction. Given such redemption rates, Western donors can exert an otherwise inconceivable leverage with a comparatively small amount of money. For example, it could pay Russia 5% of its Nicaraguan debt in hard currency right away, and have Nicaragua pay the equivalent with a premium over a longer period. Or Nicaragua could be asked to put the money immediately into a counterpart fund for social development without having to pay the premium. Such a scheme would serve two purposes at once. It would help a creditor country, which itself is a huge debtor, and one which the West has a strong interest in stabilizing socially and politically. And it could mobilize development money in a terribly indebted Third World country to the equivalent of 10% of its Gross National Product.

There has been some research into the possibilities of such a scheme by UNCTAD (the Secretariat of the United Nations Conference on Trade and Development), but no results are yet available. Nor has such a swap ever been implemented. However, such schemes would enable NGOs to `multiply' their resources even beyond what is possible in an ordinary `bilateral' conversion. Nevertheless, NGOs must bear in mind that not only resources but also complications, delays, misunderstandings and additional technical difficulties tend to multiply in such schemes.

IUCN is working on a similar scheme for Vietnam's ruble debt, presuming that Russia would prefer its loans to Vietnam to be repaid in hard currency and would therefore accept a discount on the face value of the debt. It is also interesting to note that Russia is both a debtor and a creditor country and would itself like to benefit from debt conversion. The Russians should therefore have an interest in being as generous towards their own debtors as they would like their creditors to be with them, an argument it is possible to make to other ex-Socialist states.

CHAPTER 4 : Who can become a debt converter?

The easiest answer to that question is: everybody! Trading debt is a market operation; so the full answer is: everyone can become a debt converter, provided they have the money or are able to mobilize it from a third party. For NGOs interested in financing development through debt swaps this means they either must have enough resources to cross a critical threshold beyond which creditors have an interest in selling their claims; or they must be able to ensure that the necessary funds are donated to them (see previous chapter); or they must be able to influence governments so that debts are donated to them.

But not everybody who can become a converter according to these fundamental criteria should also engage in this kind of business. Some additional criteria may help to discern who actually should try to use this instrument.

Criteria for a converter

First of all, an NGO that wants to convert debts into a counterpart fund should have a constituency at both ends of the pipeline[15]. It must have political backing, connections to the private or public creditors, the right personnel and, also, the technical capacities to mobilize funds, to have them donated or to convince a third party to finance the deal. And at the receiving end it must have the capacity to transform the mobilized resources into sound development efforts that reach the target group envisaged.

Many Northern NGOs that may be able to fill such a role in their home country tend to overestimate the capacities of their partner organizations in the South. A counterpart fund is generally more difficult to administer than normal grant-financed development programmes. It also comes under closer surveillance by outside institutions. Therefore, the capacities of partner organizations to fulfil expectations related to the setting up of a counterpart fund should generally be considered to be the single most important factor in a successful debt swap — and its most likely bottleneck. This capacity factor must not be neglected.

Debt swaps, it has been suggested, can even be considered from the viewpoint of `demand-side' economics[16]. In the first place, a Southern NGO must demand funds for a specific project or programme. Then there must be an in-depth evaluation of its `absorptive capacity' (capacity to manage a counterpart fund). Only then should Northern partners look for convertible debts.

Help from two sources

Two agents can play an important positive role in fostering debt conversion by NGOs, especially smaller ones: first, of course, the debtor government; and second, other NGOs with experience in debt-for-development swaps.

Governments should invite a broad spectrum of national and international NGOs to take part in debt swaps, and should provide some technical services for them on a more centralized basis. Two middle-income countries have taken up such an initiative so far: Mexico and the Philippines (see pages 10 and 26).

NGOs and the debtor government

Debtor governments normally expect the following information from a Northern NGO which wants to finance a development programme or project through a debt swap[20]:

- a general description of the NGO and its track record in the country
- general information about its local partners
- a description of the project or programme to be financed through the conversion; in particular, the expenses which are to be covered by the conversion proceeds should be outlined in detail
- a statement on the project/programme's relevance for the country's social and economic priorities.

NGOs submit potential projects to be funded through a debt swap and if the government approves the project, then the NGO is advised of appropriate debt notes that can be purchased and at what rate they will be redeemed in local currency. Such national debt-for-development funds can also be used

[15] Gonzales, E.: Swiss debt conversion and the counterpart fund in the Philippines; in: *Debt conversion for financing sustainable development*, op.cit.

[16] Association Conversion de la Dette pour le Développement et l'Environnement (ACDE), undated Folder

[20] Fues *op.cit.* p. 18

as a tool for encouraging creditors to donate their debt notes. They can therefore be offered a range of development projects that can be supported through a swap[17].

The Philippine Central Bank's Debt for Development Fund also supports swaps technically. So far NGOs have been surprisingly reluctant to take advantage of this[18]. On the national NGO scene in Mexico the reaction towards a comparable facility has been somewhat more enthusiastic[19].

In France ACDE (l'Association Conversion de dette pour le Développement et l'Environnement), which has been established by several NGOs in order to provide technical advice and support to members during debt conversions, also provides the opportunity for smaller NGOs to benefit from conversions. ACDE pools minor contributions from particular smaller NGOs (which otherwise would not have justified the administrative effort for a conversion) into one bigger operation which then gives reasonable leverage to all participants[21].

CHAPTER 5 : Who can participate?

One of the most difficult aspects of development policies in general is bridging the gap between rich donors — be they private or official aid agencies — and the poor in the developing countries. Debt conversion is no exception to that fundamental problem. Debt converters should be prepared to find this substantial difficulty complicated further by the vicissitudes of the conversion process. The opportunity to reduce a country's debt burden and to provide development financing in one single operation has to be paid for by the extra effort needed to ensure that the target groups actually benefit. In this chapter we explore the experiences which some institutional converters have already gained.

The problem of representation

One fundamental concept of development policy is that target groups should be reached in ways that give them the opportunity to represent themselves instead of being taken care of in a paternalistic manner. The question is: how can a country's poor, who are often poor precisely because they are treated as an amorphous unorganized mass, represent themselves? And how can they do so in the complicated context of a debt conversion scheme? A very general answer will serve as the starting point for this chapter: that is, they must do it through their own organizations, ones that already exist and serve them well before the converter appears on the scene[22].

So who is there, willing and able to represent the poor, whom the authors of a conversion scheme would be seeking to benefit? Broadly speaking, we can distinguish four possible actors:

(a) national or local people's or mass organizations (referred to as `POs')

(b) national or local NGOs

(c) local governments

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[17] Saravanamuttoo, N & C. Shaw: *Making Debt Work for Education — How Debt Swaps Can Contribute to African Education*; Association for the Development of African Education; Paris 1995; p.29

[18] Gonzales *ibid*

[19] P. Enrique Gonzales Torres, S.J.: *Fondo para la Asistencia, Promoción y Desarrollo, I.A.P. (Una experiancia de Swap-social en Mexico)*; Mexico 1994

[21] Association Conversion de la Dette pour le Développement et l'Environnement (ACDE), undated Folder, p.8

[22] This question is the subject of a huge quantity of literature which can not be dealt with here. Therefore we just define this baseline and move on to the more technical question that is particular to the conversion process.

(d) national government[23].

Generally one can state that the possibility for the poor to express their own interests diminishes from (a) through (d). Consequently the converter should seek representation of POs when and wherever this is possible. However, as a rule, institutional capacities, especially for the administration of funds, vary in the opposite direction. To escape a trade-off between target group participation and institutional capacity, candidates for the administrative body of a counterpart fund should be identified by using the same criteria for NGOs that receive regular funding from Northern counterparts: they must have a track record and they must be transparent in their set-up and operation.

Debt conversion as a form of foreign domination?

Some authors who emphasize that debt swaps only have a marginal debt reduction effect consider the shift of decision-making power over the debtor country's internal resources to be the single most important effect of swaps. Garnier[*] is highly critical of a "whole spectre of new actors interested in a new alchemy' regarding the allocation of a nation's public funds: whereas ministries, parliaments, and parastatals were used to deciding on the allocation of resources, they now find themselves replaced with a "new alchemy" of central bank, national and international NGOs, investors and international financial institutions.

This argument points to the real danger of imposing a kind of foreign domination onto a country through the leverage of its indebtedness. As real as this danger may be, it needs to be calculated against some countervailing factors:

- **debt swaps are no more an intervention from outside than ordinary project financing — especially when it comes as a loan;**
- **there is at least some manoeuvering space for any government to finance internal investment through swaps without igniting inflation; the swap needs to be tailored to that capacity;**
- **swaps are not necessarily a zero-sum-game, especially when they are used to finance productive investment; even if the resulting internal indebtedness is not less than the burden of the former scheduled debt service, the investment will create net income which in the same or a following period will serve the indebted government or the population at large; debt service never does so.**

Beyond these more pragmatic considerations it needs to be pointed out that the idea of a democratic state serving an indebted society to its best is all too often a myth. And it is even more so in the era of orthodox structural adjustment, where an "old alchemy" of oligarchic national interests and IFI's intervention along the lines of neoliberal ideology allocate resources for anything but a country's poor.

Here again the Swiss experience shows how such opportunities can be used, through the example of the Philippines (see also Figure 4):

NGOs in CPFs: a Philippine example

The situation in the Philippines is characterized by an enormous number of NGOs. These are further grouped in several, partly competing NGO networks. When the Swiss, in the context of their debt reduction facility, came to set up their counterpart fund, it was crucial to get a strong NGO representation into the decision-making body of that structure. They found the legal ground for including NGOs: the Philippine Local Government Code assigns NGOs a comparatively broad

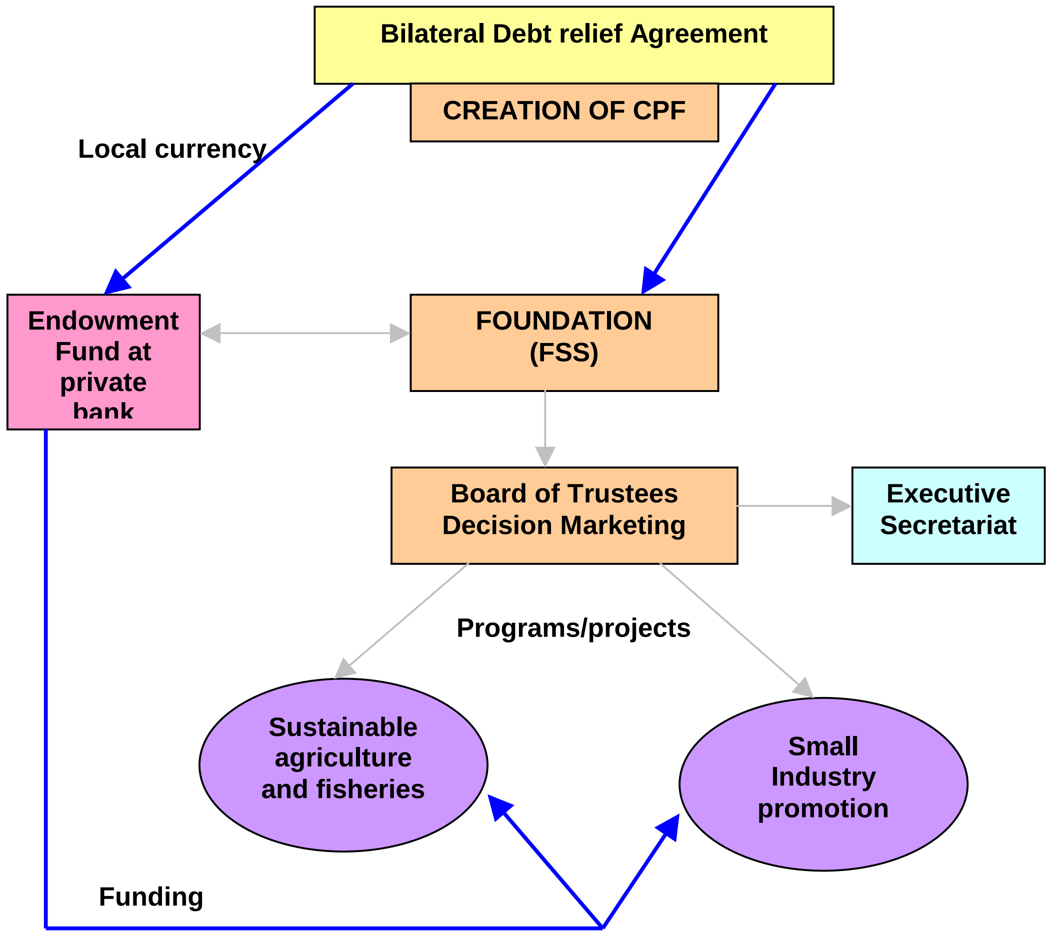
[23] Like `NGO', which in recent years has been widely covered in the literature, the term `PO' covers a very broad range of organizations. For the purpose of this book the two may be distinguished as follows: an NGO is an organization which acts mainly through a technically competent staff led by a leadership which represents the organization's membership. A PO is a mass organization which represents or aims to represent a considerable part of the respective sector's population (be that sector defined socially, geographically or both).

[*] *Garnier, L.: Los debt swaps: una evaluación critica. San José 1991*.

influence in the design and implementation of local development projects. On the national level, the Swiss contacted an umbrella organization of NGO networks, the `Caucus of Development NGO Networks' (CODE-NGO). This network, in turn, resisted the temptation to act as the monopoly NGO grouping for the Swiss fund. Instead CODE-NGO proposed hosting an open series of consultations regarding criteria for structures and projects.

NGOs iN CPFs

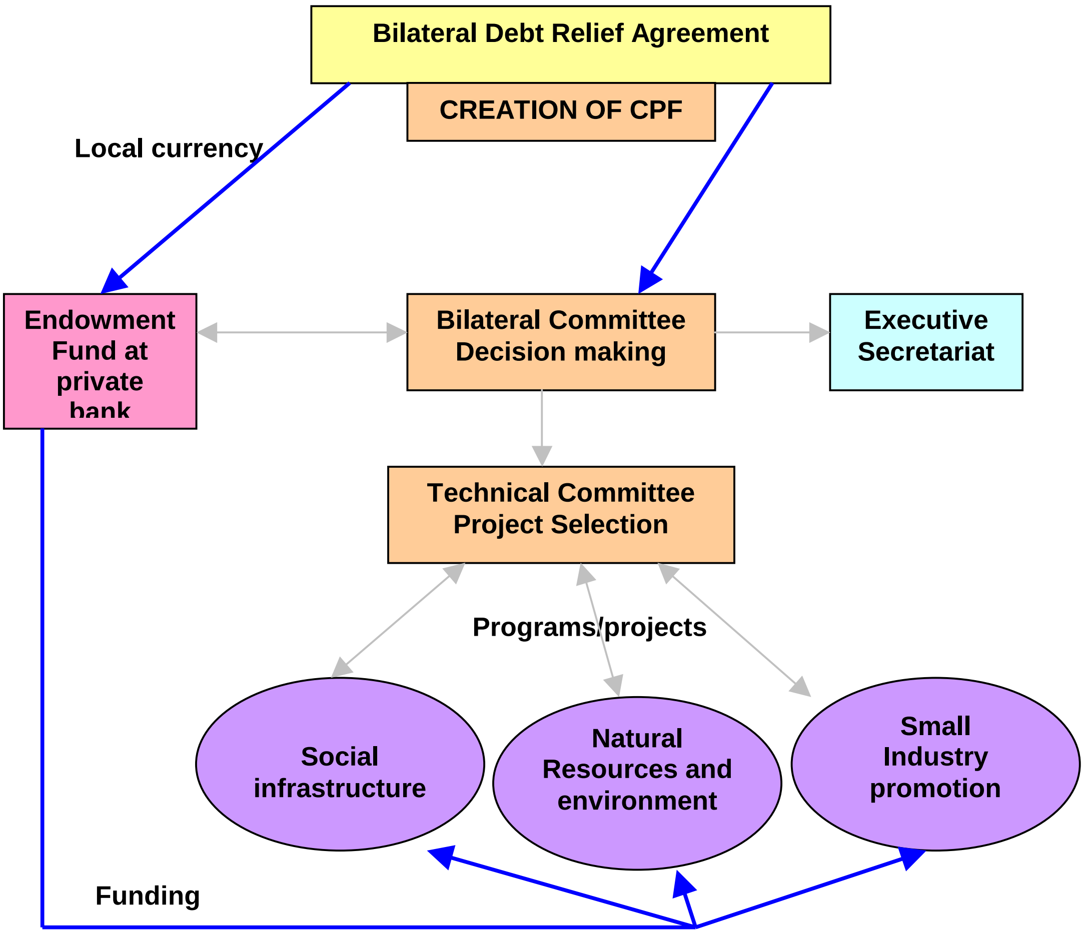
Figure 4. Swiss Counterpart Fund Structure, Philippines.



Debt volume :	Sfr 42.4 mn
Redemption rate :	50%
CPF Volume :	Sfr 21.1 mn
Owner of CPF :	Foundation for a Sustainable Society, Inc.
Board of Trustees :	Representatives of major Philippine NGO networks :
	PSBP, EDCS, NGO-CCD, PHILDHRRA, PHILSSA
	Helvetas Programme Office Manila

Source : The Swiss Debt Reduction Facility

Figure 5. Swiss Counterpart Fund Structure, Peru.



Debt volume :	Sfr 196.2 mn
Redemption rate :	25%
CPF Volume :	Sfr 49 mn
Bilateral Committee :	Ministry of Finance of Peru Swiss Embassy in Lima
Technical Committee :	Secretaria ejecutiva de Cooperatión Tecnica internacional de Ministerio de la Presidencia (SECTI) Swiss Development Cooperation (COTESU) Fondo Nacional para Areas naturales protegidas por el Estado (PROFONANPE) Centro de Estudios y Promoción de Desarrollo (DESCO)
Beneficiaries :	50% governmental organizations 50% non-governmental organizations and private sector

Source : The Swiss Debt Reduction Facility

The basic principle that no single NGO should benefit from the CPF was extended so that no single NGO network had a monopoly. In a long and sometimes exhausting process Philippine NGOs, through most of the relevant networks, have been able to participate in a single-level-administrative structure (see below) with its own and the Swiss governments. In this country with an estimated 13,000–14,000 NGOs it proved to be a decisive element, not only for the democratic quality of the whole programme, but also for its viability in the possible storms of rivalry among NGOs.

How to organize participation

After finding an answer to the question “Who is to participate?”, the next problem is “How is participation to be organized?” This brings us to the issue of the administrative structure of a Counterpart Fund. And again very broadly we can find two fundamental models:

- the one-level-structure
- the two-level-structure[24].

The two-level structure

We shall look first at the second model, as it is by far the most common in the Swiss context. This model distinguishes between the two levels of a `bilateral committee' (it may in particular cases be named differently) and a `technical committee' (see the Swiss CPF-structure for Peru in Figure 5 as a typical example). In the bilateral committee the two governments are represented. It is the ultimate decision-making body for the CPF. Any funding needs to be approved there. The two governments either can participate on equal terms in that committee — as is the case in most of the Swiss funds — or there can be a distinction which reserves most of the ultimate decision-making power to the creditor government. The technical committee's main task is to invite the submission of projects, to consider them and in turn submit them for approval to the bilateral committee. This is where governments sometimes like to have national or international NGOs involved, in order to carry out the nitty-gritty work and also to buffer discontent from submitting NGOs or POs which do not find their projects approved[25]. The work of the NGOs/POs in that committee can be an exhausting, rewarding and/or frustrating exercise. They may find themselves in a double bind: being allowed to submit projects themselves or find them submitted by other NGOs to whom they are strongly connected; and then having to analyse their own (or supported) projects but having to leave the ultimate decision to their own and a foreign government. They will not necessarily be on good terms with either of these two authorities.

On the other hand, there are some debtor governments that not only rhetorically but very honestly wish to foster NGO participation, whether for lack of capacity on their own, or recognising the NGOs' stronger ability to mobilize people. Such governments make approval by the bilateral committee a formal matter. As a result, this upgrades the technical committee to the position of the real decision-maker. In such a case even the two-level structure implies broad opportunities for the non-governmental system. So far experience tends to fall somewhere between these two extremes.

The one-level structure

The other model can be considered as more advanced regarding the participation of the non-governmental sector. Instead of the two committees there is only one, which tends to be named `administrative committee'. Both kinds of players sit at the same table: government representatives and NGOs which have been appointed to be members in their capacity as representatives of the development community, for their technical capacities, or for their ability to mobilize target groups. As shown in Figure 4, the Swiss-Philippine CPF offers a typical one-level-structure.

This administrative committee invites project submissions and revises and approves them, although some of the more technical tasks may be delegated to member NGOs, state agencies or some independent institution. Once this committee has been established, decision-making tends to be quicker and more transparent than with a two-level structure. Establishing the committee may, on the other hand, be a more difficult process.

Its structure implies a very broad participation of local NGOs, not only at the technical but also at the decision-making level. It even has been designed in a way which allows it to receive more conversion

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24 One could as well speak of two- and three-level-structures instead, counting the executive secretariat as an entity on its own. We do not do so here, in order to keep the models as simple as possible — we just want to mention that in addition to the representative bodies, an entity needs to be set up for the implementation.

25 The Swiss experience has been that generally the creditor government has been much more interested in genuine involvement of NGOs than have most debtor governments.

funds unrelated to the Swiss facility for which it was designed in the first place. So those NGOs which have a primary interest in debt reduction rather than in financing a specific development programme, and are newcomers in the conversion business, may find it attractive to have the counterpart resources managed within an existing structure: one which has been set up in the context of one of the most sophisticated conversion programmes in the world, with the participation of the broadest possible spectrum of Philippine NGOs[26].

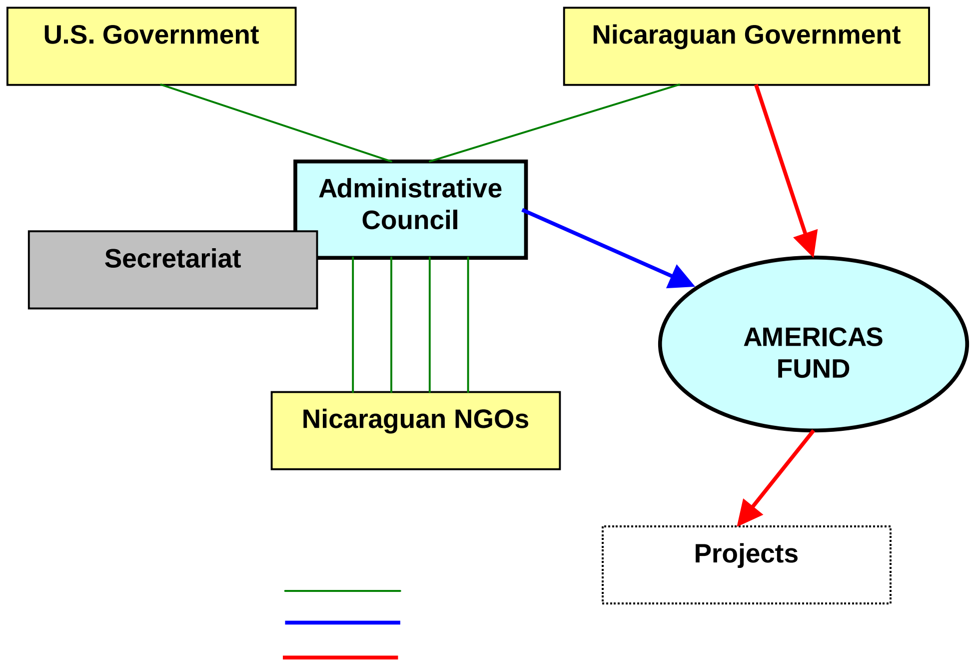
The `multi-purpose' structure

The idea of a `multi-purpose' structure has also been developed elsewhere. Within the context of its Global Initiative for National Environmental Funds (GINEF), IUCN-The World Conservation Union has included the management of counterpart funds into the menu of NEFs set up in different parts of the world. Examples are the Foundation for the Philippine Environment (FPE) and Bolivia's joint government/NGO structure Fondo Nacional para el Medio Ambiente (FONAMA). Characteristics of a structure such as IUCN/FONAMA's are: actors on both sides of the transaction are efficiently coordinated; and FONAMA is a multipurpose mechanism, which is perfectly able to manage counterpart funds but also has a range of other possible sources of funding and is therefore less dependent on debt swaps alone. So far the majority of FONAMA-approved projects have been funded through donations[27]

`MULTI PURPOSE' STRUCTURE

The Fondo para la Asistencia, Promoción y Desarrollo (FAPRODE) in Mexico plays a similar role to that of the NEFs. It uses its own resources and international credits to buy Mexican debt, which has been declared by the Mexican Government beforehand as eligible for conversion at a specific rate. Subsequently Mexican NGOs have the opportunity to change their foreign currency into Mexican pesos at about 115% of the normal rate. The premium is relatively small as compared to other swaps, because the secondary market price of Mexican debt is quite stable at around 80%[28].

Figure 6. Functioning of a USAID `Americas Fund'.



[26] There is broad agreement among specialists that the Philippine NGO scene is one of the largest — with more than 15,000 institutions nationwide — and due to the wars of the past a most difficult one to organize for a common project.

[27] See address in Chapter 8.

[28] P. Enrique Gonzales Torres *op.cit*

The higher degree of participation assumes, of course, that everybody at the table has equal rights and duties. The Americas Funds, which the US State Department has set up out of converted debt service by some countries with debts to the USAID, show how some decision-makers can be more equal than others. At first sight the Americas Funds resemble the Swiss-Philippine Fund. A closer look at the governments' treaties which establish the funds shows two important differences:

- Participating NGOs are not elected in an open and transparent process by fellow NGOs, but nominated by the two governments
- Notwithstanding voting in the administrative committee, the representatives of the two governments have the right to veto any project if it exceeds US$100,000[29].

CPFs with such strings attached, especially in countries with a counterinsurgency tradition, can hardly be considered as viable forms involving target group participation in development financing[30].

The WWF model

The WWF (Barry Spergel, WWF-US) has elaborated further the concept of environmental funds and sees three main possibilities for fund governing structures:

Funds with a mixed government/NGO Governing Board

Advantages:

- Can serve to institutionalize co-operation between the public and private sectors
- Can combine most of the advantages offered by both of the other two types of funds, while avoiding many of their limitations
- Likely to result in projects that are sustainable in the long run, by combining local initiative with government support

Disadvantages:

- Citizens of the country may be confused about whether or not to regard the fund as an official government organization
- Likelier to suffer from lack of focus than the other two types of funds, if purposes and project criteria are not clearly specified at the outset
- If the NGO side always has a clear majority, then the government may not take the fund as seriously or commit as many resources as it would to a government fund; if the government side always has a clear majority, the NGOs may be taken for granted and they may simply focus on getting near-term funding for their own projects

Funds associated with a Government Agency

Advantages:

- Can be a tool for implementing national environmental strategies and effecting policy changes
- Can provide a way to organize and coordinate official development assistance for the environmental sector
- Can provide support for under-funded governmental responsibilities, such as park guard salaries, protected area infrastructure, and so on

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[29] E.g. *Agreement between the Government of the United States of America and The government of the Republic of El Salvador concerning the establishment of an Americas Fund and administering commission*. In this particular case the proposal with its mutilated participation has sparked fierce discussions within the NGO scene on whether to participate or not.

[30] Moreover an EAI's Americas Funds is conditional on a current IMF structural adjustment programme; see: Debt For Development Coalition: *The EAI program: Implications for the Not-for-Profit Community*; Washington DC July 30th 1990.

- Can be a recipient for earmarked taxes, fines, and permit fees

Disadvantages:

- Personnel, programmes, and policies can be subject to sudden political changes
- Can be top-down in approach and insufficiently responsive to local needs
- NGO and local community suspicion of government
- Can be bureaucratic and restricted by civil service rules and government pay scales

Funds with a Governing Board composed entirely of NGOs

Advantages:

- Likely to be responsive to local needs, based on popular participation
- Promotes values of democratization and local participation
- Able to integrate grass-roots economic and social development with environmental programmes
- Well suited for institution strengthening of local NGOs and providing support to local grass-roots projects
- Independent of changes in government, thus offering institutional continuity
- Can serve as a vehicle for private donations (individual, corporate and foundation)

Disadvantages:

- With a diverse group of NGOs, it can be difficult to reach consensus on programmes, policies, and implementation
- Not being associated with government can mean that it is hard to influence national environmental strategies and policy reform
- Generally unable or uninterested in funding governmental responsibilities, such as park guard salaries, protected area infrastructure, and so on, which may be essential for biodiversity conservation

Alternatives for a Counterpart Fund

In either case, the one- or two-level structure, the fund itself can take at least three fundamentally different forms: It can be designed either

- as a cash fund
- as an endowment fund, or
- as a revolving fund.

Cash fund

To start with the simplest form: the cash fund receives the counterpart money in one or several tranches and spends it according to the availability of money and approval of projects. All spending is done on a grant basis. Project monitoring can be carried out by the fund administration; and it may serve as basis for future approvals of projects by the same institution.

Endowment fund

The endowment fund invests the counterpart money received from the debtor government in an interest-bearing form such as bonds, private bank accounts, real estate, etc., and spends only interest earned on those investments for the purposes of the CPF. This form trades cash availability, which, of course is considerably smaller than in the case of the cash fund, against the establishment of a long-term instrument for development financing. Moreover the establishment of administrative bodies is also a more long-term affair. The more emphasis the purchasing NGO or debt-donating government puts on the development financing (as opposed to the debt reduction) dimension of the operation, the more likely it is to establish such a long-term structure. It needs to be said, however, that for an endowment fund there is a critical mass, below which annually available disbursements would be too small to justify the administrative effort[31].

Revolving fund

The revolving fund, in turn, disburses the cash in the same way as the cash fund, but it does so on a loan basis. A long-term financing mechanism is thus established in the same way as with an endowment fund. The investment, however, is focused on the CPF's stated development goals. Here again there is a trade-off, this time between investment security and immediate outreach to the target groups. Assuming that loans made in the context of the fund's development aims are not as secure an investment as government bonds or real estate, the fund trades greater availability of cash for its projects against a higher degree of insecurity.

Immaterial equivalents for debt relief

Especially in the poorest and most debt-distressed countries creativity is really needed. In an environment where funds are difficult to set up and to administer, creativity can find unconventional ways to combine debt reduction with the provision of items which are essential for a specific development purpose. Examples:

In the context of the recent debt conversion between the Swiss Government, the Guinea Bissau Government and IUCN — The World Conservation Union, a counterpart fund has been set up in the country. IUCN through its local members, suggested setting up a relatively modest counterpart fund but favoured the adoption by the Government of a locally NGO-designed Coastal Zone Management Plan including the creation of a National Park and a Biosphere Reserve. The government accepted on the grounds that this plan had been locally designed and driven and operated for the benefit of the local population. When the counterpart fund using local currency, held in a non-interest bearing account, saw its assets being eaten away by inflation, IUCN found a way to change these local currencies into Swiss francs by authorizing the use of these funds to finance local activities related to its own programmes and keeping the equivalent amount in Swiss francs at the disposal of the counterpart fund.

Another solution might have been to lend this money, with a bank guarantee provided by an institution like the FIG (Fond International de Guarantee), to a small peasants' trade cooperative which so far has had to borrow money every year from a private African bank at prohibitive interest rates. The loan is used to buy the produce of the small farmers to sell it on the London commodities market. Once the commodities have earned hard currency, the cooperative has to change the hard currency back into local currency to refund the private bank. The farmers' cooperative could have refunded the hard currency instead to the Counterpart Fund.

There are several such cooperatives in Africa.

Deciding factors

None of these alternatives is generally superior over the others. Which is chosen depends on several factors, among them: the immediate absorptive capacity of NGOs and state agencies, the amount of funds available, the experience NGOs have with revolving funds, and the relationship between the NGO community and the central government.

Experience shows that a clear and extensive definition of the criteria for project submission helps to make funding transparent and calculable for everybody involved. The various Swiss funds include very detailed regulations for project submission and approval[32].

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[31] The Swiss define the minimum investment gain needed as at least ten times the administrative cost in order to justify the establishment of a counterpart fund. See: Swiss Coalition: *Entschuldung und Gegenwertfonds. Erste Erfahrungen*; Seminarbericht März 1994; p.25

[32] They cannot be discussed at length here. For a good example see the criteria in the Bolivian case: Swiss Coalition: *Entschuldung und Gegenwertfonds. Erste Erfahrungen*; Bern 1994; p. 14–19

Where should the fund be located?

Whatever the form of the fund, you have to decide where to locate it. It is often, but not always, preferable to keep the money in the country in local currency. There are three main options, depending on the local financial situation: each has its pros and cons. You have to carefully analyse the local financial situation and be able to answer the following questions before taking a decision:

- Are we in a country where there is an existing good and secure banking system?
- Are we in a country where a devaluation exercise is likely in the near future (cf. the CFA zone)?
- Are we in a country with hyperinflation?
- How is the local financial market: regulated, partially deregulated, totally deregulated?
- What is the balance of payments (BOP) situation of the country?
- What is the legal situation?

Once you have carefully analysed the local financial situation, you might consider one of the two main following options:

1) The funds are located in local currency in a domestic bank.

(They could also be placed in a hard currency account in a domestic bank.)

Advantages:

- The fund operates under the law and customs of the country of the beneficiary.
- It builds domestic capacity in trust and financial management.
- NGOs have a strong sense of ownership.
- It increases confidence in the local financial market, which may attract more capital to the country and has a macro-economic effect.
- The fund can be used to raise awareness of environmental/development issues.

Disadvantages:

- If the structure of the governing body of the fund is not well designed, it may give the impression that the fund is nothing more than another budget line for the government.
- The fund is prey to political instability and corruption.
- Its legal status may not meet minimum requirement regarding fiscal situation.
- There is always the risk of devaluation.
- You may be working with an inadequate banking systems (no interest-bearing accounts, high inflation).

2) The funds are invested abroad, in a fiscal `paradise' (Offshore Trust) and managed by Offshore Asset Managers.

This can of course only be implemented if you have decided to have an endowment fund and the local currency can be legally exchanged into hard currency. (An alternative could be that the fund be located in a `developed' country and managed in close co-operation with a Southern NGO.)

Advantages:

- Your investment remains in hard currency, in a secure place and managed by highly qualified professionals.
- You have a highly sophisticated and secure legal framework for your money.
- Good facilities for asset mobility are available if it becomes necessary.

Disadvantages:

- You lose the opportunity to build domestic financial and fund management capacities — and you have a high technical dependency.
- There is a loss of sense of ownership and control.
- You must pay the cost of services.

These are only options and should not be seen as universal rules. Each situation requires its own mechanism and structure.

CHAPTER 6 : Financing the debt conversion

Who will provide financing for debt conversion, and how much does it cost?

"Who will pay?" is, as in all things, one of the most important questions for debt conversion. There are basically two alternatives: a very simple one, and a more complex one which will trigger off a lengthy discussion about pricing and other details. We discuss both in this chapter. Finally, we present a third possible source of finance.

The simple answer is that funding comes from the converter itself. A well-funded development agency which prefers to get its local currency for a specific programme by a conversion operation, rather than through a currency transaction, simply takes it out of its country-, programme- or sector-budget. UNICEF is a case in point. Some of the bigger agencies operate the same system. They buy private debts on the secondary market and convert them into local currency according to agreements they themselves conclude with the debtor government.

Things are, of course, more complicated if the converter is a development agency which does not dispose of the necessary resources. They have two options: they can either get the debt donated to them (a `debt assignment') or quasi-donated (against a symbolical or immaterial equivalent — see box); or they can have recourse to private donor or public fund money to buy the debt from its original bearer.

Commercial banks and other corporations donating depreciated debt for debt-for-development swaps may find enough reason to do so through a combination of tax-deductible business losses and charitable contributions. These may be large enough to compensate for the whole remaining value of the debt.

How profitable these donations may be for the donor will, of course, depend on legislation regarding loss-deductibility and tax exemption of donations in the respective country (see also: "How to find convertible debt" in Chapter 2).

Debt assignment

A debt assignment is an operation whereby a creditor (usually but not always a public creditor) gives (assigns) the debt to an NGO under certain conditions. The NGO receiving the debt negotiates its value with the debtor government. As it received the claim for free, the NGO is of course well placed to sell its debt to the debtor government at an extremely low price. Whatever the price, it will be pure profit for the NGO.

The negative side of such an operation is the conditionality that the creditor government may wish to attach to the deal. The creditor may also request a minimal price.

This kind of operation is very attractive for NGOs because it does not require any financial investment for the deal, nor does it require any technical negotiation. But a disadvantage is that it may require a lot of political negotiation and the use of the proceeds depends very much on the creditor.

The 10% clause

Official debts can be sold to a converter under the 10%-clause which the Paris Club has established within its Toronto and Naples Terms for Severely Indebted Low Income Countries (SILICs) and Houston Terms for Severely Indebted Lower Middle Income Countries (SILMICs). The clause does not say anything about pricing, so that in extreme cases, governments may be free to donate their debts for nature conservation or development. In reality, however, the clause is regarded by creditor governments as a means to get immediate cash for some of the debt's face value. Especially in the cases of Severely Indebted Low Income Countries (SILICs), which presently are eligible for up to 67% debt- or debt-service reduction, creditor governments find their claims diminishing more and more in value without a real improvement in the indebted country's future capacity to pay. Therefore NGOs should be prepared to meet with great reluctance from their finance ministries or central bank when they try to obtain debt-for-development swaps under the Paris-Club clause — unless they are able to come up with a very good reason to give special treatment in a particular case[38].

Overview of major bilateral debt reduction facilities

Some creditor countries have set up special funds in their national development aid budgets in order to make use of the 10% clause. Some have funded debt cancellation without paying much attention to whether they have been within the 10% framework. Moreover some have not restricted funds to the conversion of ODA debt covered by the Paris Club or any other multilateral regulation. The most important national funds established so far are:

Belgium

The Belgian Round Table on Commercial Debt Relief[33]. In 1985 the Belgian export credit agency Delcredere/Ducroire (OND) started to explore alternative ways to deal with the considerable amounts of outstanding unserviced debt by Third World countries. At the same time the official Belgian aid agency was looking for ways to reduce the negative impact of the external debt on the development of Least Developed Countries (LLDCs). Close cooperation between the two agencies led to the first debt-for-aid conversion in 1987. A small stock of debt was sold to the aid agency at full nominal value (100%!) and then converted into a counterpart fund in local currency, also to its full amount. The fund was to be jointly managed by the Belgian aid agency and the debtor country's authorities. In 1992/3 efforts were made to extend the debt-for-aid swap mechanism to other categories of debts due to Belgian creditors, mainly commercial banks.

Belgian NGOs pushed strongly for inclusion of commercial debts in the scheme. But they were as strongly opposed to using official — and even more so aid budget — money to bail out private banks. Consequently they first proposed swapping debts against a symbolic franc. This proved unacceptable to the creditor banks. They suggested selling at full face value with a minimum of 100% of the secondary market price. They finally agreed to sell at 50% of OND face value. This rate is not negotiable any more, but banks are, of course, free to accept the deal or leave it.

The Minister of Development Aid and the Association of Belgian Banks signed a framework agreement on 21 October 1993. They hoped that it would reduce by half the debt owed to Belgian banks in the three following years. Belgian development NGOs argue that banks are not held adequately responsible for their role in bringing about the over-indebtedness of many debtor countries, as they still receive *at least* the secondary market price for their claims. NGOs tried in vain to put a ceiling of 5 to 10% of the nominal value onto any buy-back operation.

The NGOs were also unhappy with the limited impact of potential relief. The October 1993 agreement between the government and the banks is limited to LLDC long-term debt with the (politically motivated) exclusion of Zaire. That country owes the bulk of all LLDC debt towards Belgian banks.

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[38] The former GDR debts are one such case: German NGOs argue for special treatment beyond the Paris Club regulations, or at least to their fullest possible debt reduction effect — this could mean, for example, selling 10% of commercial claims for a symbolic price. So far NGO efforts have not been successful.

[33] See: J.L. Hick and Rudy De Meyer in: *Debt conversion for financing sustainable development; op.cit*

Switzerland

Switzerland established a national debt reduction facility on the occasion of the 700th anniversary of the Swiss Confederation. The project was launched as a political campaign by Swiss development NGOs and led to a referendum in 1991. The vote paved the way for setting up the facility, which provides a total of SFr500m for the buy-back of debts owed to Swiss creditors.

The facility's funds are used to buy the `tail-ends' of Swiss suppliers who have been compensated under the national Export Credit Agency (the Swiss ERG). The 70% which is ERG-owned, is donated to the facility, if the holder sells its tail-end of 30%. So far some 95% of tail-end-holders with regard to countries in the programme have sold their claims to the facility. By the end of 1994 about half of the funds available had been spent. Half of that amount was invested in operations which led to the establishment of counterpart funds by the debtor countries.

Up to August 1995[34] agreements have been set up with 17 of 28 eligible countries for buy-backs of export-credit debt, cancelling almost SFr1bn of hard-currency debt. In six countries debts have been cancelled without an equivalent effort by the debtor government, either because the debts were too small or because it was feared that setting up counterpart funds might cause unintended side-effects such as inflation or excessive stress for the national budget. In 11 countries `creative debt relief' was practised, i.e. governments set up counterpart funds (discussed in various parts of this booklet). A new and interesting element has been the `immaterial' equivalent scheme involving the Government of Guinea-Bissau, which in return for the debt cancellation, besides setting up a very small counterpart fund, committed itself to establish the legal basis for a future nature reserve.

As the Swiss facility was born out of an interest in debt reduction and not in financing development, it also differs from other schemes regarding the pricing mechanism. It is in the interest of the Swiss NGOs to share their gains from the facility with the debtor governments. Therefore the redemption price is *below* the facility's expenses for the debt titles. In that respect, the operation is not as good a deal for the development NGOs on the receiving side, but an even better one for the indebted country's government and society as a whole.

In order to promote and facilitate buy-backs and counterpart-fund structures, the Swiss NGOs have set up the `Debt for Development Unit'. The experiences which have been gained by the Swiss NGOs in this pioneering effort have been and still are an inspiration to NGOs in other countries.

France

The French government has set up a special fund for the cancellation of public ODA and non-ODA debt against the funding of priority development projects in local currency by the debtor government. The fund foresees the conversion of some FF4bn of non-performing development credits rescheduled under the Paris Club rules. It was set up in October 1992 at the francophone governments' summit in Libreville. The `Libreville Fund' is restricted to four franc-zone countries: Cameroon, Congo, Gabon and Côte d'Ivoire. In contrast to the Swiss facility, its disbursements are not tied to the implementation of an orthodox structural adjustment programme. Up to the end of 1993 FF1bn was disbursed. This amounts to one-fourth of the whole amount scheduled for the operation[35]. NGOs may be involved in counterpart-financed projects.

France also entered into debt-for-aid swaps with Egypt converting its ODA-debt of about FF58m. Local proceeds are deposited in a social fund for development. Similar transactions

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[34] Swiss Coalition: *The Swiss debt reduction facility. A state of the art*. Berne 1995

[35] Bouchet, M.H.: *Les experiences des pays de l'OECD en matière de conversion et d'abandon de créances*; Papier pour le seminaire CNUCED, Genève 27/8.1.1994

were concluded for the Philippines to an amount of FF20m. Further debts of Poland, Honduras, and Tanzania have been cancelled against the establishment of such funds[36].

United States

In 1990 the United States initiated its `Enterprise for the Americas Initiative' (EAI) which among other things included a debt swap option for ODA claims to Latin American and Caribbean countries. Debts are being reduced and restructured. Interest on the new EAI debt can be paid in local currency, to be deposited in an environmental fund. The fund is administered jointly by the two governments. To a limited degree carefully selected NGOs are invited to co-administer it. Up to the end of 1993 some US$1.6bn had been dealt with under that scheme. Roughly half had been written off. US$134.1m has been paid in local currency as interest on the rest and invested in environmental projects[37].

Germany

In Germany a `Rio Fund', equipped with an initial DM50m, was established after the United Nations Conference on Environment and Development in 1992. The facility serves to finance the cancellation of ODA debt towards the German Government against the payment of 30–50% of its face value into a local ecology fund. NGOs are invited to submit project proposals to the Ministry of Economic Cooperation and Development and to participate in the administration of funds and projects in the recipient country. In the first years of the facility's existence resources were released slowly. Nonetheless its volume has expanded from year to year. For 1996 a total of DM200m has been provided in the budget for Economic Cooperation. The criteria for project eligibility have also been enhanced; they now include projects which aim at "eradicating poverty"; and the redemption rate has been lowered to 20%. The fund is being administered by the Ministery of Economic Cooperation (BMZ), and so far 14 countries (possibly soon to be 17) have become eligible for funding. In "special cases" debtor country NGOs are allowed to submit projects.

Canada

The Canadian Facility of US$145m is similar to the German Rio Fund. Canada plans to use the fund to convert ODA debts owed by Latin American countries into local currency funds to finance environment and sustainable development projects. Beside these major conversion funds, most other Paris Club member countries provide the opportunity to swap either ODA or non-ODA debts or both.

The debate about conditions

By setting up debt conversion funds governments have sparked fierce discussions among NGOs as to whether or not aid money should be used for the cancellation of debts[39]. The common denominator, which has finally been defined and which allowed most NGOs to consent to the establishment and use of those funds, is that they must be additional to the normal aid budget. The problem with additionality is that it is sometimes hard to define. Nobody knows what would have happened to an aid budget, had a certain sum not been assigned to debt conversion. If aid budgets are shrinking and part is used for debt buy-backs and conversions, is the fresh money share shrinking because part is diverted into the creditors' own treasury via a special facility for buying back otherwise irrecoverable debts? Or does it provide at least something for the poor debtor country during a period when everyone is caring less? NGOs need to be aware of the danger of becoming instruments of

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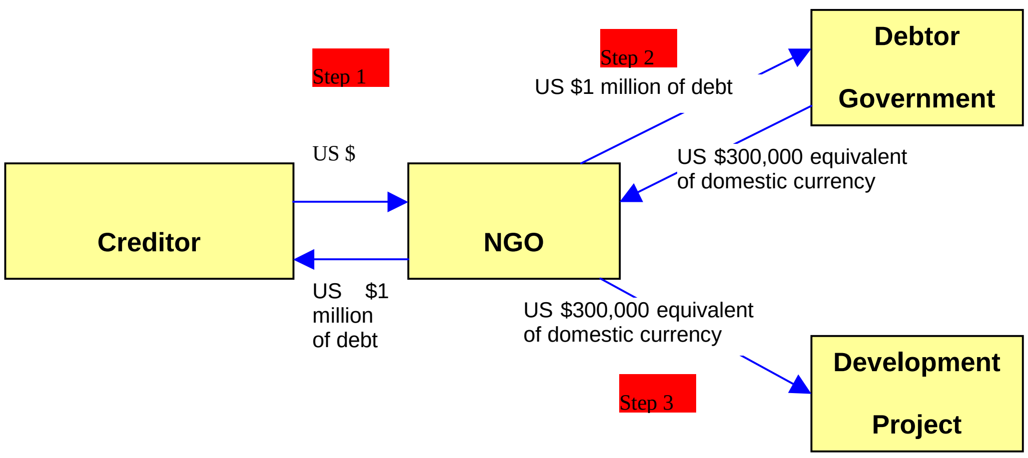
[36] Association Conversion de la Dette pour le Développement et l'Environnement (ACDE), undated folder

[37] Figures from *World Debt Tables 1994/5*, p.168. The implications of the EAI model will be discussed in more detail below.

[39] See especially: Fues *op. cit.*; Ted van Hees/Volker Kasch: `Policy and operational issues for the use of debt conversion'; in: *Debt conversion for financing sustainable development op. cit.*

their own country's finance ministries; but they should at least give their governments a chance to come up with real additional money.

Figure 7. Typical debt-for-development conversion structure.



Steps

1. NGO purchases US$ 1 million of debt at discount for US$ 200,000 (20% of face value) from creditor
2. Debtor government purchases the US$ 1million of debt at discount for US$ 300,000 equivalent of domestic currency (30% of face value)
3. NGO invests the US$ 300,000 equivalent in a government-approved development project in the country

Results

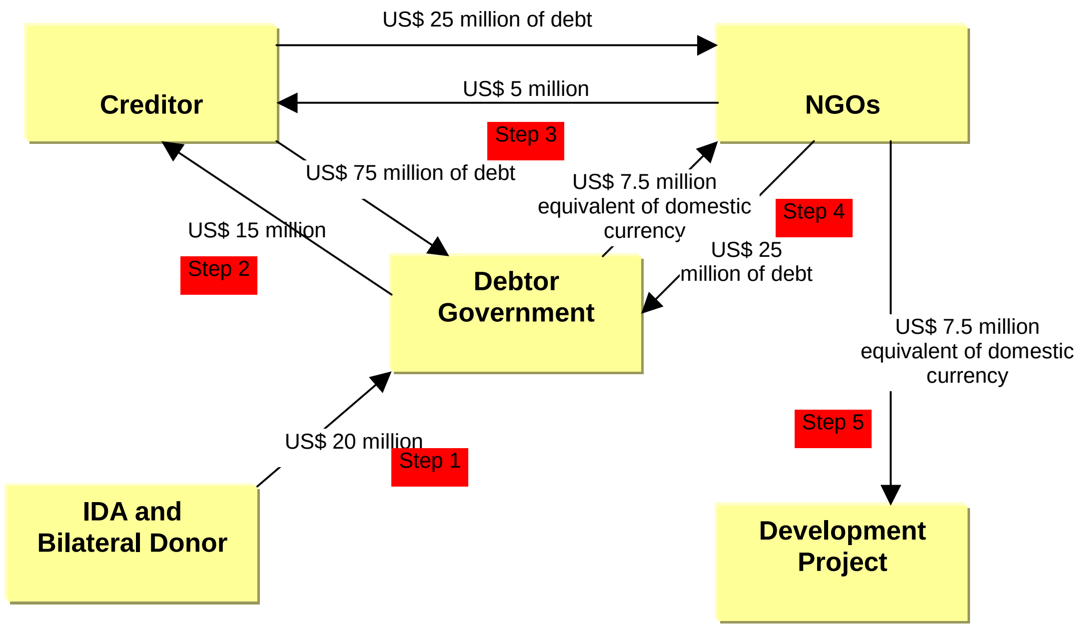
Debtor country retired US$1 million of external debt for US$ 300,000 equivalent of domestic currency (30% of face value).

Creditor received market price for US$ 1 million of debt (US$ 200,000).

NGO receives US$ 300,000 equivalent for US$ 200,000 investment

US$ 300’000 equivalent of domestic currency is invested in a domestic development project.

Figure 8. IDA-financed debt reduction operation with debt-for-development option (debt purchased by NGOs).



Steps	Results
1. IDA and bilateral donors provide debtor with US$ 20 million grant.	**Debtor** retires US$ 100 million of debt for US$ 22.5 million (US$ 20 million from IDA, US$ 2.5 million from debtor- step 3-4).
2. Debtor purchases US$ 75 million of debt at discount for US$ 15 million (20% of face value)	**Creditor** sells US$ 100 million of debt at market price (US$ 20 msn).
3. NGOs use own hard currency resources to purchase 25% of debt (US$ 25 million face value) at discount for US$ 5 million (20% of face value)	**IDA and bilateral donors** finance buyback with US$ 20mn). **US$ 15 million** of which goes to creditors ; US$ 5 million balance is invested in domestic development projects in the debtor country.
4. Debtor purchases US$ 25 million of debt from NGOs for US$ 7.5 million in domestic currency.	**NGOs** receive US$ 7.5 million equivalent of domestic currency for debt purchased for US$ 5.0 million. US$ 7.5 million equivalent in domestic currency is invested in domestic development projects in the debtor country at a cost to the debtor government of US$ 2.5 million.

Zambia's 1994 debt-for-development swap

In a two-tranche operation in July and September 1994, Zambia undertook an extensive programme to reduce much of its outstanding commercial debt.

This debt reduction programme began with negotiations between the government of Zambia and the World Bank to include Zambia as one of the countries eligible to participate in the IDA Debt Reduction Facility programme. Zambia fulfilled the three requirements of the programme, i.e. It was classified as low income, it had a World Bank approved medium-term economic plan in place, and it had a comprehensive debt management strategy.

Once Zambia's participation in the programme was agreed in principle, the government (represented by the Zambian Bank and the Ministry of Finance), in accordance with the World Bank, decided that Zambia's commercial creditors would be offered three possible options: first, they could receive cash for the debt directly from the government; second, they could sell or donate their debt note to an NGO, which would use it for a debt-for-development swap; third, they could exchange the debt for long-term bonds redeemable at a premium in privatizations for equity. The World Bank agreed to provide an IDA grant, in addition to resources from bilateral donors, to pay for the purchase of debt. For the debt-for-development swap option it was agreed that for every dollar paid by an NGO, the government would give it the same amount back in local currency plus a 50% premium. As an example, IUCN paid US$230,000 to convert US$2,200,000 and got $230,000 back plus a premium of 115,000 in kwacha. The profit for the NGO was therefore equivalent to the premium.

Preparatory phase

In the `preparatory phase', four bilateral donors — Germany, the Netherlands, Sweden and Switzerland — agreed to add their own resources to that of the IDA Facility. US$22m was eventually used for debt retirement. The government of Zambia received a further US$3m technical grant to cover legal and financial advisory technical fees and other administrative expenses. The Government of Zambia contracted the Debt for Development Coalition (Finance for Development) to structure, coordinate and implement the swap. The Coalition advised the government of the structure of the questionnaire that potential NGOs would submit for approval of participation in the debt-for-development swap option. The Government negotiated with its creditors a purchase price of 11 cents on the dollar. Once this purchase price was

fixed, the Government sent out a global offering to all its commercial creditors to sell their debt, choosing from the possible options.

Simultaneously, a number of NGOs, acting through the Coalition, submitted project applications for government approval. The government had previously identified water and sanitation, health, primary education, vocational training, educational infrastructure and the social safety net as its priorities to be supported through the swap. Approximately 50 NGOs had their projects approved for participation in the swap.

The Debt for Development Coalition then matched participating NGOs with creditors willing to participate in the swap option. Only 14 of the approximately 50 NGOs had funds available for purchase of debt. As only two creditors chose to donate debt, the remaining NGOs were unable to participate further. On behalf of the 14 NGOs, the Coalition then negotiated debt purchase agreements with creditors willing to sell their claims. The NGOs made cash deposits into an escrow account to ensure that they had the US$10.2m required to buy the debt notes.

The Ministry of Finance, in order to fulfil government obligations to provide a 50% kwacha premium to NGOs, made a kwacha allocation in the national budget equivalent to US$5.1m to support this expenditure.

Purchase phase

Following the preparatory phase, the operation entered the *purchase phase*. The World Bank and bilateral donors provided the Zambian Government with a grant of US$22m. The Ministry of Finance handed US$11.8m over to the commercial banks against debt notes worth US$107.4m. At the same time the US$10.2m that NGOs had deposited was transferred to commercial banks against debt claims of US$92.3m. In total US$199.7m was purchased.

Swap phase

In the *swap phase* the NGOs handed over the debt notes worth US$92.3m to the government and in exchange the remaining US$10.2m from the IDA grant was put into an escrow account for the participating NGOs. The Zambian Bank committed a further US$5.1m as local currency spending on the project. The IDA money was made available for project spending as either foreign currency — to purchase any necessary imports — or as local currency.

Result phase

In the final *result phase* two actions took place. First the Zambian Bank retired commercial debt worth US$199.7m. Prior to the swap Zambia's commercial debt stood at US$440m, of which US$240m was considered eligible for the debt reduction programme. Hence 83% of eligible debt, or 45% of total commercial debt, was extinguished through the programme. Second, the NGOs launched projects in virtually all social sectors.

It is worth noting that the US$15.3m of project funding was not all disbursed to NGOs immediately. The money was kept in an interest-bearing dollar account for each NGO and disbursed only on a pre-arranged date (typically each quarter). In order to protect the value of the investment against devaluation, the amount of local currency paid out was calculated according to the prevailing exchange rate.

Condensed from: Saravanamuttoo, N. & C. Shaw: Making Debt Work for Education. DAE Paris 1995, p.32–38

Multilateralization

Under certain conditions `multilateralization' could be a way to finance debt-for-development swaps. The most prominent among the multilateral instruments is the IDA Debt Reduction Facility (DRF). It was established in 1989 and serves to facilitate buy-backs in IDA-loan countries. It therefore provides

IBRD resources and bilateral donor money in, roughly speaking, equal amounts[40]. In two of the seven cases of IDA-DRF supported buy-backs, a development-swap dimension has been included. In Bolivia, IDA enabled the exchange of US$31.5m of commercial debt against US$5m of IDA debt, a transaction completely funded by USAID. The government, in turn, gave a 50% premium on the redemption rate of 16%, paying the equivalent of US$7.5m to a national childcare organization[41].

The development swap feature was also included in the debt reduction programme concluded by Zambia in 1994 with funding by the IDA and several bilateral creditors. (see pages 44–45) With US$96.5m eliminated by the operation, this has been one of the most voluminous development swaps in history[42].

For the ideal functioning of IDA- and/or bilateral donor-supported debt-reduction operation see Figure 8 as opposed to Figure 7 (see pages 42-3)[43].

Self-financing

Finally, debtor governments themselves can finance debt swaps, either through fresh money from multilateral or bilateral official creditors, and even without it. In the debt buy-back programme for Bolivia in 1992, which functioned through the emission of various kinds of government bonds exchanged at an average of 16 cents for every dollar of commercial debt, one option was to transfer bonds from the original creditor to an NGO. The transfer was to benefit a predetermined development or conservation project agreed by the three actors. An additional incentive for creditors to pass the bonds on to the NGO (apart from tax exemptions at home) was the fact that the bonds' interest was tied to the tin price[44]. It is important to note that debtors are of course not allowed by international financial regulations to repurchase their own debt on the secondary market, unless there is a special authorization from the creditor (this is not very common).

How much is the debt worth?

Experts have on various occasions lamented the high degree of arbitrariness which generally goes with `social' swaps. In a situation where the buyer's interest is not (exclusively) to get the maximum local currency for its hard currency, but rather to relieve the debt burden of the debtor country, the logic of the market will not work along standard textbook lines. Prices will be the result of a new kind of negotiation between not just two but three parties, because the buying NGO always needs to check with the debtor government as to whether it would be willing and able to provide local currency in exchange for the cancellation of that specific private hard currency debt[45]. Nonetheless, a secondary debt market is simply a financial market where debt securities are traded. As in every market, the price is the result of supply and demand, in this case for securities. Secondary markets exist only for countries where the potential number of operations is high enough. So far, only private debts have been traded on secondary markets. An open market cannot exist if there are only 10 items to sell. However, accessing these markets is quite difficult and the only way to do it is through a Specialized Bank Agent or a specialized private financial company. These often charge two percent of the face value as a fee. We would not recommend this kind of operation for small inexperienced NGOs. Bigger NGOs with a well established financial division may decide to undertake such actions. Note that it is

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[40] An overview of all operations completed by the facility until December 1995 is in: The World Bank: *World Debt Tables 1996*; p.35. In total US$2.5bn of principal have been extinguished at an average redemption price of 12 cents per dollar.

[41] On the whole process see: Jack Ross: `Debt conversion in the framework of the Paris Club, the London Club and beyond'; in: *Debt conversion for financing sustainable development* op.cit.

[42] Debt for Development Coalition Inc.: press Release July 29th 1994

[43] Taken from: Debt for Development Coalition Inc.: *Debt for development conversions in the context of the debt reduction facility for IDA-only countries*; Washington Oct. 1993

[44] Delgadillo, J.C.: *La deuda externa boliviana*; La Paz 1994, p. 74

[45] Prices are published regularly in the financial press. For example, interested NGOs can check prices for the most important middle-income countries in the weekly *Emerging Markets Debt Report*.

often the creditor which informs the NGO or bank about its willingness to sell. Initially, these markets were set up by middle-income debtor countries for debt-equity operations involving international corporations.

Official bilateral debt

There is no such market price for official bilateral debt. There is simply no incentive at all for official bilateral creditors to join the market. This is especially regrettable as it leads — in the few cases where swaps are undertaken — to quite arbitrary prices for the resulting counterpart funds. Sometimes claims against one particular country are converted at a broad range of conversion rates: Costa Rican debts have been purchased by Dutch, Swedish and US aid agencies at an average price of some 15 cents per US$1. While the Dutch received a countervalue of 30 cents per dollar, the Swedish got 40, and US agencies up to 85[46]. Griffith-Jones and Mistry[47] describe the dilemma from the viewpoint of official export credit agencies (ECAs):

ECAs have not yet developed a satisfactory way of determining whether their claims should be priced above, below or at market value, since there are persuasive arguments in support of all three options. The case for pricing official claims above market prices rests on the degree of preferred creditor status which governments are supposed to enjoy in their transactions with each other and the leverage that creditor governments can bring to bear on debtor governments to recover their claims if they were so inclined. The case for pricing official claims at below market price rests on the record of debt-service performance on official claims relative to private claims between 1982–92, which would provide a strong accounting and actuarial justification for the view that the Net Present Value (NPV) of official claims was considerably lower than their private counterparts. The case for pricing the claim at market value is that all other values are hypothetical, while the market value is the only `real' benchmark of value at a particular moment.

NGOs interested in swapping official claims against development funds, of course, will stress the argument for a lower value, but need to be aware that finance ministries which otherwise are heralds of a free market economy will come up with rather strange ideas regarding this particular not-so-free market.

At present Germany is eager to sell as much as possible of its former GDR claims. The Finance Ministry's department which is in charge of the sale, however, has no idea at what price to sell. So it demands Paris Club cancellation rates, i.e. 50% or 33% (as the price of 67% debt forgiveness). This makes the transaction potentially attractive for countries with a high secondary market value, but unattractive for those with a low one. NGOs should join bankers in demanding the establishment of a free market in that respect. From a Third World perspective, the Non-Aligned Movement's Ad Hoc Advisory Group on Debt has identified the first signals of an emerging market for official bilateral debt: they interpret the French Government's plans to auction off about US$100m of Egyptian debt as a test case to sell billions of dollars of developing countries' debt owed to official bilateral creditors at a discount[48]. Egypt may also be a precedent for the German Government. Whether either will contribute to a break-through regarding official debt marketization remains to be seen.

NGO criteria

NGOs in turn have tried to develop their own criteria for deciding whether to undertaking a debt conversion. Provided that the NGO is not looking only for the cheapest way to finance its project, but has at least an equivalent interest in debt reduction, the baseline is that the maximum payment into a counterpart fund should equal the immediate cash flow relief. This means a country should not be obliged to pay more to the counterpart fund than it is actually paying to international creditors. In this

[46] Frans van Loon: `A banker's perspective on debt and conversion'; in: *Debt conversion for financing sustainable development op.cit.*

[47] Griffith-Jones & Mistry (1994); p.99

[48] Report of the Non-aligned Movement Ad Hoc Advisory Group of Experts on Debt; Jakarta August 1994; p.43

way the NGO avoids putting an undesirable additional strain on the national budget[49]. On the other hand, this principle would make unserviced debt (such as the Nicaraguan debt towards Russia) unconvertible.

Donor criteria

This `debtor-friendly' position has been maintained by the Swiss Debt Reduction Facility, while the former US Debt for Development Coalition Inc. for example has established a more `converter-friendly' scheme: it demands (and receives) the redemption rate plus a premium from the debtor government. As DDC has been doing development swaps on behalf of client NGOs and not on behalf of itself, it has learned how much extra benefit is necessary to convince NGO boards of the advantages of a conversion. Generally 15% has not been enough to persuade investors to undertake the transaction. In practically all cases, however, 100% has been sufficient[50].

The debtor government, in turn, is also provided with some manoeuvering space by the pricing mechanism. It is not condemned to sit and watch what the benevolent NGO and a reluctant creditor government will hammer out and then take the outcome or leave it. It can influence the negotiating position of the purchasing NGO by offering a higher premium for the financing of its own priority sectors than for others. Or it could set up quotas for convertible portions of debt, which are then assigned according to its political priorities[51].

Where no market for securitized debt exists, a possible alternative is to buy the debt at an `offer price'. This simply means that in absence of a secondary market, the creditor wishes to sell at a pre-established price. The investor knows from the beginning what to pay and can therefore negotiate the resale price in local currency (the `redemption rate') with the debtor government prior to the repurchase operation with the seller. In other words, the investor knows from the beginning that buying at 20 with sales possible at 25 will produce a profit of five. There is no risk at all.

This is the most common kind of operation. Most export guarantee institutions have lists of prices for different countries. One just has to ask them and find out whether the debtor government is interested in the deal and how much the redemption rate would be.

Some export guarantee institutions (like the French Coface) sell through public bidding. The rule is that the institution or private company which offers the more for a particular debt gets it. But Coface reserves itself the right to sell at varying prices, according to the use the buyer plans to make of the proceeds. In other words, Coface will probably sell more dearly to private profit-oriented companies than to NGOs. The problem is that a sealed proposal has to be sent with the price you are willing to pay for a particular amount of debt face value, and it is only after the deadline for applications that you learn whether Coface accepts the proposal. Prior to the offer, it is of course also important to know the redemption rate as agreed by the debtor.

The best procedure is to ask the export guarantee institution to put your organization on its mailing list and to pass on offers by fax as they come in.

CHAPTER 7 : Potentially negative side-effects

Let's assume that after reading this booklet you have found debt conversion attractive as a means to finance a development programme which you are planning in a partner country, and you wish to achieve some debt reduction for the country as well. Before turning to Chapter 8 and consulting the list of organizations that might help you implement your programme, there are a few things you should consider. As emphasised earlier, debt conversion is more time- and energy-consuming than an ordinary currency transaction, and might involve some potentially negative effects which are not visible at first sight. Some are rather political in character, while others tend to be pragmatic. So look first at the following sections. If you still think conversion is the best alternative after reading this: go ahead!

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49 See: Fues *op.cit.* p.25

50 Debt for Development Coalition (1993) p.12

51 Debt for Development Coalition (1993) p.15

Be aware that by converting debt into development funds you have accepted the legitimacy of (at least that particular portion of) the debt.

Figure 9. Swap potential analysis.

	Low inflation	**High inflation**
Debt that would be serviced	I Very desirable	II Desirable, but monetary impact needs to be regulated for large operations
Debt that would not be serviced	III Desirable only if spending priority changes essential to justify program due to efficiency gains	IV Only desirable if conditions in both II and III are met

The issue of legitimacy

The issue of the legitimacy of Third World foreign debt has caused fierce debate among NGOs since the outbreak of the debt crisis[52]. Summarizing the present state of the discussions, one can say that nobody questions any more the legitimacy of the total debt of one particular country or even of all Third World countries. Like other aspects of the debt question, the legitimacy discussion has undergone considerable refinement. Today research enables organizations which formerly were leaders in the general legitimacy debate to determine very precisely which parts of the overall foreign debt they think are illegitimate. These debts, it is still argued, should be exempted from any conversion — because they should have been cancelled from the outset. To take the best example, the Philippine Freedom from Debt Coalition (FDC), which initially took a very critical position in the country's conversion debate, finally joined the movement for it — while maintaining that specific reservation towards `illegitimate' loans. The FDC has identified at least six “fraudulent loans” to the Philippines, together amounting to US$4bn of the country's foreign debt. FDC considers whether an NGO campaigns for their cancellation as a test of the NGO's honesty on the debt issue[53].

UNICEF, an important debt swapper, has tried to resolve the legitimacy question by implementing a clearly defined set of negative criteria, which seem similar to an ethical investor's list. The organization does not deal with debts “incurred through arms sales, tobacco, alcohol, etc”[54].

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52 The issue as such cannot be discussed at length here. Two publications summarize the discussions at the meetings held in parallel to the 1988 World Bank/IMF General Assembly in Berlin, when, if ever, the delegitimation option got the strongest support: *Gegen IWF und Weltbank. Beiträge vom Internationalen Gegenkongress*; Köln 1989; and Duchrow, Raiser, Füllkrug-Weitzel: *Geld für wenige oder Leben für alle. Dokumentation des Ökumenischen Hearings zum Internationalen Finanzsystem*; Frankfurt 1989.

53 `*Freedom from Debt Coalition's summarized position on NGO involvement in debt-for-development swaps'*; undated position paper, paragraphs 4 & 19. Even beyond the identified fraudulent cases the FDC claims the right to revise any debt before conversion if it is judged “immoral and anti-people”. In that category may figure “quite a number of `development' projects funded by the World Bank and the Asian Development Bank (which) have trampled on the people's rights, welfare and livelihood and have inflicted much damage on the environment and indigenous culture, even though they may not be fraudulent in the narrow sense.” (para. 13) Even taking into consideration that IBRD and ADB loans can not be swapped at all, such a broad and unspecific “fraudulence clause” might reduce the range of possible debt swaps considerably.

54

Swaps and structural adjustment

Another aspect of the legitimacy debate involves the linking of Paris Club swap options or IDA-cofinanced operations to an IMF-led structural adjustment programme. Being bound into an overall debt reduction operation which is conditional in this way brings NGOs into the uncomfortable position of indirectly legitimizing orthodox structural adjustment, which they otherwise may criticize harshly.

Like publicly financed buy-backs, conversions run the risk of using public or even private aid money to bail out commercial banks.

NGOs converting bank debts into development funds or trying to convince governments to finance those operations have learned that banks may try to make a profit out of their bad debts. This has to be prevented by an adequate pricing policy, which ensures that private creditors bear their share of the burden. Depending on the creditor country's loan-loss provisions, even selling off bad debts at 30% of face value may be profitable for a private creditor. NGOs should make sure that the creditor's consent to sell is motivated by the opportunity to limit damage and not by the chance to make a net profit.

Depending mostly on the use of the proceeds but also on its size and time frame, a debt conversion may have an inflationary effect which does more harm to the country's development than the conversion can do good.

The IMF has specifically warned against the danger of spiralling inflation caused by the increase in local currency supply which any debt swap implies. NGOs should indeed be aware of that danger. The bias of the Fund (see next paragraph) can hardly do justice to the opportunities provided by the conversion scheme. The NGO itself needs to carry out a monetary analysis which balances the opportunities against this specific danger. All experiences have been encouraging: there is no known case where a debt-for-development swap or a series of swaps have been large enough to exert any inflationary effect. The converter should make sure that the resources to put into its counterpar funds are actually in the state budget and do not come from the Central Bank, i.e. from the state's money-printing press.

Stephanie Griffith-Jones and Percy Mistry have shown that, contrary to the simplistic view of the IMF — which focuses only on the short-term money supply effect — debt conversions can even lead to contraction in the medium run: “The expansionary monetary effect declines very rapidly and, after four or five years, debt conversions can actually have a contractionary impact on money supply as a result of reduced future public spending demands.” Of course, a careful fiscal management scheme by the Central Bank and/or treasury is indispensable. But given such a scheme, experiences like that of Chile have shown that conversions (of all kinds) can be carried out to a very large extent without igniting the inflationary engine. Griffith-Jones and Mistry point out that it makes a difference whether the debt to be converted has been serviced or is about to be serviced. If so, the result will be a shift from external payments to internal spending. If not, the whole effect will be on the debtor country's allocation of scarce resources. Figure 11 helps evaluate the desirability of a potential debt-for-development swap in light of the probability of servicing the debt and the initial inflation rate.

The inflationary threat is largely eliminated if the development swap leads to a short-term increase in production so that the increase in money supply is quickly matched by an equally enhanced goods supply. This makes the use of counterpart funds for agricultural or small-scale industrial development projects highly attractive. Griffith-Jones and Mistry, however, point out that even social investment in education and health may enhance capital productivity, and that this in the long run offsets any short-term inflationary threat.

A more radical view

The Philippine Freedom from Debt Coalition offers an innovative and, somewhat more radical view: “In a situation where the economy remains stagnant, a calibrated increase in money supply is desirable in order to stimulate production and generate employment.” This position — run the risk of raising inflation in a still controllable amount, if this gives us a chance to overcome economic stagnation — is shared by economists from many countries whose national production capacity has collapsed under the IMF's hyperstabilization policies. Debt swaps, especially when they are oriented towards fostering national production directly or indirectly, provide the best chance to expand money supply in a way that it has an immediate positive effect on goods supply and therefore no inflationary impact at all.

NGO capacity must be available at both ends of the deal.

The operation of debt conversions cannot simply be made the task of operational departments of development NGOs accustomed to running traditionally funded development projects. Though not impossibly difficult, debt swaps are more complicated to execute. For many NGOs involved they are innovative, and they imply a lobbying component in order to be made reality. For all these reasons it is clear that additional personnel capacity needs to be introduced to make effective use of the potential conversions. Both the more `public' Debt for Development Unit of the Swiss NGO coalition and the more `private' service agency, the former US Debt for Development Coalition Inc.[62] have shown that capacities, at least on the national level, are best provided in a centralized way, offering services for a broad range of possible converters.

Moreover, there is also a clear need to establish comparable NGO capacities at the receiving end, i.e. in the debtor country. If NGOs want a scheme to be NGO-dominated or at least provide NGOs with a considerable influence in decision-making for a counterpart fund, they need to invest in educational work among partner organizations about the opportunities and, later on, implementation. It is a false economy for NGOs to decide not to hire additional specialized staff with an ability to handle counterpart funds. In such cases, the NGOs could all too easily be marginalized by government with its overwhelming capacities[63].

Secondary market prices may be subject to huge fluctuations over time.

Securities repurchase operations normally take a long time from the first proposal to the final stage of implementation. Those who purchase debt on the secondary market need to be especially aware of possible price changes in relatively short periods of time. IDA-financed buy-back operations have not only helped to bring a country's debt burden down; they have also been notorious for causing sharp rises in prices in the commercial secondary market. NGOs planning to convert debt should monitor the secondary market carefully and also keep a constant eye out for possible major buy-back opportunities. Otherwise they run the risk that their calculations, for comparatively small operations, will be rendered valueless.

As an extreme example, remember that the secondary market for the Argentine debt during the last year of the Alfonsin presidency was about 5% of the face value; and a few years later, under the Menem-Cavallo team, the price went up to 80% of face value.

Beware of debt speculators

Some private financial organizations even specialize in debt speculation. Presuming that North Korea will one day re-unite with the South, a private company in Geneva is buying up North Korean securities at 3% of face value in the hope of redeeming them at a profit when the country is reunited. The same applies with regard to Cuba: speculative companies are buying Cuban debt notes on the expectation that after Fidel Castro's death, the new leader will embrace a more capitalist system and the debt's value will therefore go up on the secondary market.

Mutual obligations between the NGO and the debtor government must be defined clearly and positively (see WWF contract in Annex 1).

NGOs trying to carry through a debt-for-development swap will find themselves in a position of counting on payments from a Third World government which is likely to be wrestling with acute liquidity problems. Therefore it is not simply colonialist for the NGO to check very carefully that for any year when payments are due, they are actually foreseen in the government budget. Moreover, agreements between the NGO and both governments must stipulate enforcement measures in case

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[62] See note on page 5.

[63] In the best of cases a legal regulation provides a quota of the funds established to the NGOs involved.

the debtor government fails to pay. This normally includes the threat of reinstalling the original hard currency debt in the case of continuous default. As a general rule one can say that the more detailed and precise the trilateral agreement, the less stressful for the NGO is the implementation phase (in any case, the NGO is more interested in implementing development projects than in fighting legal cases against the debtor country's government). A standard CPF agreement between the debtor country and its creditors, as mediated by the Swiss Coalition, includes the following elements:

1. the redemption rate
2. disbursement modalities
3. priority sectors
4. CPF management structures
5. accountability and reporting requirements.

Disbursements

Special attention must be paid to the disbursement modalities. NGOs need to consider the various options which exist for government payments. Basically, there is a cash versus a bond option — i.e., the NGO fund receives payments to a bank account it holds or has held in trusteeship in the debtor country, or it receives government bonds with a specified interest for a long period. Both options have their advantages and draw-backs. Factors governing the choice include:

- The bond option implies an additional — if minor — element of risk
- The bond option makes the administration easier
- The cash option implies a stronger burden on the state budget
- Even if paid in cash, fund administrators have to find some reliable investment, which is likely to be state bonds anyway.

Summarizing all the pro's and con's, the Swiss give a clear preference to the bond option — at least in the Philippine case, where servicing of the bonds by the government seems very reliable[64].

Debt for development schemes may run into conflict with IMF-imposed monetary policy.

Many of the structural adjustment programmes which the IMF imposes on Third World countries require an extremely tight money supply policy. A standard procedure has been that IMF control over the country's Central Bank eliminates inflation through a more or less fixed and overvalued rate against the US dollar. As a consequence interest rates rise sharply, foreign currency reserves become subject to strong speculative pressure, and the restricted internal credit supply affects local productivity drastically.

A debt-for-development scheme aims at improving the internal money supply. For that purpose the scheme converts foreign currency debts, which it is not anticipated will be serviced from the state budget any way. What may happen is that the NGOs, the creditor and the debtor will agree to institute a debt-for development-operation, but IMF supervisors say `no'. NGOs, and possibly creditor governments, need to be aware of this problem, and should be willing to exert pressure on the IMF to lessen its restrictive pressure on the prevailing monetary policy in order to expand production. The chances of prevailing against the almighty gods of stabilization in Washington DC, are higher if the CPF's investments are directed towards production instead of infrastructure. This will enable the converter (and possibly the creditor government which may be supportive) to put forward such arguments in favour of enhanced money supply.

[64] Swiss Coalition: *Ready for take-off! Auf dem Weg zu einem neuen Finanzierungsinstrument für philipinnische NGOs*; Bern 1993

Beware of `round-tripping'

In the past investors have occasionally succeeded in reconverting the cheaply purchased local currency into foreign exchange and thus in taking it out of the country again. Even if in some cases re-exchange might be useful for development purposes[65], using swap-produced funds for that purpose should be avoided. In most cases round-tripping is simply speculation and should therefore be blocked by strict controls over the swap-created funds. The danger is greatest where fiscal authorities are weak. Even where this is so and an NGO could use the proceedings to finance the international part of a programme's costs, it should be most reluctant to do so — if it wants to regard its activities as a contribution to sustainable development and the swap as an effort to reduce a country's debt burden.

CHAPTER 8 : Who will lend a hand?

Once you have decided that conversion may be an interesting tool for your development financing — what next? Whom can you contact to get the project going? The following list features institutions that are specialized in supporting debt conversions — there are not many of them — in section (a). Section (b) lists national or international development institutions which in one way or another are also involved in debt conversion, and therefore are likely to be sources of advice.

Especially if you are considering a swap for the first time, do not try to negotiate with banks and governments on your own. Conversions involve more technicalities than we could describe in this booklet. With the exception of the Swiss Coalition and ACDE, the institutions in section (a) are professional consultancy agencies that will facilitate your debt conversion for a fee, normally computed from the net gain from the conversion as opposed to a traditional foreign currency exchange[66].

(a) Debt-for-development consultants

Swiss Coalition — Debt for Development Unit.

Monbijoustrasse 31
Postfach
CH-3001 Bern, Switzerland
Tel.; 41-31-3811714
Fax: 41-31-3811718
E-mail: scoalition@igc.apc.org

Contact: Alfred Gugler, Richard Helbling

New York Bay Company, Ltd

New York, New York 10006

USA
Tel.: (212) 344-5450
Fax: (212) 344-5575

Europe Office
New York Bay Geneva
Chemin de la Dôle, 20
CH 1295 Tannay/Vaud, Switzerland
Tel.: 41 22 776-3910
Fax: 41 22 776-7349

Association Conversion de Dette pour le Dévelopment et l'Environnement (ACDE)

6 Rue de Talleyrand

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65 The Debt for Development Coalition considered it to be useful, where it helps to bring in indispensable imports for the development programme; see DfDC *op.cit.* p.13

66 Except for the New York Bay Company, which requires two percent of the face value converted.

F-75007 Paris,
France
Tel.: 33-1-45504678
Fax: 33-1-47530673
Contact: Anne Guillaume-Gentil

Agence E4 International

81 Rue des Archives
F-75003 Paris,
France
Tel.: 33-1-48873778
Fax: 33-1-48873811
Contact: Anne Auriault

(b) Institutions with experience in debt-for-development

Conservation International

1015, Eighteenth Street, N.W.
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UNCTAD — Development Finance Unit

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EURODAD

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NCOS

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Emerging Markets Department
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SÜDWIND

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Contact: Pedro Morazán

Epargne Sans Frontière

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MEDA Trade and Consulting (MTC)

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CHAPTER 9 : Further reading

The following list includes both references quoted in the text and other relevant literature. Two volumes, however are specially recommended:

Griffith-Jones & Mistry (1994), *Conversion of official bilateral debt*, is in a way the standard work on debt conversion. Though dating back to a 1991/2 research project and therefore a little outdated regarding figures, it is still the most comprehensive study of all relevant aspects of the conversion process. Despite its title the book does not cover only official debt conversion: it also deals with the trade in private claims. Unfortunately it is not always easy to read, especially for NGO activists who are not trained economists.

The various progress reports on the Swiss debt reduction facility (the latest being *The Swiss Coalition of Development Agencies: The Swiss Debt Reduction Facility — A State of the Art*; Berne August 1995) are useful to NGO representatives interested in the manifold details of inter-governmental negotiations and the technical details of setting up counterpart funds for a local NGO community.

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Delgadillo, J.C.: *La deuda externa boliviana*; La Paz 1994

Dogsé P. and B. von Droste: *Debt-for-Nature Exchanges and Biosphere Reserves*; UNESCO 1990

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FAO (Dr C. A. Quesada Mateo, ed): *Debt-for-nature swaps to promote natural resource conservation*; Rome 1993

Fues, T.: *Schuldentausch für Entwicklung. Chancen und Grenzen einer deutschen Entschuldungsinitiative nach Schweizer Vorbild*; Stuttgart 1992

Garnier, L.: *Los `Debt-Swaps': Una Evaluación Critica*. CECADE San José 1991

Gélinas, J. B.: *Et si le Tiers Monde s'autofinançait; Montréal 1994*.

Gerster, R. & A. Gugler: *Schweizerische Entschuldungsmaβnahmen: Wo stehen wir heute*; i3w-Dokument; 1993

P. E. Gonzales Torres, S.J.: *Fondo para la Asistencia, Promoción y Desarrollo, I.A.P. (Una experiancia de Swap-social en Mexico)*; Mexico 1994

Griffith-Jones, S. & P. Mistry: *Conversion of official bilateral debt, vol.1*; UNCTAD Geneva 1994

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GLOSSARY

Glossary of principal terminology used

Glossaire des principaux termes utilisés

Glossario de la terminologia en uso

English	**French**	**Spanish**
Accrued Interest	Intérêts échus	Intereses acumulados
Assets	avoirs, actifs	activos
Assignment (debt)	cession (de dette)	cesión de deuda
Auction	procédure d'adjudication	adjudicación
Bid	offre (appel d')	Ilcitación
Bonds	obligations, bons	bonos, obligaciones
Budgeted	budgétisé	presupuestado
Buy back (= repurchase)	rachat (de dette)	recompra (de deuda)

English	French	Spanish
Credit worthiness	solvabilité	solvencia
Currency (local)	monnale locale	moneda local
Currency (hard)	devise, monnale forte	divisa, moneda fuerte
Debt carrying capacity	possibilité de payer la dette	posibilidad de pagar la deuda
Debt secondary market	marché secondaire de la dette	mercado secundario de la deuda
Debt conversion proceeds	produit, fonds issus de la conversion	producto (financiero)
Debt for assets	dette pour biens en nature	deuda contra bienes
Debt for cash	dette contre numéraire, monnale	deuda por efectivo
Debt for development	dette pour le développement	deuda por el desarollo
Debt for equity	conversion de dette en prises de participation	deuda por toma de participaciones
Debt-for-nature	dette pour l'environnement	deuda por natureleza
Debt for offsets	dette contre compensation	deuda para compensación
Debt-for-policy	dette contre réformes politiques	deuda por politicas
Debt service	le service de la dette	el servicio de la deuda
Debt servicing	payer le service de la dette	pagar el servicio de la deuda
Discount	une décote	descuento
Commercial guaranteed debt	dette commerciale garantie	deuda guarantida
Endowment Fund	fonds pérenne	fidelcomiso
Escrow agent	agent de séquestre	agente de …
Escrow account	compte de séquestre	cuenta de …
Face value	valeur nominale, faciale	valor nominal
Grace period	différé de palement, période de grâce	periodo de gracia
Hold a debt	détenir une dette	tener una deuda
Inconvertible currency	devise inconvertible	moneda no-convertible
Instalment	acompte, versement partiel	adelanto, pago partial
Invitation for bid	appel d'offre	Ilamado a Ilcitación
Leverage (to)	accroître les ressources	aumentar los recursos
Maturity date	échéance	fecha de vencimiento
Maturity due	date d'échéance	plazo de pago

English	French	Spanish
Not-for-profit	sans but lucratif	sin fines de lucro
Outstanding debt	encours de la dette	deuda pendiente
Proceeds	paiements, fonds, produit	pago, fondo, producto
Promissory note	billet à ordre	
Redeem the debt (to)	rembourser la dette	reembolsar la deuda
Redemption	rachat, paiement, recouvrement	recompra
Redemption price	prix de rachat	precio de recompra
Redemption rate	taux de conversion, de redemption	tasa de conversión, de canje
Rescheduling agreement	accord de rééchelonnement	acuerdo de recalendarizacion
Round tripping effects	effets de carrousel effets de bicyclette	effectos de Ida y vuelta, de carousel
Securities	titres	títulos
Securitized debt	dette titrisée	deuda titulada
Share	action, titre, valeur	acción, título, valor
Sinking fund	fonds ou compte courant	cuenta corriente
Sovereign debt	dette publique	deuda pública
Staggered maturities	amortissements échelonnés	amortisaciones escalonadas
Subcontract (to)	sous-traiter	sub-contratar
Tendering of the debt	soumission, présentation de la dette	soubasta de la deuda
Trust Fund	Fonds fiduciaire, fonds d'affectation spéciale	fondo fiduciario fidelcomiso

DEFINITIONS

Specialist terms used in this guide

Commercial Guaranteed Debt: often, private traders or creditors take out a guarantee for their loans. Export Guarantee Institutions (Eximbank, Coface, Ducroire, NCM, etc.) refund the lender if the debtor fails to repay. These institutions are often public. On repayment of the initial creditor, the debt changes its owner and becomes the property of the institution (which is often a public institution), and therefore passes from private into public hands. The private debt becomes a bilateral public debt.

Debt assignment operation: an operation whereby you do not repurchase securities but you are assigned these securities by a generous creditor provided you use the proceeds for development cooperation or other agreed activities.

Debt face value: the initial value of the debt, the amount that is written on the security (paper) the investor holds.

Inflationary Effect: a side effect produced by the release of large amounts of currency into the local financial market. If the amount of money increases in a country, people have an easier or cheaper access to money and therefore tend to buy more (increased demand). If the demand for goods increases, prices increase, if prices increase, salaries tend to go up, if salaries goes up, prices follow, etc., and this generates inflation.

It is very unlikely that NGOs will be faced with this kind of problem from debt-for-nature or development swaps. Even if so, there are easy mechanisms to avert inflation, such as delaying and diluting the injection of money into the local market.

Liquidity problem vs. solvency problem: this is another rather theoretical debate that does not really affect debt swaps. In the recent past, most creditor countries presumed that indebted countries had the national wealth (natural resources) needed to generate funds to re-pay their debt but did not have enough capacity to process this wealth and thus generate the liquidity to make the repayments. Creditors were confident that with time and effective development policies, debtor countries would be able to extinguish their debt. The most common policy towards them was therefore to help debtors service their debts through balance of payments support funds. This theory has proved wrong. It is now commonly agreed that the debt of SILICs is largely a solvency problem. Whatever measures are taken, without stock treatment, poor debtor countries will never be able to repay their debt. It is therefore urgent to apply debt stock reduction treatment.

Redemption rate: the percentage of the face value that the debtor country has agreed to give an investor in exchange for the securities held. The investor redeems the debt held for a certain percentage of its face (initial) value.

Round-tripping effects. By converting a debt, you help the indebted country to save hard currency. But if you change the debt conversion proceeds that you have received in local currency back into hard currency, the initial beneficial effects of the debt conversion on a country's balance of payments disappears. You have made a `round trip'.

Secondary Market: a market where debt securities are traded. A creditor may wish to cash in on holdings and therefore be willing to sell debt claims to a potential buyer who will try to redeem them with the debtor. The price will of course depend on the basic supply/demand rule: it is likely to be low for countries where there are little chances that the debtor country will be able to pay its debt in the near future or where the demand for securities is very low and the offer is high. In most SILIC countries, there are no secondary markets and the price is agreed between the buyer(s) and seller(s).

Securitized debt: some debts are global and therefore cannot be repurchased as a whole. It is sometimes useful to divide the debt into small parts that can be repurchased. If you divide the debt into securities, you securitize it.

Sinking Fund: a fund whose capital and interest are used for a specific purpose. The fund expires when there is no more money in it.

Trust Fund: a fund whose assets are left to the management appreciation of a fund manager. The proceeds of these funds are often dedicated to a very specific purpose.

NOTES ON TEXT

Notes

2. The term `market' may in some cases be misleading. It is correct to speak of `secondary markets for private debt' in most Latin American debtor countries. In most African countries on the other hand, sovereign debt trading is rather based on an ad-hoc `offer price'.

55. Regarding the Belgian experience see: Rudy de Meyer: `The Belgian Round Table from an NGO perspective'; in: *Debt conversion for financing sustainable development. op.cit.*

56. In most countries undergoing a structural adjustment programme this alternative is barred anyway by the IMF's fiscal controls.

57. Griffith-Jones/Mistry *op.cit.* p.34

58. This is not a bad thing by definition. One could imagine situations where oppressive debtor governments can be forced to spend state revenues on social priorities which they otherwise might have used for repression or luxury consumption. Such conditions, of course, must be analysed very carefully. See Chapter 5 above

59. Griffith-Jones, S.: *Conversion of official bilateral debt: the opportunities and the issues*; World Bank Annual Conference on Development Economics Washington DC 1992, p.14

60. Griffith-Jones and Mistry, *op.cit.* p.86

61. Freedom from Debt Coalition, *op.cit.* pt.14

ANNEX 1 WWF World Wildlife Fund DEBT-FOR-NATURE AGREEMENT

This DEBT-FOR-NATURE AGREEMENT is dated as of March 20, 1990 between WORLD WILDLIFE FUND, INCORPORATED, MINISTERIO DE RECURSOS NATURALES, ENERGIA Y MINAS AND FUNDACION DE PARQUES NACIONALES.

Preliminary Statements.

(1) WHEREAS Costa Rica is one of the most ecologically diverse countries of its size in the world. Its various habitats, including numerous tropical forest types, harbour some 10,000 plant species, over 200 species of mammals, and more bird species than are found in the United States of America and Canada combined.

(2) WHEREAS the government of Costa Rica, represented by the Ministerio de Recursos Naturales, Energia y Minas (the "Ministry") has requested the Central Bank of Costa Rica (the "Central Bank") to permit the financing of conservation activities through the use of the existing mechanism for the exchange of external debt, which was approved by the Central Bank in Junta Directiva No. 4338-89, Article 7, dated February 8, 1989.

(3) WHEREAS Fundacion de Parques Nacionales (the "Foundation") is a leading private, non-profit conservation organization engaged in activities relating to the establishment, development and protection of Costa Rica's national parks and equivalent reserves as well as promotion of educational activities related to the environment and scientific research as applied to the conservation of natural resources.

(4) WHEREAS at meeting no. 4385-89, Article 3, held on November 22, 1989 and meeting no. 43891-89, Article 4, held on December 22, 1989, the Board of Directors of the Central Bank empowered the Central Bank to accept an exchange of US$10.8 million aggregate principal amount of Costa Rican external debt for monetary stabilization bonds denominated in Colons, the proceeds of which will be devoted to financing activities relating to the conservation of Costa Rica's natural resources. Such exchange and the terms of the Bonds will comply with all applicable requirements of Costa Rican law.

COSTA RICA-WWF AGREEMENT

(5) WHEREAS World Wildlife Fund, Incorporates (WWF) has provided financial assistance and other support to the Foundation for the purpose of financing qualifying activities relation to the planning, development, administration and protection of Costa Rica's national parks and reserves, through the debt exchange mechanism approved by the Central Bank.

(6) WHEREAS the Regional Conservation Unit of Talamanca, located in the Talamanca mountain range, has great natural, cultural, and hydroelectric resources. This 622,000 hectare conservation Unit covers approximately 12% of the country's national territory. Under the name of La Amistad, it was accepted as a biosphere reserve by the United Nations for the Educational, Scientific and Cultural Organization on August 12, 1982.

(7) WHEREAS the Foundation, as Trust Creator, and Banco Cooperativo Costarrricense, R.L., as Trustee, have entered into Trust Agreement No. 10-90, dated March 20, 1990, a copy of which is annexed hereo as Attachment B. Pursuant to the Trust Agreement, the Trustee will disburse the proceeds of the monetary stabilization bonds it receives from the consersion described in Section 1 below to finance the activities of the Regional Conservation Unit of Talamanca as provided in Attachment A.

THEREFORE, the parties agree as follows:

Section 1. Debt-for-Nature Swap. WWF will arrange for the acquisition of public sector indebtedness of Costa Rica in an aggregate principal amount of up to US$600,000 (the **"Indebtedness"**). The Indebtedness will be exchanged, in accordance with all applicable requirements of Costa Rican law into monetary stabilization bonds issued by the Central Bank (the **"Bonds"**) in an aggregate principal amount in Colones equivalent to 100% of the aggregate principal amount of the Indebtedness exchanged therefore. The Bonds will be delivered to the Trustee, who shall be entitled to receive all payments of principal and interest thereon in accordance with the terms of the Bonds. The Trustee will follow the instructions of the Foundation in making disbursements of these proceeds to finance the activities of the Regional Conservation Unit of Talamanca.

Section 2. Use of Proceeds

A. The proceeds payable on the Bonds will be used to finance the following activities:

1. planning, administration, protection and management of protected areas and their buffer zones (including, but not limited to, boundary demarcations, elaboration of management plans, development of infrastructure and implementation of other activities in the general fields of nature interpretation, environmental education and sustainable use of natural resources); and

ANNEX 1

2. training a cadre of conservation professionals through the organization and implementation of in-country workshops, field courses, university training programs and related activities to improve the local capacity for protecting and managing Costa Rica's natural resources, especially its parks and reserves.

b) The foundation will cooperate with WWF in selecting, developing and implementing specific projects within the framework of Section 2(a) in accordance with WWF's country Plan and the National Conservation Strategy of Costa Rica. Proceeds payable on the Bonds will be dedicated to projects of the type specified in Attachment A to this Agreement, as mutually agreed from time to time by the Foundation and WWF.

c) Projects under this Agreement will be compatible with the national policies of the Costa Rican government, and with the objectives of the Foundation, the Ministry and WWF.

d) The expenditure of the proceeds of the Bonds will be verified by, and new projects will be selected upon the basis of, reports, budgets and proposals submitted every six months by the Foundation.

SECTION 3. Administration The Foundation and the Ministry will cause a representative of WWF's selection to be appointed to serve on the Comision coordinadora Interinstitucional de la Reserva de la Biosfera de la Amistad.

SECTION 4. Other Participants This Agreement does not preclude the participation of other non-profit conservation organization committed to our mutual goals of wise use of Costa Rica's natural resources, whenever such participation will enhance the success of a project.

SECTION 5. Controlling Language This Agreement shall be executed in two versions, one in English and the other in Spanish, both of which shall bind the parties hereto and constitute but one instrument; **provided, however,** that, in case of doubt as to the proper interpretation of this Agreement, the English text shall be controlling in all cases, except in connection with any legal action or proceeding brought in respect of this Agreement in the courts of component jurisdiction of Costa Rica, in which case the Spanish text shall be controlling.

MINISTERIO DE RECURSOS NATURALES, ENERGIA Y MINAS, FUNDACION DE PARQUES NACIONALES WORLD WILDLIFE FUND, INCORPORATED

Acknowledged by

CENTRAL BANK OF COSTA RICA

COSTA RICA-WWF AGREEMENT

ATTACHMENT A TO DEBT-FOR-NATURE AGREEMENT

Proceeds in Colones paid on the Bonds pursuant to this Agreement shall be used as follows:

I. Protected Areas Management

Protection and management of the Regional Conservation Unit of Talamanca (including but not limited to, boundary demarcation, elaboration of management plans, infrastructure, and implementation of activities in the general fields of nature interpretation, environmental education, and sustainable use of the natural resources).

Regional Conservation Unit of Talamanca ("La Amistad")

Area: 622,000 hectares

Location: Talamanca Mountain Range, Eastern Costa Rica

Features: The Regional Conservation Unit of Talamanca contains some of the greatest biological diversiy in all of Costa Rica. It contains large areas of virgin forest and many species of mammals, including the country's largest population of tapir. Also contained in the region are numerous species of birds, amphibians, reptiles and fish.

Threats: Poaching and deforestation.

II. Training

Training programs shall be designed to improve the ability of the National Park Service, Forest Service, Wildlife Department and the Ministry to administer the Regional Conservation Unit of Talamanca.

III. Other

Other needs of the Regional Conservation Unit of Talamanca as identified in the National Conservation Strategy and such institution-building needs as may be mutually agreed upon by the Foundation and WWF.

IV. Allocation of Proceeds

Proceeds from the Bonds will be allocated to specific projects (and subject to appropriate requirements as to qualifying activities) as agreed by the Foundation and WWF from time to time.

ANNEX 2 : Severely and moderately indebted countries

SILICS	SILMICS	MILICS	MIMICS
Afghanistan	Algeria	Albania	Cape Verde
Burundi	Angola	Bangladesh	Chile
Cambodia	Argentina	Benin	Colombia
Cameron	Bolivia	Chad	Dominican Republic
Central African Republic	Brazil	Comoros	Greece
Congo	Bulgaria	Egypt Arab Rep.	Hungary
Côte d'Ivoire	Cuba	Gambia	Indonesia
Equatorial Guinea	Ecuador	Haiti	Morocco
Ethiopia	Gabon	India	Papua New Guinea
Ghana	Iraq	Lao PDR	Philippines
Guinea	Jamaica	Malawi	Russian Federation
Guinea-Bissau	Jordan	Nepal	Tunisia
Guyana	Mexico	Pakistan	Turkey
Honduras	Panama	Senegal	Uruguay
Kenya	Peru	Zimbabwe	Venezuela
Liberia	Poland		Western Samoa
Madagascar	Syrian Arab Republic		
Mali			
Mauritania			
Mozambique			
Myanmar			
Nicaragua			
Niger			
Nigeria			
Rwanda			
Sao Tomé and Principe			
Sierra Leone			
Somalia			
Sudan			

SILICS	SILMICS	MILICS	MIMICS
Tanzania			
Togo			
Uganda			
Vietnam			
Yemen, Rep.			
Zaire			
Zambia			

SILICS — Severely indebted low-income countries

SILMICS — Severely indebted lower middle-income countries

MILICS — Moderately indebted low-income countries

MIMICS — Moderately indebted middle-income countries