Environmental Finance

Debt-for-Environment Swap in Georgia:
Pre-Feasibility Study and Institutional Options

PART ONE

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EAP TASK FORCE

The Task Force for the Implementation of the Environmental Action Programme for Central and Eastern Europe (EAP Task Force) was established in 1993 at the “Environment for Europe” Ministerial Conference in Lucerne, Switzerland. Its Secretariat was established at the OECD as part of the Centre for Co-operation with Non-Members. Since its creation, the EAP Task Force has proven to be a flexible and practical tool for providing support to political and institutional reforms in the countries of the region. After the Aarhus Ministerial Conference in 1999, its efforts were refocused on the countries of Eastern Europe, Caucasus and Central Asia (EECCA). More detailed information about Task Force activities can be found on its website at: www.oecd.org/env/eap

This report is also available in Russian under the title:

Обмен долгов на охрану окружающей среды Грузии: предварительное технико-экономическое обоснование и предложения по институциональным механизмам

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Foreword

This publication was prepared in the framework of the Task Force for the Implementation of the Environmental Action Programme for Central and Eastern Europe (EAP Task Force). The publication consists of two separate reports, dealing with different aspects of the debt-for-environment swap in Georgia. The first report – Debt-for-Environment Swap in Georgia: Pre-Feasibility Study and Institutional Options (the Pre-Feasibility Study) – aims to assist the Government of Georgia in analysing opportunities for, and challenges to, swapping (part of) its external debt for domestic financing of priority environmental projects. The report suggests that such a swap is potentially feasible and could be beneficial to both Georgia and the creditor countries. The second report – Potential Project Pipelines for the Expenditure Programme Financed by the Debt-for-Environment Swap in Georgia (the Pipelines Report) – focuses on the financial and economic analysis of the five most promising project pipelines (biodiversity protection, biogas production, small and mini hydropower generation, wastewater management and municipal waste management) that were identified during the Pre-Feasibility Study. These project pipelines could make up a potential expenditure programme to be co-financed with resources generated through debt-for-environment swaps in Georgia.

Some of the data and information in the Pre-Feasibility Study were provided by the Consortium of BCEOM, HALCROW GROUP Ltd. and COWI – the companies that implemented the project “Support to the Implementation of Environmental Policies and National Environmental Action Programmes in the Commonwealth of Independent States (CIS)”, financed by the European Union Technical Assistance to the Commonwealth of Independent States (EU TACIS). Data on the debt structure and the repayment profile reflecting the 2004 agreement of Georgia with Paris Club creditors were collected and processed by Nana Gibradze.

Although the two reports are closely related and complementary, they can stand alone and be read separately. The Pre-Feasibility Study was mostly prepared by Grzegorz Peszko from the OECD Environment Directorate (former Manager of the Environmental Finance Programme at the OECD/EAP Task Force Secretariat and current World Bank staff member), in co-operation with Malkhaz Adeishvili, Head of the Environmental Policy Department of the Ministry of Environmental Protection and Natural Resources of Georgia.

The Pipelines Report was prepared by a team of (mostly Georgian) consultants under the guidance and supervision of the EAP Task Force Secretariat at the OECD. Gabriel Labbate, Paata Janelidze, Grigol Lazriev and Nino Partskhaladze were responsible for developing the analysis of the individual project pipelines. Nelly Petkova worked on the reports at their second stage and prepared them for publication. Special thanks go to Xavier Leflaive (Manager of the Environmental Finance Programme at the EAP Task Force) for his support during the last phases of this work and to Brendan Gillespie (Head of the Non-member Countries Division at the OECD Environment Directorate) for his valuable comments and overall guidance from the outset of this project. Carla Bertuzzi helped with collecting statistical data in preparing the publication. All these contributions are gratefully acknowledged.

The Pre-Feasibility Study was made possible thanks to the financial support of the EU TACIS. The Dutch Government, through its Ministry of Housing, Spatial Planning and the Environment, provided financial support for the preparation of the Pipelines Report.

The views expressed in these reports are those of the authors and do not necessarily reflect the views of the OECD, the EU or their member countries.
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<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>CBA</td>
<td>Cost-benefit analysis</td>
</tr>
<tr>
<td>CEE</td>
<td>Central and Eastern Europe</td>
</tr>
<tr>
<td>CEP</td>
<td>Caspian Environment Programme</td>
</tr>
<tr>
<td>CI</td>
<td>Conservation International</td>
</tr>
<tr>
<td>CIDDA</td>
<td>Canadian International Development Agency</td>
</tr>
<tr>
<td>CIS</td>
<td>Commonwealth of Independent States</td>
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<tr>
<td>DANCEE</td>
<td>Danish Environmental Assistance to Eastern Europe</td>
</tr>
<tr>
<td>DEM</td>
<td>Deutschmark</td>
</tr>
<tr>
<td>DEFS</td>
<td>Debt-for-environment swap</td>
</tr>
<tr>
<td>EAP TF</td>
<td>Task Force for the Implementation of the Environmental Action Programme for Central and Eastern Europe</td>
</tr>
<tr>
<td>EBRD</td>
<td>European Bank for Reconstruction and Development</td>
</tr>
<tr>
<td>EC</td>
<td>European Commission</td>
</tr>
<tr>
<td>ECA</td>
<td>Europe and Central Asia</td>
</tr>
<tr>
<td>EDT</td>
<td>External debt</td>
</tr>
<tr>
<td>EECCA</td>
<td>Eastern Europe, Caucasus and Central Asia</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>EUR</td>
<td>Euro</td>
</tr>
<tr>
<td>EU TACIS</td>
<td>EU Technical Assistance to the Commonwealth of Independent States</td>
</tr>
<tr>
<td>FONAMA</td>
<td>National Fund for the Environment of Bolivia</td>
</tr>
<tr>
<td>FONCODES</td>
<td>Social and Poverty Fund of Peru</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross domestic product</td>
</tr>
<tr>
<td>GEF</td>
<td>Global Environmental Facility</td>
</tr>
<tr>
<td>GFCF</td>
<td>Gross fixed capital formation</td>
</tr>
<tr>
<td>GHG</td>
<td>Greenhouse gas</td>
</tr>
<tr>
<td>GNP</td>
<td>Gross national product</td>
</tr>
<tr>
<td>GRP</td>
<td>Gross regional product</td>
</tr>
<tr>
<td>HIPC</td>
<td>Highly Indebted Poor Countries (Initiative)</td>
</tr>
<tr>
<td>IBRD</td>
<td>International Bank for Reconstruction and Development (World Bank)</td>
</tr>
<tr>
<td>IDA</td>
<td>International Development Association (World Bank)</td>
</tr>
<tr>
<td>IFAD</td>
<td>International Fund for Agricultural Development</td>
</tr>
<tr>
<td>IFI</td>
<td>International financial institution</td>
</tr>
<tr>
<td>ILO</td>
<td>International Labour Organisation</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>JBCI</td>
<td>Japan Bank for International Cooperation</td>
</tr>
<tr>
<td>KfW</td>
<td>Bank Kreditanstalt für Wiederaufbau (German Bank for Reconstruction)</td>
</tr>
<tr>
<td>MBIFFCT</td>
<td>Mgahinga and Bwindi Impenetrable Forest Conservation Trust Fund of Uganda</td>
</tr>
<tr>
<td>MDF</td>
<td>Municipal Development Fund of Georgia</td>
</tr>
<tr>
<td>m/mln</td>
<td>Million</td>
</tr>
<tr>
<td>NEAP</td>
<td>National Environmental Action Programme</td>
</tr>
<tr>
<td>NGO</td>
<td>Non-governmental organisation</td>
</tr>
</tbody>
</table>
NIS    New Independent States of the Former Soviet Union
NPAF   National Pollution Abatement Facility of Russia
NPV    Net present value
NTEF   National Trust Ecofund of Bulgaria
O&M    Operation and maintenance (costs)
ODA    Official development assistance
ODP    Ozone depletion potential
ODS    Ozone depleting substance
OECD   Organisation for Economic Co-operation and Development
PAC    Pollution abatement and control
PEM    Public expenditure management
PPP    Purchasing Power Parity
PRGF   Poverty Reduction and Growth Facility
PROFONAMPE Protected Areas Fund of Peru
PSP    Private sector participation
REC    Regional Environment Centre
SAP    Strategic action programme
SDR    Special drawing rights
SME    Small and medium enterprises
TNC    The Nature Conservancy
TRACECA Europe Caucasus Asian Transport Corridor
UNCTAD United Nations Conference on Trade and Development
UNDG   United Nations Development Group
UNDP   United Nations Development Programme
UNEP   United Nations Environmental Programme
UNFCCC United Nations Framework Convention on Climate Change
UNICEF United Nations International Children’s Emergency Fund
US     United States of America
USAID  US Agency for International Development
USD    US dollar
USEPA  US Environmental Protection Agency
WB     World Bank
WWF    World Wildlife Fund
XGS    Exports of goods and services

List of Physical Units

kg   Kilogramme
km   Kilometre
kWh  kilo Watt hour
m³   Cubic metre
MW   Mega Watt
Exchange Rates

In the conversion of financial data presented in this report, i.e. Georgian Lari into US dollars (USD) and Euros (EUR), the following annual average exchange rates were used:

Table 1. Exchange Rates, Lari/USD, and Lari/EUR, Yearly Average

<table>
<thead>
<tr>
<th>Year</th>
<th>Lari/USD</th>
<th>Lari/EUR</th>
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<tbody>
<tr>
<td>1996</td>
<td>1.26</td>
<td>..</td>
</tr>
<tr>
<td>1997</td>
<td>1.3</td>
<td>..</td>
</tr>
<tr>
<td>1998</td>
<td>1.39</td>
<td>2.16</td>
</tr>
<tr>
<td>1999</td>
<td>2.02</td>
<td>1.83</td>
</tr>
<tr>
<td>2000</td>
<td>1.98</td>
<td>1.86</td>
</tr>
<tr>
<td>2001</td>
<td>2.07</td>
<td>2.07</td>
</tr>
<tr>
<td>2002</td>
<td>2.2</td>
<td>2.43</td>
</tr>
<tr>
<td>2003</td>
<td>2.15</td>
<td>2.36</td>
</tr>
<tr>
<td>2004</td>
<td>1.90</td>
<td>2.27</td>
</tr>
<tr>
<td>2005</td>
<td>1.82</td>
<td>2.27</td>
</tr>
</tbody>
</table>


Map of Georgia
A debt-for-environment swap (DFES) can provide a low income country, such as Georgia, with a unique opportunity to link debt reduction with global environmental benefits and poverty alleviation. DFES can help Georgia to move towards the fulfilment of international environmental agreements in a manner that is compatible with its own sustainable development plans. Because some benefits of environmental projects have a regional or global character, they may not be financed in the absence of some international transfers, such as those provided by a debt-for-environment swap. Moreover, the implementation of such projects can contribute to peace and security in the Caucasus region by alleviating regional and cross-border conflicts related to the management of shared and trans-boundary natural resources. A debt-for-environment swap is also a practical instrument to mainstream environmental objectives in the social and economic growth agenda of the Georgian government and to strengthen institutional capacity to prepare “financeable” environmental projects and to manage public environmental expenditures more efficiently.

A debt-for-environment swap has advantages over alternatives, such as debt-for-equity swaps and debt-for-aid swaps. A debt-for-environment swap provides an opportunity: to exchange larger volumes of debt than these other alternatives; to generate new and additional resources for Georgia without adverse budgetary and inflationary consequences; to capture revenue from the sale of assets that have market value; and, to link global and cross-boundary environmental benefits (climate, biodiversity, international waters) with local economic development, and the rehabilitation of infrastructure for the poor as well as poverty reduction.

At the same time, there are risks involved with DFES. These include risks such as: distorting more efficient debt treatment operations (restructuring and relief), macro-economic and political instability, inflationary impacts, further deterioration of the fiscal situation and the possible failure to use debt swap funds as intended.

The main conclusion of this study is that a debt-for-environment swap between Georgia and creditors of the Paris Club is feasible and could generate benefits for both, and for the international community more broadly. Lessons learned from the Georgian case are relevant for other low-income countries in the region and beyond.

There is a good rationale for Georgia to negotiate a debt-for-environment swap. Following a dramatic economic downturn and civil wars, the political and macroeconomic environments in Georgia have stabilised. Economic growth has been steady in recent years. However, with about 50% of the population living in poverty (at about USD 30 a month) and with a GDP/capita of USD 1 2481.5 (compared to an OECD average of GDP/capita of USD 226 000 in 2003, Georgia remains a low-income country, eligible for International Development Association (IDA) support. By the standards of the International Monetary Fund (IMF), already in 2000, Georgia’s external debt was estimated to have reached an unsustainable level. More than half of Government expenditure was used for servicing public debt, crowding out essential spending on social and environmental infrastructure, and threatening the sustainability of further

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1 Measured in current Purchasing Power Parities (PPPs).
2 Measured in current exchange rates and PPPs.
economic development. As a result, Georgia sought restructuring of its external debt with the Paris Club creditors.

In 2001, Georgia agreed with the Paris Club to reschedule and restructure its external debt. A special clause to this agreement created an opportunity for additional bilateral local currency debt swaps on a voluntary and bilateral basis with Paris Club creditors. As a result, the then Georgian President established an inter-ministerial working group, including the Ministries of Finance and Environment, to discuss and develop the modalities for negotiating a debt-for-environment swap. This is an indicator of the high level political support that exists, and is no doubt needed, for Georgia to successfully conclude a DFES. Internationally, there seems to be a greater willingness now to consider such swaps than in the past. In addition, on 21 July 2004, Georgia and the Paris Club signed yet another debt restructuring agreement which also includes a clause on debt swaps.

This report explains why Georgia’s main creditors may be willing to negotiate a debt-for-environment swap. According to the 2004 Paris Club agreement, there are no limits to swap official development assistance (ODA) loans, while non-ODA loans are capped at a maximum of 5 million special drawing rights (SDR) per country.\(^3\) In calculating the potential revenue from a DFES in Georgia, a 15% swap rate of ODA loans generally has been assumed, while for non-ODA loans the maximum amount allowed has been used. With the participation of six major creditors, and with a swap of 15% of the entire flow of annual debt repayments, Georgia could expect over Euro 3.4 mln (in 2005 prices) of annual revenue in 2009, decreasing to approximately Euro 1.8 mln by 2014 and then climbing back up to about Euro 2 mln by 2020. On the assumption that the four major creditors only agreed to a swap, the annual revenue would reach Euro 2.6 mln in 2009, then decrease steadily to almost Euro 1.3 mln in 2014 and fluctuate between Euro 1.3-1.4 mln thereafter.

In these two scenarios, the total expected revenues from the debt-for-environment swap over the period 2006-2023, might be **Euro 42** or **Euro 30 mln**, respectively. In net present value terms (at a 12% discount rate), this would represent Euro 18.7 or Euro 12.9 mln, respectively. While these figures may not seem large in absolute terms, they should be contrasted with the approximately Euro 5.3 mln of environmentally-related investment expenditure made in Georgia in 2001. In the optimistic scenario outlined above, the revenues from the debt-for-environment swap in 2006 would amount to 45% of the 2001 baseline of environmentally-related investments. For the second scenario, this figure would be 25%.

The proposed design of the DFES would enable donors and international financial institutions to augment these resources with additional grants (even loans in the distant future). The proposed design can also mitigate the potential threat that inflation would erode the real value of revenue.

Establishing a credible expenditure programme that responds to the priority concerns of both creditors and the Georgian government will be essential to gain support for a debt-for-environment swap. The proposed programme should be narrowly focused on a few priorities and demonstrate how a solid pipeline of projects could be prepared and supported to meet its objectives. A review of Georgian priority problems and creditors’ preferences suggests that the most promising projects could be those that aim at: reducing emissions of greenhouse gasses that affect global climate; reducing pollution of international waters; protecting biological diversity; and facilitating access of the poor to safe water and sanitation services.

Within each priority area, project opportunities were examined to identify the types of projects that could achieve environmental benefits together with poverty reduction and local sustainable growth. Taking account of the possible size of the DFES, additional resources would be required to support any large

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\(^3\) The SDR serves as the unit of account of the IMF and some other international organisations. Its value is based on a basket of key international currencies. At the moment of writing of this report 1 SDR = 0.704 USD.
project pipelines or large individual capital investments. Therefore, careful selection of the most cost-effective projects, and requirements to co-finance projects from other sources, would need to be a cornerstone of project selection in order to make a real difference in any of the priority areas listed above.

In the course of this work, five potential project pipelines were identified and further economic and financial analysis carried out. These pipelines include projects in the areas of biodiversity protection, biogas production, small and mini hydropower generation, wastewater management and municipal waste management. This in-depth analysis is presented in the second part of this publication: Potential Project Pipelines for the Expenditure Programme Financed by the Debt-for-Environment Swap in Georgia. It is worth noting that even if a DFES does not materialise in Georgia, the project pipelines that have been identified as part of this work could still be used by the Georgian government in discussions with donors when developing technical co-operation programmes.

This study contains a detailed analysis of various options for managing a debt-for-environment swap in Georgia. The following fundamental design characteristics are recommended:

- Direct, bilateral swaps with individual creditor countries rather than trilateral swaps through intermediaries (e.g. non-governmental organisations) should be tried first. The institutional framework for bilateral swaps, however, needs to be designed so as to foster a multilateral framework for bilateral transactions and to accommodate additional trilateral swaps, should they be arranged by interested third parties.
- Expenditure should be disbursed through a locally established financial facility which would select projects competitively under the supervision of relevant stakeholders rather than directly to specific projects with a limited competition and tied procurement. Swapping debt for specific projects can be considered, if the value of the transaction is small.
- In order to avoid any inflationary impacts, and to manage the absorptive capacity of the project pipeline, the swap would involve the Georgian government transferring the entire flow of future debt repayments over an agreed period (the swap-as-you-repay scheme) rather than as a one-time transfer of the present value of the debt.
- The local financial facility should be established as a modular structure with a “core” revolving fund that would receive periodic injections of resources equivalent to the amount of the forgiven debt repayment in that period. The facility should, however, be able to open parallel accounts and financing ”windows” – some with endowments, some sinking, others revolving, depending on the preferences of creditors and the nature of demand for financing in the country.
- A prudent strategy would be to finance projects with grants only. As institutional capacity and financial markets develop, other financial products can be considered. Co-financing should always be required to achieve financial leverage and additionality.
- Accountability to all stakeholders, but freedom from ad hoc political interference, will be necessary conditions to win international credibility and hence, attract resources. Accountability, transparency and efficiency must be the cornerstones of governance and everyday operations. The governing body of the financial facility should be open to creditors involved in the DFES. The facility’s executive management should be very professional, with a high degree of operational independence in project cycle management, subject to strict accountability for performance. International good practices in public expenditure management should be applied.
- The project cycle should have clearly defined stages, responsibilities, procedures and project selection criteria. Cost-effectiveness should be a key quantitative basis for appraisal and selection of projects. Subjective, discretionary elements in project selection should be minimised and subject to procedures.
- Competition in procurement under the DFES scheme should be maximised to boost efficiency. If trade-offs occur between efficiency and incentives to creditors to join the swap, then the contributions of different creditors should be taken into account in the procurement procedures.
The choice of the legal status of the local financial facility requires additional analysis. Preliminary findings seem to suggest that a public foundation located in Georgia has certain comparative advantages over other options.

The estimated annual administrative costs of managing a DFES scheme in Georgia (Euro 73 000 – 94 000) would be fully justified only if the revenue generated by the swap amounts to a minimum of about Euro 1.3 mln per year. If this threshold cannot be achieved, more cost-effective institutional options will need to be considered for the phase-in period of the scheme.

Preparatory activities usually take much time – experience shows that arranging a DFES could take between two and three years. This involves signing agreements with individual creditors, incorporating the DFES into the budget law for the year when the first swap will be executed, and establishing a financial facility. Additional time is needed to develop the project pipeline for the first appraisal session. The Georgian government needs to take these stages into account when preparing its strategy for negotiating with creditors.

International experience shows that during negotiations with creditors, a crucial factor for success is a strong signal from the debtor country’s government indicating that the DFES is a national priority. Moreover, in order to be effective, the preparatory process needs a strong leader. The Ministry of Finance, working closely with the Ministry of Environmental Protection and Natural Resources, could provide this leadership.

Harnessing this opportunity will not be easy. However, as experience in countries like Poland has shown, DFES can be an efficient way to secure additional public finance for environmentally-related projects in countries where such commitments are challenged by strong budgetary pressures.
1. BACKGROUND

Since declaring its independence from the Soviet Union in 1991, followed by a civil war and drastic economic decline, Georgia has accumulated a substantial amount of official foreign debt. As of the end of 2003, the total stock of Georgia's debt was estimated to be USD 1.95 billion (Source: IMF document dated 12 May 2004, published on the IMF website www.imf.org). Georgia’s stock of debt owed to Paris Club creditors as of June 2004 was estimated to be USD 525 million (Source: Paris Club creditors), of which USD 225 million are in official development assistance (ODA) claims and USD 300 million in non-ODA claims. Altogether, indicators of the external indebtedness of Georgia have improved, as evidenced by the decline in the external debt-to-GDP ratio from 46% at the end of 2003 to about 36% at the end of 2004 (IMF, 2005). Nonetheless, Georgia is still facing problems with repaying its external debt.

Georgia has achieved a certain level of macroeconomic stabilisation and modest economic growth over the past five years (see Annex I on major macroeconomic indicators). However, the economic decline at the beginning of the 1990s was so deep (the GDP fell by 80% between 1990 and 1993) that, until recently, these positive economic trends in Georgia have had little impact (in absolute terms) on the social and economic conditions in the country. Economic growth weakened after 1998, picked up after 2002, and has been forecasted at 8.5% for 2005. Poverty rates, however, have proven difficult to decrease and continue to be at about 50% of households, with 17% of the total population living in extreme poverty. According to the World Bank classification, with GDP per capita at 2 481.5 USD4 in 2003, Georgia still belongs to the poorest countries in the world and is classified as a low-income, International Development Association (IDA)5 country. Inequality has increased and the poor have suffered disproportionately from inadequate access to social services and basic infrastructure.

A traditional problem in Georgia has been the very weak fiscal position of the government. Tax collection by the general government (including extra-budgetary revenue) was only 14% of GDP in 2000 (IMF, 2001), one of the lowest collection rates in the countries of Eastern Europe, Caucasus and Central Asia (20.1% on average) and indeed in the world.6 In particular, after the rapid build-up of government arrears in 1998-1999, the government had to arrest the national deficit by drastic cuts in expenditure commitments. External debt service in 2002 was estimated by the IMF at 31% of central government revenues.7 The fiscal crisis was aggravated by the inefficient and often less than transparent management of public expenditure. Furthermore, much of the country’s public infrastructure, upon which sustainable development depends, has been gradually falling apart because of war, vandalism and the lack of funds for rehabilitation, maintenance and even proper operation.8 Expenditures on the sound management of natural resources and environmental protection have often been neglected because the benefits from such

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4 Measured in current Purchasing Power Parities (PPPs).
5 The International Development Association (IDA), established in 1960, is the part of the World Bank Group that provides long-term interest-free loans (credits) and grants to the poorest of the developing countries. It does this to support economic growth, reduce poverty and improve living conditions.
6 The average in OECD countries was 37.3% (Source: EBRD 1999, OECD, IMF and WB, 2001).
investments rarely flow to the decision makers. In addition, many of these externalities have a public goods character.

After the “Rose Revolution” of 2003, the macroeconomic situation in the country began to stabilise. In 2004, real GDP grew by 6.2%. The preliminary projections for real GDP growth for 2005 are 8.5%. After the “Revolution”, the government took serious measures to strengthen its fiscal position with subsequent clearance of the bulk of domestic arrears incurred by previous administrations. The government has launched a comprehensive reform in the public sector, including the strengthening of fiscal management on both the revenue and expenditure sides. In 2004, as a result of improved tax collection, tax revenues rose to 18.2% and are expected to increase by half percent yearly between 2006-2008. The government’s efforts have elicited strong international support, including a restructuring of Georgia’s debt to the Paris Club and large aid pledges at a donors’ conference in mid-2004.

In 2001-2003, inflation remained at an average of 5% and the exchange rate was stable. In the second part of 2004, inflation rose from 3.6% in June 2004 to over 9.7% in March 2005. According to the IMF, inflation is targeted at 7% by the end of 2005, before declining to an average of 4% in the medium term.

One of the serious problems facing Georgia is debt sustainability. In early 2004, the country’s total external debt reached 49% of GDP. In July 2004, an agreement with the Paris Club rescheduled payments due to Paris Club creditors. The external debt service to exports ratio was reduced to 6.4% (from 13% in 2000). By the end of 2004, the external debt stock also decreased to 37% of GDP (from 49% in early 2004). Following the rescheduling of Georgia’s debt in July 2004, bilateral agreements with a number of creditors have been reached (see Annexes IX and X).

While Georgia’s debt situation has been improving, there is still some risk that it might worsen. Georgia’s debt burden is still vulnerable to adverse external and domestic developments, which can be mitigated by continued implementation of measures to increase foreign direct investment and enhance export performance.

Georgia also faces serious environmental problems, which threaten the recovery of the local economy, particularly on the Black Sea coast and in rural areas, where sustainable economic growth depends vitally on environmental services and natural resources. In some parts of the country, environmental degradation, in particular due to water pollution and soil contamination, poses significant risks to human health. Poverty related pressures pose the risks of irreversible losses of Georgia’s rich biological diversity, which not only supports local communities with food, energy and income, but is also recognised for its global significance. Mismanagement and pollution of the rivers that flow into neighbouring countries, mainly Azerbaijan, threaten the fragile peace and security in the Caucasus. The protection of the environment and natural resources, development of forestry and rehabilitation of environmentally-related infrastructure (water supply and sanitation, energy facilities), as well as irrigation and drainage systems, were identified as the main strategic directions of the Poverty Reduction and Economic Growth Programme of Georgia (Government of Georgia, 2000). However, environmental expenditures, both by the public and private sectors, are very low and fall far short of the needs of even operating and maintaining existing environmentally-related infrastructure, such as water supply and wastewater treatment, to say nothing of achieving environment-related millennium development goals agreed at the Johannesburg Earth Summit (DANCEE/OECD EAP Task Force, 2001).

10 Ibidem.
12 Ibidem.
Box 1. Debt, Environment and Poverty Links

The high level of external debt service has several effects on the environment. First, debt service diverts public spending away from domestic expenditure, and environment is often the easiest victim of budget cuts due to its public goods character and the lack of strong interest groups behind its protection. Second, the need for obtaining foreign currencies through increased exports exerts additional pressure on the unsustainable extraction of natural resources (e.g. timber, gold, minerals, metal scrap, etc.), which are the major sources of Georgia’s foreign currency earnings. Third, debt service reduces imports, which in turn increases the immediate demand for domestic resource substitutes. The degradation of environmental resources under debt pressure is particularly aggravated by the high level of poverty in the country. In most cases, it is the poorest sections of the population that are forced to pursue an unsustainable use of natural resources (e.g. forests, fish and wild animal stock) to meet their daily survival needs. In the medium and long term, the unsustainable use of natural resources degrades the most easily accessible and essential assets, on which poor communities depend.

Recognising the difficulties of the situation and the need for action, the Georgian government has explored ways to relieve the pressure resulting from servicing its external debt and the pressures this puts on the environment. On 6 March 2001, the Government of Georgia agreed with Paris Club creditors to restructure a portion of Georgia’s external debt. This agreement followed the International Monetary Fund’s approval of Georgia’s arrangement under the Poverty Reduction and Growth Facility (PRGF) of 12 January 2001. The agreement with the Paris Club consolidated roughly USD 58 million due on loans contracted by Georgia before 1 November 1999. This amount consisted of the principal falling due from 1 January 2001 through 31 December 2002 (of which USD 1 million are ODA loans). A provision for debt-for-environment swaps (DFES) was incorporated into the overall debt restructuring package. The agreement states that "on a voluntary and bilateral basis, each creditor may also undertake debt-for-nature, debt-for-aid, debt-for-equity swaps or other local currency debt swaps" (Paris Club Press Release, 6 March 2001).

On 21 July 2004, Georgia held a second round of negotiations with Paris Club creditors, which resulted in another Debt Restructuring Agreement. The Paris Club agreed to reschedule Georgia’s bilateral debt due in 2004-2006. This agreement was preceded by the IMF Second Review (under the Three-Year Arrangement under the Poverty Reduction and Growth Facility14), in the amount equivalent to special drawing rights (SDR) 98 million (65% of the quota), or approximately USD 139 million. The IMF Review was approved on 4 June 2004. Georgia’s debt to Paris Club creditors will be treated under the Houston terms (as given below), consolidating about USD 160.6 million of arrears (including late interest) as of 31 May 2004 and maturities due from 1 June 2004 till 31 December 2006. The provisions of the Agreement apply to the debt that was contracted before the cut-off date set as of 1 November 1999. The Agreement does not cover the consolidation agreement concluded according to the agreed Minute of 6 March 2001 (i.e. the first agreement reached with the Paris Club). The debt relief will be applied as follows:

a. Maturities and 50% of arrears:
   - Non-ODA credits are to be repaid over 20 years, with 5 years of grace with progressive repayment at interest rates at least as favourable as the rates of previous bilateral agreements; and
   - ODA credits are to be repaid over 20 years, with 10 years of grace with interest rates at least as favourable as the concessional rates applicable to these loans.

b. The remaining 50% of arrears will be repaid over 3 years.

14 IMF aid programme that aims at providing a basis for economic stabilisation and long-term growth.
This agreement also allows for debt swaps, including debt-for-nature, debt-for-aid, debt-for-equity or any other local currency debt swaps to be conducted between Georgia and its creditors:

a. All ODA loans; and
b. Amounts of outstanding non-ODA credits and loans, up to 20% of the outstanding amounts as of 31 December 2000 or up to 5 million SDR, whichever is higher

**Box 2. What is a Debt-for-Environment Swap?**

The main idea underlying a debt-for-environment swap (DFES) is that instead of continuing to make external payments on outstanding loans in hard currency, a debtor country makes payments in local currency to environmental projects in the country on terms agreed with creditors.

The Georgian government has already taken some essential steps for arranging debt-for-environment swaps with its creditor countries:

- In 1998, the Ministry of Environmental Protection and Natural Resources circulated a proposal for invoking the debt-for-environmental swap provision to interested parties within the Georgian government (President of Georgia, State Minister, Minister of Finance, Minister of Economy and Minister of Foreign Affairs) to get their opinion on the potential debt-for-environment swap with creditors.
- Simultaneously, the Georgian Minister of Environment, the Chairman of the Parliament and the Ministry of Economy initiated preliminary discussions and communications with the World Bank regarding the possibility of co-operation to facilitate debt-for-environment swaps with bilateral creditors. In 2000, the Minister of Environment of Georgia asked the World Bank for assistance in negotiating debt-for-environment swaps with creditor countries.
- In March 2001, Paris Club creditors agreed on a debt restructuring scheme until 2003, including a clause allowing for debt-for-environment swaps on a voluntary and bilateral basis.
- Following this agreement, the President of Georgia established an inter-ministerial working group (consisting of representatives of the Ministry of Environment, Ministry of Economy, Ministry of Finance and Ministry of Foreign Affairs) to develop a framework for negotiating debt-for-environment swaps with creditor countries.
- In July 2001, the Georgian Minister of Environment requested the OECD/EAP Task Force Secretariat to assist the Georgian government in developing the framework for negotiations.
- In 2002, the first draft of this pre-feasibility study was developed jointly by the OECD EAP Task Force and the Georgian Ministry of Environment.
- In 2003, the Government of the Netherlands provided a grant through the OECD Secretariat of the EAP Task Force to facilitate an interagency and international debate on the debt-for-environment swap for Georgia and to conduct a study on ideas for project pipelines.
- In February 2003, the Georgian Ministry of Environment, in co-operation with the Ministry of Finance and the OECD Secretariat of the EAP Task Force, organised the first international consultations on this issue.
- On 21 July 2004, Georgia held a second round of negotiations with the Paris Club. Paris Club creditors agreed on a debt restructuring scheme until 2006. The clause on debt swaps, including conducting debt-for-environment swaps on a bilateral and voluntary basis, was again incorporated into the agreement with the Paris Club.
- In 2005, the EAP Task Force Secretariat completed a full-fledged financial and economic analysis of the five most promising pipelines that could be co-financed with resources generated through a potential DFES in Georgia.
2. DEBT-FOR-ENVIRONMENT SWAPS AND ALTERNATIVE DEBT TREATMENT OPERATIONS

Debt-for-environment swaps are obviously attractive to the ministry in charge of environment in the debtor country. For the ministry of finance, however, the most important consideration is whether the debt swap will reduce the burden of debt servicing in a cost-effective way. Its main objective is to minimise the expected debt servicing costs and the cost of holding liquid assets, subject to an acceptable level of risk, over a medium- to long-term horizon. The alternatives to a debt swap include various transactions that the government can make to ensure that the government's financing needs and its payment obligations are met at the lowest possible cost and in a risk-averse manner. These alternatives may include unconditional debt relief, rescheduling debt servicing, primary debt issues, secondary market operations, depository facilities, and clearing and settlement arrangements for trade in government securities.

Some of the main risks of a debt-for-environment swap, that a debtor country’s government may be concerned about, are listed in Box 3 below. These risks are discussed in more detail further on in this chapter.

**Box 3. Main Risks of Debt-for-Environment Swaps**

The main risks of debt-for-environment swaps include:

- Inflationary impact;
- Credit rating downgrade;
- Distorting more efficient debt treatment operations (restructuring and relief);
- Inefficient public expenditures;
- Fiscal crisis;
- Reducing regular domestic environmental expenditures; and
- Mismanagement of funds.

Debt swap is one form of partial debt relief through which creditors can recuperate a portion of the economic value of their loans by attaching consideration to debt relief. Hence, for creditors, debt swaps are usually more attractive than unconditional cancellation of debt. For Georgia, however, unconditional debt relief is always better than swaps with some “strings” attached. Avoided debt service payments could be used by Georgia for any priority purposes, including environment, if the country chooses to do so. Hence, Georgia, as any rational debtor, might hesitate to negotiate a swap, as long as there is an opportunity for an unconditional debt reduction or generous rescheduling of payments.

Georgia and other poor countries of the former Soviet Union may not want to rule out the possibility of debt restructuring operations in the future. Therefore, it is important to ensure that swapping debt for environment will not limit future opportunities of debt relief or rescheduling.
Box 4. Fiscal Capacity to Service Debt Swaps

Debt-for-environment swaps involve contractual obligations to pay. Georgia would have to demonstrate a credible fiscal capacity to fulfil these obligations and service debt swaps. This would require legal, institutional and political guarantees that the appropriate allocations will be included in the future state budgets and that these allocations will be used for agreed purposes. The country would also have to convince creditors that it will consistently implement economic reforms and strengthen the fiscal position of the public sector.

2.1. Debt Swaps and Debt Rescheduling

Following the 2001 restructuring package, Georgia was technically not in default on its official debt and was servicing its obligations until 2003. However, the fiscal position of the country remained fragile, especially until the “Rose Revolution” at the end of 2003. That is why, in the spring of 2004, Georgia approached the Paris Club and agreed to a further debt restructuring in July 2004. The clause allowing additional debt swaps was again requested by the Georgian government and included in the agreement with the Paris Club. During the discussion with the OECD project team in the spring of 2004, the Ministry of Finance expressed concerns about requesting swaps of debt that can be rescheduled under possible future debt treatment operations agreed with Paris Club creditors.

If the debt swap agreement involves a one-off swap of the stock of debt, a conflict is indeed likely. This risk can, however, be mitigated by designing the transaction so that it swaps not a percentage of the stock of the net present value of the debt but a percentage of the flow of future debt repayments. This model of a debt-for-environment swap transaction was successfully applied in Poland. Such a transaction would simply split any future instalments of debt service payments into two parallel flows – one, in the original loan currency, to the creditor, and another, in local currency, to domestic environmental projects. This operation would leave the outstanding debt stock unaffected, and would not create financial or legal barriers to future opportunities for debt rescheduling or relief.

Box 5. Debt-for-Environment Swaps and the Risk of Inflation

Although rare, debt-for-environment swaps can have an inflationary impact, if the size of the swaps is large compared to the debtor country’s economy and the funds are disbursed too quickly in a short period of time. This is so because in the traditional debt-for nature swap model, a flow of future annual debt repayments in foreign currency is converted into a one-year expenditure in local currency equal to a sum (stock) of discounted present values of future repayments. Inflationary risks can be mitigated by:

- Keeping the swaps small in comparison to money supply in the national economy;
- Issuing long-term bonds so as to spread the period of disbursement (see discussion in Section 3.1); and
- Designing the transaction as a flow of annual debt service swaps instead of a one-time swap of debt stock (see Section 3.1).

Possible future debt rescheduling or relief would decrease the flow of money for environment from the swapped credits. Because of that, even structuring the swap as a percentage of future debt service flows could concern some creditors who highly value environmental goods and services "purchased" through swaps. They might also be concerned about transactional costs of multiple operations on the same credit.

Thus, some future debt rescheduling or relief might be hindered, if a debt swap is already in place against a particular credit. This possibility should be very carefully considered by the Georgian government when
proposing a debt-for-environment swap to its creditors. A DFES can bring important fiscal relief only if it is identified as a percentage of long-term flow debt rescheduling from a particular creditor. It is recommended that discussions on debt-for-environment swaps be fully integrated into strategic negotiations on long-term approaches to debt treatment.

2.2. Debt Swaps and Debt Relief

All arguments related to linkages between debt swaps and rescheduling hold with respect to debt relief. There are a few additional nuances, however. While Georgia can reasonably expect some rescheduling of its external debt in the future, it probably cannot count on many opportunities for unconditional debt cancellations. Notwithstanding the difficulties that Georgia is having at present, it is not the poorest nation in the world and there are prospects for development in a predictable future. It is the ambition of the Georgian government – and of the Georgian people, who are very entrepreneurial – to continue growth, attract investment and re-establish its international credit rating. Georgia is not eligible for the Highly Indebted Poor Countries (HIPC) initiative, which is valid for the lowest income and the most heavily-indebted countries in the world. For these reasons, in Georgia, opportunities for debt forgiveness are likely to arise only under exceptional conditions, and only once in a very long period of time. Credible commitment to economic and fiscal reforms remains an important, necessary condition for convincing creditors to give Georgia preferential debt treatment.

Box 6. Debt-for-Environment Swap and Unconditional Debt Relief: the Case of Poland

Before 1991, the Polish government was negotiating with the Paris Club an extensive package for rescheduling its post-communist debt. The rescheduling package included up to 50% of debt relief offered by most creditors to Poland, with the recognition of the pioneering role that Poland was playing in driving radical market and democratic reforms in the post-communist block of Eastern Europe. It was obvious to all parties that this was a unique opportunity for unconditional debt relief. The debt-for-environment swap initiative was carefully prepared in parallel to these negotiations, but launched only after the extent of negotiated rescheduling and unconditional debt reduction was perceived as final. As a result, Paris Club creditors agreed to create an opportunity for additional bilateral debt swaps of up to 10% of the value of the remaining debt. The US used this opportunity almost immediately, agreeing to swap the allowed maximum, that is, 10% of its debt. In order to avoid fiscal bottlenecks, the transaction did not include a one-off swap of the entire debt stock. Instead, the Polish government promised to transfer every year an agreed percentage of the debt repayments due – in national currency – to a local financing facility, the EcoFund, which was established to manage project pipelines. Over the years, the EcoFund has facilitated five additional swaps from other creditors, each on slightly different terms. Altogether, the Polish DFES scheme has generated an unprecedented amount of over half a billion USD – more than all other debt-for-environment and debt-for-nature swaps in the world taken together. Due to its outstanding performance and very attractive expenditure programmes, the EcoFund has also attracted additional multimillion donor grants for environmental purposes.

The Polish example shows the importance of a clear and credible commitment to economic and governance reforms in gaining the interest and trust of creditors. It shows how the concerted efforts of the whole government and a smart negotiation strategy, combined with a very attractive expenditure programme, well-designed transaction and sound DFES financial facility, can bring spectacular results. The lessons from the successful Polish experience are very relevant for Georgia and other countries of the former Soviet Union.

In the case of Georgia, an opportunity for some debt relief may actually arise in the near future in the context of the so-called CIS-7 initiative, i.e. the International Initiative to Promote Poverty Reduction,

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Growth and Debt Sustainability in Low-Income CIS Countries.\textsuperscript{16} The major reason why some creditors have launched this initiative is to give the poorest debtors from the former Soviet Union immediate debt relief to boost their emerging market economies in a way that will allow them to pay their remaining debts in the future. This will most likely be the “first-and-last-chance” initiative. Otherwise, the creditors would create incentives for Georgia and other former Soviet Union countries to resume uncontrolled borrowing, with the expectation that once their debt stocks become unsustainable again, their debt would be forgiven once more in the future. In economics, this situation is known as a “moral hazard problem” and creditors always try to avoid it.

It is important that the DFES scheme be well prepared in parallel to negotiations of the unconditional debt reduction and be put on the table immediately after the unconditional relief agreement has been reached. Missing this chance could decrease the probability of swaps in the future because after the debt relief agreement has been concluded, creditors may be very reluctant to open new negotiations on debt issues.

Debt-for-environment swaps need to be well integrated into the Georgian government strategy for the CIS-7 initiative. If proposed, the DFES should be clearly additional to any unconditional debt relief that may be expected under this initiative. The CIS-7 initiative has not been clearly formulated yet. However, it is likely that the debt relief options proposed in its framework will include some other conditions. In this case, a debt-for-environment swap could be considered as one of the options within the CIS-7 initiative.

\begin{center}
\textbf{Box 7. Debt Swaps and Sovereign Credit Rating}
\end{center}

If the Ministry of Environment raises the issue of a debt swap internationally without proper consultations within the government, the Ministry of Finance may have cause for concern. If government officials in a debtor country launch a debate on a debt swap, the international financial markets can interpret it as a signal of a possible debt default. As a result, the credit rating of the debtor country may be affected, increasing the cost of future borrowing on international markets. In Georgia, the Ministry of Environment is acting very carefully. Moreover, provisions for debt swaps were integrated into a wider debt restructuring package in 2004, which was agreed with Paris Club creditors. This agreement contains a clause that enables further bilateral debt swaps. Therefore, pursuing debt swaps in Georgia should not adversely affect its sovereign credit rating.

\textsuperscript{16} The initiative covers Armenia, Azerbaijan, Georgia, Kyrgyz Republic, Moldova, Tajikistan and Uzbekistan, for details see: http://lnweb18.worldbank.org/eca/eca.nsf/General/F269F5FA7017062F85256B810078CE70?OpenDocument
3. SWAPPING DEBT FOR MULTIPLE PURPOSES: ENVIRONMENT AND DEVELOPMENT

The 2004 agreement with Paris Club creditors on restructuring the Georgian external debt provided the opportunity for each creditor to undertake bilateral and voluntary debt swaps for many different targets, including nature, aid, and equity or other local currency swaps. From this menu, Georgia can choose some or all options in different combinations. This entails the non-trivial dilemma of establishing priorities for possible swaps and designing an optimal "win-win" package of debt swaps, taking into account what creditors would be most willing to accept and what would be most appropriate for Georgia. In this chapter, each option is briefly reviewed and discussed, and the advantages and disadvantages of different options are identified. In the end, a recommendation on the choice of the optimal debt swap package is proposed. In addition, Annex IV contains a more detailed framework for mixing debt-for-environment swaps with other debt swaps.

### Box 8. Different Targets for Debt Swaps

- **Debt-for-aid swap** is a transaction that converts external debt into a grant disbursed on official development assistance terms.
- **Debt-for-equity swap** is a transaction that converts external liability into ownership (by the creditor) of local assets. These assets most commonly include shares in local companies, but may also be natural resource stocks.
- **Debt-for-nature/environment swap** is a transaction that reduces external debt in exchange for the debtor country’s commitment to spend an equivalent amount, or an agreed portion of the reduced liabilities, at home, in local currency and on agreed conditions, to finance “brown” (pollution abatement, development of environmentally-related infrastructure) or “green” (nature conservation or preservation of biological diversity) environmental projects. Debt-for-environment swaps can (and should) be designed to also alleviate poverty and foster economic development.

3.1. Debt-for-Aid Swaps

Debt-for-aid swaps may be attractive for creditors as a transparent transaction and usually as a one-time only financial transfer. Managing related expenditure can be easily incorporated into an established programming framework of bilateral official development co-operation agreements. This gives creditors direct control over disbursement and enables partial recuperation of financial benefits through reduction of the baseline aid budget and through tied procurement (swapped debt used to purchase goods and services from the creditor/donor country).

Moreover, debt-for-aid swaps offer creditors an attractive opportunity for swapping debt without a significant additional flow of financial resources to the debtor country. Debt-for-aid often means financial transfers between various agencies within the creditor country government, i.e. outstanding receivables on foreign official loans are financed by decreasing, or not increasing, the foreign aid budget. Such swaps can
reduce the budget available for financing other official assistance programmes, and for this reason, can be more easily accepted by the creditor country government.

For the same reasons, Georgia may find debt-for-aid swaps less beneficial. From the Georgian perspective, the major question is the value added that such a transaction would provide compared to the aid-as-usual scenario. A legitimate expectation of Georgia would be that debt-for-aid should not substitute baseline official development assistance, but would mobilise "new" and "additional" resources. Unfortunately, such an expectation would most likely be difficult to meet if debt were swapped for aid. Even if it may not affect bilateral assistance that has already been committed, it is very likely that such a swap would influence the allocation of foreign assistance budgets in the future.

**Box 9. Dept-Swap and Aid**

As Zylicz notes, if a debt swap is a one-time transaction to free the debtor of some of its current debt service or of a portion of the stock of liabilities in exchange for a domestic environmental expenditure, then a direct subsidy from a bilateral official assistance programme to finance this expenditure is more efficient. Designing the swap transaction, however, to change the entire future flow of payments assists the debtor in a more permanent manner. Such a transaction cannot be easily substituted with an official assistance grant. From a creditor's point of view, such a deal may be perceived as an inflexible tool as it requires a long-term commitment. For the very same reason, from a debtor's point of view, a swap is a more convenient form of assistance, since it secures a more stable source of funding than aid packages, which typically have a much shorter time frame. Furthermore, a well-designed swap reduces transaction costs in the future – both for the first creditor and for all those who would be willing to follow later. The first swap can demonstrate the feasibility of the transaction and set up a predictable institutional framework, facilitating other potential transactions at a low cost. It also provides an opportunity for building sustainable local institutional capacity for appraising and managing portfolios of environmental projects. With traditional official assistance, projects are developed and managed by *ad hoc* teams of foreign consultants who come and go, and the involvement of local sub-contractors is usually marginal, mostly because of the short-term nature of contacts.


Debt-for-aid swaps could, in principle, be used for environment and development purposes. However, as described earlier, such a transaction usually is a one-time transfer, as opposed to extending the debt repayment flows over a longer period of time. The commitment periods of official assistance budgets are not longer than one to two years. Indicative programming may sometimes stretch up to three years, but not more. Because of its short term, the value of transactions cannot be very large. If a significant amount of future liabilities were swapped for domestic expenditure on aid over a maximum period of two to three years, this could create fiscal difficulties for the Georgian government and could distort its foreign exchange regime. A government can bypass this constraint by issuing bonds to raise the necessary amount of money up-front and smooth payments for the scheme over a longer period of time. Such an action would also “vaccinate” against potential distortions to monetary policy that could be caused by pumping large amounts of domestic currency into the economy in a short period of time. But it would involve the additional cost of bond issuance and servicing (which is very high for Georgian government bonds). It would also compromise its sovereign borrowing capacity, and so may not be a feasible option for Georgia in the short to medium term. As international experience shows, debt-for-environment swaps can be designed to mitigate these problems and to redirect much more resources to the local economy in a way that does not create macroeconomic distortions and does not affect the debtor’s creditworthiness. Moreover, the expenditure programme under the debt-for-environment swap can be made fully compatible with the objectives of official aid programmes. Environment and development goals are often synergistic.
3.2. Debt-for-Equity Swaps

The crucial difference between debt-for-equity and other debt swaps considered here is that under this scheme, the creditor can recapture more of its assets. It is therefore not surprising that 98-99% of all debt conversions worldwide have been swaps for equity. These swaps have been quite successful in solving some of the liquidity problems in a number of Latin American countries. They are often preferred by creditor governments as ad hoc measures to compensate their domestic financial institutions affected by the debt conversion. Some creditors also use this instrument to take over strategic assets in debtor countries, e.g. energy infrastructure or strategic industrial sectors. This is the preferred transaction of the Russian Federation to resolve the debt of the former Soviet Union countries accumulated to the Russian government or to energy companies controlled by the Russian government.

A debt-for-equity swap can be attractive to creditors on strictly financial terms, if the value of the swap is smaller or equal to the market value of the equity. The market value of the equity, in turn, is equal to the risk-adjusted present (discounted) value of the future flow, net of tax profits generated by the assets acquired through a swap.

Unlike foreign firms, which are interested exclusively in financial return, some creditor governments are interested in environmental and social benefits that cannot be captured in monetary terms by a private investor. In this case, a creditor government might be willing to accept a swap value that is larger than the market value of the equity. The difference would be the actual debt relief or the price that the foreign creditor government would pay for producing local social and environmental benefits in the debtor country, some of which are trans-boundary or global in nature. The market value of environmental assets must, however, be greater than zero. Otherwise no foreign firm would be willing to accept the assets, even free of charge.

However, swapping debt for assets that have a positive market value would not always be beneficial for Georgia. Selling assets on the market, through a competitive sale, is likely to yield more revenue than swapping these assets for debt reduction with a single creditor under a very limited competition. Unless the creditor buys assets through competitive bidding (a rather unlikely arrangement under the swap), the purchase price is likely to be lower than the market value (Zylicz, 1998). For these reasons, Georgia would benefit from swapping debt for assets that cannot find buyers otherwise, i.e. those whose market value is zero.

Another important consideration is that debt-for-equity swaps cannot contribute to capacity building in the debtor country as much as the more long-term and comprehensive approaches of the debt-for-development and debt-for-environment swaps discussed below.

A transaction beneficial to Georgia on economic grounds is unlikely to attract creditors’ interest, unless the assets in question yield some non-market services that have public goods character that a creditor government is interested in. Therefore, the optimum strategy for Georgia would be to sell on the market whatever has market, financial value, and swap the debt for the economic value of non-market services. These non-market services may include services provided by improved environmental assets (water, air, soil), such as the reduction of premature mortality and morbidity, flood protection or support of sustainable agricultural output. Annex IV includes a more detailed description of the possible synergies between debt-for-equity and debt-for-environment swaps.

18 Ibidem, pp. 38-42.
3.3. Debt-for-Environment Swaps

A debt-for-environment swap is one of very few mechanisms that, in low-income countries, can provide sustainable support for local economic development and, at the same time, mobilise domestic spending to protect purely public and common goods (such as biodiversity) or pure externalities (such as trans-boundary or global pollution). These basic goods and services that nature provides are the essential basis for subsistence, social welfare and sustainable growth of local communities. They are also common global assets that sustain life on earth and determine the future growth of the world economy, as recognised by numerous international environmental conventions and treaties. The tragedy of common goods, such as most services provided by pristine nature, is that they can yield only limited cash revenues to their owners or users. Therefore, they are bound to be depleted (many irreversibly) because of the inability of their owners and users to co-operate. This depletion is exacerbated by the immediate pressure of poverty and the need for cash (e.g. in order to service the foreign debt).

A debt-for-environment swap can be used to finance "green" public goods (nature reserves, sustainable tourism or sustainable agricultural practices) or to finance the abatement of industrial pollution externalities – the so-called “brown” projects (improving energy efficiency, reducing pollution from the power and district heating sector, or in selected industrial facilities). Debt-for-environment swaps can also be used to finance development of collective environmental infrastructure, such as wastewater collection and treatment systems, handling of accumulated toxic waste, etc. In particular, a DFES can facilitate development objectives by financing access for the poor to essential infrastructure services, such as water, sanitation and energy. Many services provided by this infrastructure can also yield trans-boundary or global benefits. Usually, in the absence of financial incentives, a low-income country cannot realistically be expected to finance the full costs of projects that partly benefit downstream or downwind countries. By the same token, the immediate and local needs of a low-income country usually crowd out projects that would generate returns that are global in nature, such as the prevention of climate change, and the protection of international waters or of biological diversity.

However, most of these projects would also yield important economic benefits to poor local communities, which depend on environmental goods and services for subsistence and sustainable growth. For example, treating the discharge of wastewater into the Black Sea from the coastal cities would not only prevent eutrophication of this sensitive international water reservoir but would also help bring tourists back to the currently polluted beaches. Harvesting local renewable energy sources, such as small rivers, geothermal waters, or biomass, would not only benefit the global climate, but would also provide access to cheap and sustainable energy for local communities that do not have access to or cannot afford electricity and heat produced from imported fossil fuels. Therefore, a debt-for-environment swap can be viewed as a mechanism that blends local and foreign financing to implement projects that support local economic development and poverty reduction, but that otherwise would not have been financed because of their public goods character, or because their benefits are shared by many countries. Swapping debt-for-environment and development at the same time offers more opportunities to link global environmental benefits with local economic development and poverty reduction strategies than the other debt swaps described above.

For Georgia, swapping debt for environment is an attractive option for a number of reasons:

- It provides new and additional local currency expenditure that does not replace other public spending.
- It can leverage additional local expenditure on environmental public goods that are highly important as foundations of the country’s sustainable development but are typically not as urgent as the immediate pressures to provide food and security to poor people, even if this undermines the long-term, sustainable basis for local food supply.
• It offers opportunities to integrate environmental quality improvement into poverty reduction, social well-being and economic recovery through protecting public health, creating new jobs and harvesting local resources and skills to generate sustainable revenues to local communities.

• It provides a unique opportunity for low-income countries, such as Georgia, to move towards the fulfilment of international environmental agreements (such as the Climate Convention, the Convention on Biological Diversity, and the Convention on Ozone Depleting Substances).

• It can contribute to the alleviation of regional and cross-border conflicts related to the management of trans-boundary natural resources (e.g. surface and underground waters, forests and wildlife).

• It is a practical and effective instrument for mainstreaming the environment in the social and economic growth agenda of the Georgian government. As the Polish experience has shown, by raising environmental issues at the debtor country's government forum, swap negotiations elevate the status of environmental departments and make them partners with financial and industrial agencies.\textsuperscript{19}

• If properly designed, a debt-for-environment swap can contribute to the improvement of the institutional capacity in the country to develop and implement result-oriented environmental programmes, to prepare projects and to manage public expenditure in a transparent, accountable and efficient manner.

• It provides an opportunity to swap larger volumes of debt. This may raise legitimate concerns that the swap may exert inflationary pressures because of the need to increase local currency expenditure. However, the current inflationary pressure can be mitigated by the design of the swap transaction. Instead of a one-time swap of a certain portion of the present face value of the debt, the swap can be extended over time by agreeing to divert each year in the future period, an agreed portion of the debt service when payments are due.

\textit{For creditors}, a debt-for-environment swap has a number of attractive aspects:

• For creditors affected by pollution generated in the debtor country, it can bring direct benefits by eliminating the source of environmental damage. In the case of Georgia, the only creditors that would obtain direct environmental benefits from a DFES with Georgia are the Black Sea countries (i.e. Turkey and Russia).

• For creditors using the same common resource stock, a debt-for-environment swap can provide an opportunity to reduce the over-consumption of this stock by the debtor country. Again, this benefit could be important mainly in the Black Sea region, in so far as Georgia contributes to the unsustainable harvesting of the fish stock or other marine resources.

• For creditors concerned with global environmental problems (climate change, seas and oceans, biological diversity, depletion of ozone layer, etc.), it offers an opportunity to "purchase" global environmental benefits more cheaply than at home. This benefit is proportional to the scale of potential global benefits that can be produced in Georgia (e.g. the potential reduction of emissions of greenhouse gases or ozone depleting substances, the size of potential carbon sinks, and the size and diversity of endemic natural ecosystems).

• For creditors concerned with international security, a debt-for-environment swap offers an opportunity to foster cross-border co-operation and confidence between (potentially) antagonistic countries. Such measures may include protecting common natural biological resources, e.g. nature reserves, endangered species or lakes. A debt-for-environment swap can also help to eliminate sources of international conflict by improving the management of water resources in trans-national rivers or by reducing pollution loads that affect the quality of life in neighbouring countries. These benefits may be significant for several creditors since the Caucasus is still often perceived as an unstable region.

• For creditors concerned with poverty reduction, a debt-for-environment swap offers plenty of win-win opportunities to reduce poverty while enhancing environmental sustainability. In low-income countries, like Georgia, a large share of the population depends heavily on natural ecosystems for daily subsistence.

\textsuperscript{19} Zylicz, Tomasz (1998).
Sustainable management of natural resources, such as water, soil, forests or coastal areas, can provide a solid and sustainable source of food, energy and income to many local communities.

- A debt-for-environment swap may also have a positive effect on a creditor country’s environmental and political image in light of increasing political promotion of debt forgiveness to the poorest countries (e.g. the CIS-7 initiative) and global co-operation for environmental protection.

**RECOMMENDATION:** Debt-for-environment swaps have a number of advantages over alternatives, such as debt-for-aid and debt-for-equity swaps. DFES can more easily generate new and additional resources for Georgia, and would not replace revenue from the sale of assets that have market value. DFES can be designed as effective swaps for poverty eradication and sustainable development. This can be done by developing an expenditure programme that addresses international and global common goods issues, while reducing local poverty, improving regional security, enhancing infrastructure for the poor and strengthening the environmental foundations of sustainable development. Therefore, it is recommended that Georgia pursue a comprehensive DEBT-FOR-ENVIRONMENT SWAP SCHEME to take advantage of the synergies that exist between environmental and development objectives.
4. EXTERNAL PUBLIC DEBT PROFILE OF GEORGIA

Most of Georgia’s foreign debt is official – borrowed from foreign governments or from state institutions with sovereign guarantees. Thus, in this chapter we do not discuss debt owed to private creditors in detail. Swapping private debt can always be negotiated on commercial terms with any single creditor.

By 30 September 2005, Georgia’s official outstanding foreign debt, including government guaranteed loans, amounted to the equivalent of USD 1 750 522 941. Table 2 shows the volume and the structure of Georgian debt owed to public creditors as of end September 2005.

<table>
<thead>
<tr>
<th>Creditors</th>
<th>Outstanding Loan (USD)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>88 379 407</td>
</tr>
<tr>
<td>US</td>
<td>39 330 514</td>
</tr>
<tr>
<td>Germany (KfW)20</td>
<td>105 961 111</td>
</tr>
<tr>
<td>EU</td>
<td>102 981 330</td>
</tr>
<tr>
<td>Japan (JBIC)</td>
<td>41 124 300</td>
</tr>
<tr>
<td>Turkey</td>
<td>52 425 726</td>
</tr>
<tr>
<td>Netherlands</td>
<td>921 412</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>154 245 878</td>
</tr>
<tr>
<td>OECD Subtotal</td>
<td>328 142 470</td>
</tr>
<tr>
<td>Paris Club Subtotal</td>
<td>429 962 622</td>
</tr>
<tr>
<td>Paris Club without Japan</td>
<td>388 838 322</td>
</tr>
<tr>
<td>Kuwait</td>
<td>14 649 263</td>
</tr>
<tr>
<td>China</td>
<td>2 953 644</td>
</tr>
<tr>
<td>Iran</td>
<td>12 438 632</td>
</tr>
<tr>
<td>Armenia</td>
<td>19 789 714</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>16 172 088</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>27 774 000</td>
</tr>
<tr>
<td>Turkmenistan</td>
<td>123 381 725</td>
</tr>
<tr>
<td>Ukraine</td>
<td>364 035</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>448 736</td>
</tr>
<tr>
<td>EECCA subtotal (including Russia)</td>
<td>342 176 176</td>
</tr>
<tr>
<td>Multilateral loans (IDA, IFAD, IMF, EBRD)</td>
<td>947 181 426</td>
</tr>
<tr>
<td>Total Official External Debt</td>
<td>1 750 522 941</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance of Georgia.

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20 Including the government guaranteed loans in the amount of USD 55 046 020.
4.1. Public Debt Owed to Multilateral Creditors

The largest creditors of Georgia are multilateral institutions. By 30 September 2005, Georgia’s official outstanding debt to international financing institutions (IFI) – including the World Bank, the International Monetary Fund (IMF), the International Fund for Agriculture and Development (IFAD) and the European Bank for Reconstruction and Development (EBRD) – was USD 947,181,426. International financing institutions cannot make debt swaps with client countries because of their mandate and the need to maintain the highest credit rating. Multilateral debt is not available for conversion, just as it is exempt from cancellation. This does not mean though that IFIs are against conversion of other creditors’ debt. The World Bank has facilitated several bilateral debt-for-environment swaps (e.g. in Bulgaria). The World Bank’s soft loan window – the International Development Association (IDA) – has even provided considerable amounts for debt buy-backs, which sometimes have been associated with debt-for-equity swaps. Sometimes World Bank staff have expressed interest in using adjustment lending instruments for financing debt-for-environment swaps (USAID, 1998). Possibly, in the future, a multilateral debt relief facility will be used to convert the claims of multilateral institutions into local currency funds, as has sometimes been discussed, albeit only theoretically so far. (Kaiser J. and A. Lambert, 1996). However, Georgia’s official debt to IFIs cannot be considered as a candidate for debt-for-environment swaps.

4.2. Public Debt Owed to Bilateral Creditors

As of 30 September 2005, Georgia’s debt to EECCA countries (including Armenia, Azerbaijan, Kazakhstan, the Russian Federation, Turkmenistan, Ukraine, and Uzbekistan) was USD 342,176,176. Debt owed to non-EECCA countries amounted to USD 461,165,339 (including Austria, China, Germany, Iran, Japan, Kuwait, the Netherlands, Turkey, the EU and the US). Bilateral debt to Paris Club countries (including Austria, Germany, Japan, the Netherlands, the Russian Federation, and the US) amounted to USD 429,962,622, and USD 328,142,470 was owed to OECD countries. Without Japan, Paris Club countries have accumulated USD 388,838,322 of Georgian debt.

Creditor governments generally require a country to commit to repay the reminder of the debt. Very often creditor governments use debt-for-environment swaps as part of larger debt reduction and political reform packages. Thus, political will in the debtor country is an important prerequisite for creditor governments’ interest in debt-for-environment swap transactions. A DFES has to strike a balance between the priorities of both the debtor and the creditor(s).

It is unlikely that EECCA creditors will be willing to forgive Georgia’s debt bilaterally in exchange for environmental improvements. Most of these countries themselves suffer from poor economic development and debt repayment problems to other countries. Moreover, EECCA countries, except for Armenia, Azerbaijan and Russia (neighbouring countries), are less likely to be interested in environmental improvements on the territory of Georgia. A decade ago, Armenia might have had some interest in transboundary air pollution reduction in Georgia but at this moment, due to the reduction of industrial activities in Georgia, this is not a priority issue for Armenia, which is one of the world’s poorest countries itself. Located downstream of the Kura (Mtkvari) river, Azerbaijan is concerned by river pollution reduction in Georgia. However, this is an issue of long-term negotiations between these countries, and it would not be realistic to consider a debt-for-environment swap between Georgia and Azerbaijan as a priority at present. The Russian Federation is a special case, as it may be interested in some kind of swap. This issue will be briefly discussed in the next section.

Non-EECCA countries, which do not belong to the Paris Club (e.g. China and Iran), have no transboundary environmental interests in Georgia. It is also unlikely that their concern with global environmental common goods would be a sufficient reason for them to engage in a DFES with Georgia.
The greatest immediate potential for Georgia to negotiate a debt-for-environment swap is with the Paris Club countries that are members of OECD (including Turkey). These countries agreed in March 2001, and then in July 2004, to include a clause in the overall debt restructuring agreements that would allow for debt-for-environment swaps with Georgia on a "voluntary and bilateral basis". Although most of these OECD countries have no direct trans-boundary environmental concerns in Georgia, they typically have interest in protecting global environmental public goods, poverty alleviation and regional security in the Caucasus.

Box 10. What is the Paris Club?

Founded in 1956, the Paris Club is an informal group of creditor governments, which includes mainly the major industrialised OECD countries, as well as the Russian Federation. It meets on a monthly basis in Paris with debtor countries in order to discuss and agree on terms for restructuring their debts. Save rare exceptions, a debtor country can discuss bilateral swaps for environment only if the framework restructuring agreement with the Paris Club contains a debt swap clause. Such a clause enables creditor countries to undertake additional debt swaps on a bilateral and voluntary basis, including debt-for-environment swaps. These restrictions apply in order to preserve comparability of treatment and solidarity among creditors. The amounts of debt swaps that can be obtained are capped at a certain percentage of the claims of individual creditors.

The terms under which debt swaps can take place are contained in the standard “Terms of Treatment”, which can be studied at the Paris Club website. To ensure full transparency, debtors and creditors submit a report to the Paris Club Secretariat containing details of any transactions that is undertaken.

The members of the Paris Club that participated in the reorganisation of the Georgian debt in July 2004 included representatives of the governments of Austria, Germany, Japan, the Netherlands, the Russian Federation, and the United States. Turkey, a major creditor of Georgia, also participated in the debt rescheduling. Observers at the meeting included representatives of the governments of Canada, France, Italy and the United Kingdom. The International Monetary Fund, the International Bank for Reconstruction and Development, the European Bank for Reconstruction and Development, the Secretariat of the UNCTAD, the Organisation for Economic Co-operation and Development and the European Commission also took part.

4.3. Setting Priorities for Negotiations of Bilateral Swaps

Not all creditors are likely to agree on the swap at the same time and under the same conditions. Many are more likely to come to the negotiation table once Georgia has opened a "debt swap window" and once first transactions are shown to be successful and not risky. Therefore, it is important to arrange the first swap relatively quickly and generate a critical mass of revenues so that an institutional infrastructure can be established to facilitate and accommodate further swap transactions. For bilateral negotiations, Georgia will need to target the most willing creditors/donors first. The following factors are likely to affect creditors’ willingness to engage in bilateral debt swaps with Georgia:

- Exposure to direct or indirect environmental spill-over effects originating in Georgia;
- The prior existence of an official debt swap programme or prior experience with bilateral debt swaps with other debtors;

21 www.clubdeparis.org
22 Turkey is not a permanent member of the Paris Club, but is invited as a creditor of Georgia.
Commitment to the protection of global environmental common goods and to poverty alleviation worldwide;
Expressed interest in regional security and economic development in the Caucasus; and
Prior commitments to bilateral assistance for Georgia expressed as large assistance programmes, in particular in the environment sector.

4.4. Profiles of Selected Creditor Countries

**US:** The US has extensive experience with debt-for-nature swaps worldwide, and has a large assistance programme for Georgia (including environment). Hence, the US is naturally the primary target for negotiations. The US was also the first country to swap, unconditionally, a full ceiling of debt-for-environment in Poland.

**Austria:** Austria is a good candidate due to the interest it expresses in global common goods, in particular in climate change. It is also active in the eradication of global poverty.

**Germany:** Germany is usually only willing to consider debt swaps (debt sales, debt-for-environment, poverty reduction and education) for countries that have a swap clause in their Paris Club agreement (USAID, 1998). Therefore, with regard to Germany, Georgia should in principle be eligible for a debt-for-environment swap.

**EU:** The European Union is a good candidate due to its interest in regional security in the Caucasus, environmental issues in the Black Sea, global common goods and promoting access to safe water for poor people worldwide. However, the eligibility of the EU to swap debt for environment needs to be checked. The legal structure of the loan agreement with Georgia is the same as for bilateral debt, which would make it eligible for a swap. However, the European Commission tends to present its debt as multilateral, which is not swappable.

**Japan:** Because of legal restrictions, the Government of Japan is not prepared to write-off developing country debt. Instead, Japan prefers to provide long-term rescheduling terms and new money for debt servicing through Trade and Development Board grants, which are estimated to have effects similar to debt write-offs. Thus, Japan would probably be unable to swap Georgia’s debt on the condition that it would involve a write-off of debt (e.g. redemption would have to be at 100%). At present, debt-for-environment swaps are not considered a priority for Japanese policy makers (Ministry of Finance). High-level political support would be necessary in order for Japan to participate in a DFES with Georgia. The "US-Japan Common Agenda for Cooperation in Global Perspective" provides a forum for exploring innovative partnerships that the US and Japan can undertake together through collaboration in both the public and private sectors. In collaboration with the US government, American conservation organisations are exploring how the Common Agenda can provide a framework for US-Japan co-operation relative to debt-for-nature and development swaps (USAID, 1998).

**Russian Federation:** As a creditor of the former Soviet Union countries, the Russian Federation has so far typically preferred swapping debt for equity, mainly in energy infrastructure, resource extraction and industry. Although Russia and Georgia share a long border and common access to the Black Sea, Russia has so far not expressed a clear commitment to environmental issues, neither at home nor globally. These factors make Russia an unlikely candidate for debt-for-environment swaps. However, as a debtor, Russia has been trying to convince creditors to swap its debt for environmental protection. For example, there have been negotiations between Russia and Finland to swap USD 50 million of Russian debt for environmental projects that reduce cross-border pollution. Thus, Russia may be interested in a multilateral debt swap scheme, through which it
would swap Georgia’s debt for environment in Georgia in exchange for creditors swapping Russia’s debt for the Russian environment.

**Turkey:** As neighbours, Georgia and Turkey have problems with trans-boundary water courses, such as the Kura River and the Black Sea. Since Turkey is located upstream on the Kura River, it would probably not be in Turkey’s national interest to swap its loan to Georgia for improvements in Kura River quality. Black Sea protection is more likely to interest Turkey. Both Georgia and Turkey are parties to the Black Sea Convention, which was signed in 1992 and entered into force in 1994. However, Turkey itself is seeking external funds for solving its own problems related to Black Sea protection. If Turkey negotiates any debt swap with Georgia at all, other conditions will most likely be added to the environment, such as fostering trade and economic co-operation between the two countries.

The most recent information on the status of negotiations between Georgia and its individual creditors is provided in Annex X.
5. REVENUES FORECAST

The size of the financial envelope that could be obtained from potential debt-for-environment swaps is crucial in developing a credible and realistic expenditure programme and in choosing the optimal institutional arrangement to manage swap resources. The focus of this chapter is on forecasting the revenue that can be generated through debt-for-environment swaps in Georgia. The forecasting is modelled on the Polish system. Different scenarios, with the participation of various potential creditors, have been developed and are presented here for consideration by the Georgian government. In addition, this chapter examines two major options for scheduling revenue flows and makes a recommendation on the best choice.

5.1. Scheduling Revenue Flows

Two major options for scheduling revenue flows from debt-for-environment swaps can be incorporated into the initial transaction with a creditor, or with a third party. These are:

- **A one-time swap** of an agreed amount of the present value of debt; and
- **Swap-as-you-repay annually** over an agreed period of time.

Through a one-time swap transaction, a creditor agrees to write off a portion of an outstanding debt owed by Georgia. The present value of all future repayments of this cancelled debt would be converted into local currency. This sum of Georgian Lari would be the basis for negotiations of the amount of money that the Government of Georgia would need to transfer up-front to the financial facility managing the DFES or to pay the recurrent or capital costs of specific projects. Such a transaction has often been used in developing countries to swap debt for nature protection purposes. The assets in local currency are then transferred to a trust fund and used to finance projects either from the net income or from the entire principal.

As mentioned earlier, the amount of debt to be swapped through a one-time transaction may be constrained by the liquidity limits of the debtor country, which may find it difficult to set aside a large amount of money in one instalment. In a richer country, the government would issue a bond to by-pass this problem. The Georgian government would need to evaluate how realistic this option could be in a DFES.

Through a swap-as-you-repay transaction, a creditor agrees on the percentage of the future debt service that would be diverted each year to domestic expenditures over an agreed period of time (e.g. until the year 2020). These expenditures could be transferred either to the financial facility managing the debt-for-environment swap, or used to pay for specific projects.

In the case of transferring swap resources to a special financial facility, the domestic expenditures, eligible for reimbursement from the debt swap scheme, would be subtracted once or twice a year from a special escrow account with the bank where the Georgian government services its external debt, or with a selected commercial bank. The exact cycle of transfers would need to be adjusted to the project cycle of the financial facility. Once or twice a year, financing contracts would be signed between a group of beneficiaries and the financial facility that manages the DFES scheme and that represents the government. The facility invoices the Ministry of Finance for the amount on accounts payable. The amount invoiced –
instead of being transferred to creditors’ accounts – flows back to Georgia to credit the account of the DFES financial facility, which then is able to reimburse successful project applicants (or directly their suppliers and contractors who implement the projects).

Some stakeholders may be concerned that channelling money through a financial facility is too risky. Indeed, Georgia has earned a reputation for mismanagement of public funds and corruption. If these concerns are constraints for the debt-for-environment swap, then the transaction can be designed so that the local financial facility does not physically transfer money. Its role could be reduced to managing the full project cycle, except for the financing. Having appraised and selected the portfolio of projects for financing in a given year, the facility could forward the ranked list of projects and documentation to the Ministry of Finance. After checking eligibility and making a final decision, the grant agreement could then be signed between beneficiaries and the Ministry of Finance or a designated bank. Invoices could be transferred through the DFES facility, but actual payments could be made by direct transfers from the Bank of International Settlements to beneficiaries or their contractors. Follow-up project monitoring could be done by the DFES facility. Such an arrangement solves one problem but creates other difficulties. It increases the transaction costs for both the Georgian government and beneficiaries. It also dissipates responsibilities for project selection.  

**RECOMMENDATION:** The swap-as-you-repay scheme should be the first best choice, as it would allow for the development of a more long-term project pipeline. It could also generate a critical mass of resources to finance the rehabilitation of some fixed assets without distorting the fiscal and monetary policy of the country.

### 5.2. Forecasting Revenue Generated by Debt-for-Environment Swaps in Georgia

In making a revenue forecast, we have assumed that the whole future flow of debt repayments would be diverted to the DFES scheme (modelled after the well-functioning Polish system). Taking into account the existing experience with bilateral DFES between the Paris Club and debtor countries, probably not more than 15-25% of the debt can realistically be expected to be reduced through the swap mechanism.  

Using alternative scenarios of creditor participation, Table 3 below presents estimates of revenues that potentially could be obtained through a DFES with Georgia, assuming a 15% swap rate on all repayments of ODA loans until the year 2023. For non-ODA loans, a ceiling of 5 million SDR for the total of each country has been assumed.  

The annual percentage of debt swapped is assumed as constant during the lifetime of the loan, and the first swap is assumed to take place in 2006.

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24 The Russian National Pollution Abatement Facility (NPAF), designed in the 1990s along these lines and funded by a World Bank loan, was unable to disburse available resources. Although the NPAF offered loans, the grants were not necessarily easier to disburse because of a high co-financing rate required from beneficiaries.

25 The US, Swiss and Norwegian governments agreed to convert for the Polish EcoFund 10% of the debt Poland owed them, and Sweden converted 4%. Italy 2% and France 1%. Bulgaria made a swap with Switzerland, reducing its debt by 23% ($Swiss Francs 20 million).

26 Approximately USD 7.1 million.
Table 3. Annual Revenue Flows from a DFES Scheme in Georgia under Alternative Scenarios of Creditors’ Participation (1 000 Euro, 2005 Prices)

<table>
<thead>
<tr>
<th></th>
<th>US</th>
<th>Germany</th>
<th>EU</th>
<th>Austria</th>
<th>Austria, USA, Germany, EU</th>
<th>Austria, US, Germany, EU, Turkey</th>
<th>Austria, US, Germany, EU, Turkey, Russia</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>42.54</td>
<td>137.13</td>
<td>1 107.93</td>
<td>60.41</td>
<td>1 348.00</td>
<td>2 048.64</td>
<td>2 385.84</td>
</tr>
<tr>
<td>2007</td>
<td>305.46</td>
<td>218.95</td>
<td>94.39</td>
<td>969.03</td>
<td>1 587.84</td>
<td>2 248.61</td>
<td>3 125.56</td>
</tr>
<tr>
<td>2008</td>
<td>302.00</td>
<td>425.26</td>
<td>94.65</td>
<td>730.09</td>
<td>1 552.01</td>
<td>2 195.01</td>
<td>2 377.50</td>
</tr>
<tr>
<td>2009</td>
<td>297.52</td>
<td>571.58</td>
<td>989.53</td>
<td>761.77</td>
<td>2 620.40</td>
<td>3 244.94</td>
<td>3 432.15</td>
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<tr>
<td>2010</td>
<td>293.16</td>
<td>608.20</td>
<td>970.66</td>
<td>791.84</td>
<td>2 663.87</td>
<td>3 270.46</td>
<td>3 463.17</td>
</tr>
<tr>
<td>2011</td>
<td>288.55</td>
<td>637.68</td>
<td>951.75</td>
<td>496.11</td>
<td>2 374.09</td>
<td>2 793.47</td>
<td>3 088.11</td>
</tr>
<tr>
<td>2012</td>
<td>294.19</td>
<td>666.52</td>
<td>932.92</td>
<td>520.29</td>
<td>2 413.92</td>
<td>2 586.38</td>
<td>2 899.27</td>
</tr>
<tr>
<td>2013</td>
<td>289.70</td>
<td>672.57</td>
<td>914.01</td>
<td>138.31</td>
<td>2 014.60</td>
<td>2 192.50</td>
<td>2 504.31</td>
</tr>
<tr>
<td>2014</td>
<td>285.09</td>
<td>844.66</td>
<td>0.00</td>
<td>142.97</td>
<td>1 272.73</td>
<td>1 457.01</td>
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<td>1 318.60</td>
<td>1 509.36</td>
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<td>1 413.83</td>
<td>1 611.14</td>
<td>1 954.65</td>
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<td>367.48</td>
<td>897.54</td>
<td>0.00</td>
<td>156.90</td>
<td>1 421.92</td>
<td>1 626.56</td>
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<td>2018</td>
<td>361.45</td>
<td>892.33</td>
<td>0.00</td>
<td>180.81</td>
<td>1 434.60</td>
<td>1 647.09</td>
<td>2 014.93</td>
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<td>885.96</td>
<td>0.00</td>
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<td>1 632.28</td>
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<td>880.20</td>
<td>0.00</td>
<td>176.57</td>
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<td>149.24</td>
<td>1 334.22</td>
<td>1 519.19</td>
<td>1 756.36</td>
</tr>
</tbody>
</table>

Source: Estimates based on data provided by the Georgian Ministry of Finance, using the simulation model developed by COWI Hungary.27

Notes: Assuming a 15% swap rate on all repayments of ODA loans until the year 2023. For non-ODA loans, a ceiling of 5 million SDR (USD 7.1 million) for the total of each country has been assumed. The annual percentage of the debt swapped is assumed as constant during the life of the loan. Figures include all government guaranteed debt.

Certainly, not all creditors are likely to agree on the swap. Those who do will probably make swap transactions in different periods of time and under different conditions (e.g. for a different percentage of the debt). Therefore, the possible revenue scenarios range from optimistic assumptions that all Paris Club creditors (including Russia) would agree on the swap, to the more pessimistic assumption that only a few would agree (e.g. only the US, Austria and Germany, individually).

Following the conditions of the 2004 Paris Club agreement, there are no limits to swap ODA loans, while non-ODA loans are capped at a maximum of 5 million special drawing rights (SDR) per country.28 Assuming a 15% swap of ODA loans (except for Japan, which may have legal constraints to participate in such a scheme) and reaching the ceiling for all non-ODA loans, Georgia could expect over Euro 3.4 mln (in 2005 prices) of annual revenue by 2009, decreasing to almost Euro 1.8 mln by 2014 and then climbing back up to about Euro 2 mln by 2020. On the assumption that only Austria, Germany, the EU and the US agreed to enter the swap, the annual revenue would reach Euro 2.6 mln in 2009, then decrease steadily to almost Euro 1.3 mln in 2014, and fluctuate between Euro 1.3-1.4 mln thereafter.

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27 Support by the EU TACIS NEAP-2 project for collecting data and developing the simulation model is gratefully acknowledged.

28 The SDR serves as the accounting unit of the IMF and some other international organisations. Its value is based on a basket of key international currencies. In October 2005 1 SDR = 0.704 USD.
In these two scenarios, total expected revenues from the debt-for-environment swap over the period 2005-2023 might be Euro 42 or Euro 30 mln, respectively. In net present value terms (at a 12% discount rate), this would represent Euro 18.7 or Euro 12.9 mln, respectively. While these figures may not seem large in absolute terms, they should be contrasted with the approximately Euro 5.3 mln of environmentally-related investment expenditure in Georgia in 2001. In the optimistic scenario outlined above, the revenues from a debt-for-environment swap would, in 2006, amount to 45% of the 2001 environmentally-related investment levels. For the scenario in which only Austria, USA, Germany and the EU entered the swap, this figure would be 25%.

This cash flow would probably not be available immediately. The DFES scheme would probably be established – at least for the first one or two years – with a swap from one or a few pioneers. If Germany were a pioneer, this would boost the whole scheme significantly. However, in this case, the design of the scheme would need to be lighter and cheaper.

One could expect that donors and the international environmental funding institutions may choose to increase the resources of the DFES scheme with technical assistance and/or additional grants (later even loans), but at this moment it is premature to make any specific assumptions. The chances of these additional grants (e.g. from the Global Environmental Facility) becoming available will increase, if the Georgian scheme wins the reputation of being a credible, accountable and efficient mechanism for channelling money for local environment and development. This has been clearly demonstrated by international experience gained from such schemes in Europe and from well-performing DFES funds in Latin America, Africa and Asia.

In later years, the DFES scheme in Georgia may also be replenished by opening a revolving fund window (i.e. offering loans), should this instrument be found appropriate by the governing bodies.

Given the above revenue forecasts, it is unlikely that a DFES would contribute to inflationary pressures in Georgia. Under the most optimistic scenario, the expected annual domestic spending of the DFES in 2006
would account for only 0.5% of total government consumption forecast for that same year.\textsuperscript{29} This percentage (and thus, the inflationary threat) will further diminish over time as both national income and the fiscal position of the government will recover in the future.

Moreover, the potential threat that inflation may erode the real value of revenue from a DFES would be mitigated automatically, if the Georgian government transferred its payments converted at the current market exchange rate in annual (or biannual) instalments. The DFES financial facility would then have to prepare a realistic project pipeline on time to pay invoices without excessive accumulation of un-disbursed funds in local currency. In any case, inflation in Georgia has decreased over the last few years to levels below 5%.

And last, but not least, one challenge for the Georgian government will be to convince creditors that these funds will really be transferred in full amount, on time, and for agreed purposes.

\textsuperscript{29} Forecast by the Ministry of Finance of Georgia.
6. EXPENDITURE PROGRAMME

Establishing a credible expenditure programme that responds to priority concerns of both creditors and the Georgian government will be essential to gain support for a debt-for-environment swap. As discussed earlier, a DFES has to strike a balance between the priorities of both debtor and creditor. Therefore, when the debtor country proposes an expenditure programme, it is essential that it has anticipated all possible creditors’ concerns and priorities.

The expenditure programme proposed in this study is derived from a careful analysis of Georgian environmental priorities and, above all, of the anticipated concerns and priorities of the most likely creditor governments. It combines national and global/international environmental priorities. It addresses environmental priorities jointly with poverty alleviation, creation of sustainable jobs, and sustainable economic development of local communities. It focuses on economic sectors that are priorities for both the Georgian government and creditors. And last, but not least, the programme demonstrates realistic opportunities for a solid portfolio of specific, tangible and implementable projects that could achieve the stated objectives of the programme.

Below, we briefly outline the main potential project portfolios that have been selected for the expenditure programme. Detailed economic and financial analysis of the proposed project pipelines is presented in the Pipelines Report, which is Part Two of this publication.

6.1. Priorities for the Expenditure Programme

The overview of Georgian and creditors’ preferences and the analysis of the key environmental and development problems conducted within the scope of this pre-feasibility study suggest that the most promising eligible projects would be those that aim at:

- **Reducing emissions of greenhouse gases that affect the global climate;**
- **Reducing pollution of international waters;**
- **Protecting biological diversity; and**
- **Facilitating access for the poor to safe water and sanitation services.**

In the area of **mitigating climate change**, the most mature and promising project opportunities are related to reducing net emissions of greenhouse gases through the use of hydropower for electricity generation and geothermal resources for heating and hot water, enhancing energy efficiency and implementing sustainable forestry practices. Such projects also demonstrate strong social and economic benefits for local communities, especially in the remote, poor regions of the country. Moreover, they would increase energy security and supply reliability, create sustainable jobs in small and medium size businesses, reduce dependency on fuel imports and contribute to the development of infrastructure for tourism and economic growth.
In the area of protection of international waters, the most promising projects include municipal and industrial wastewater treatment, improvement of agricultural practices and sustainable wetland management in the coastal zone of the Black Sea. In addition, projects aiming at improving water quality and quantity management of the trans-boundary rivers (Kura, Aras and Mtkvari) could provide both significant local health benefits (e.g. clean drinking and bathing water) and economic growth to Georgia (e.g. fishing and tourism), as well as make a vital contribution to international security in the region.

In the area of enhancing biological diversity, promising projects include those that foster economic development, rehabilitate infrastructure and promote the creation of alternative jobs in the support zones of natural protected areas. There are also numerous project opportunities to promote sustainable and financially viable local agriculture integrated with the conservation of rich biological diversity. In addition, eligible projects could mainstream biodiversity conservation in forestry and range management inside and outside of protected areas, making the development of the forestry and rangeland sectors more sustainable. The protection of biodiversity in the arid and semi-arid trans-boundary zone with the neighbouring countries of Armenia and Azerbaijan by promoting sustainable land use practices (e.g. rotational grazing and hunting farms), based on comprehensive ecosystem management plans, can also provide significant local and international benefits.

In the area of facilitating access for the poor to water and sanitation services, detailed financing needs were identified in the OECD EAP Task Force/DANCEE study conducted by COWI for the “Financing Strategy for the Urban Water Sector in Georgia”. However, it should be determined whether DFES funds would indeed be the most effective and efficient mechanism for financing rehabilitation of urban water and sanitation services. There may be more appropriate project opportunities in the rehabilitation of rural water and sanitation services, but this still needs to be examined because very little information is currently available about this sector. Also, any potential duplication of efforts with the already existing Municipal Development Fund, financed by a USD 21 million IDA loan from the World Bank, should be avoided.

With an annual budget of Euro 1.3 – 3.4 million, the DFES scheme would not be able to finance bulky project pipelines alone, nor would it be able to afford the financing of large capital investment projects alone. Therefore, a careful selection of the most cost-effective projects and a close examination of requirements for co-financing projects from other sources are essential if DFES operations are to make a real difference in any of the priority areas listed above.

6.2. Eligible Project Types

The expenditure priorities, proposed above, offer ample opportunities to develop solid project pipelines that could achieve environmental improvements together with poverty alleviation, employment generation and sustainable development of local economies. Such a selection of expenditure priorities would also reflect an appropriate balance between the environmental priorities of Georgia and creditor countries.

In each priority area suggested above, the bulk of resources could be used to support capital investment projects, including rehabilitation, repairs and efficiency improvements of existing environmentally-related infrastructure assets. As a principle, DFES funds should not be used to finance recurrent costs of environmental facilities because they do not provide incentives for long-term financial sustainability. Nature conservation projects can be considered as an exception but only for a limited period of time.
Providing financial support to environmental projects undertaken by local communities and by small enterprises may also be considered. These projects may aim to establish environment-friendly and commercially-viable businesses in protected areas in order to create alternatives to resource exploitation.

A smaller and capped portion of the expenditure basket (e.g. 20%) can be allocated for institutional capacity building for managing global and local common goods and for fostering co-operation between government institutions, non-governmental organisations and local communities to effectively manage open access environmental assets. This could also include project preparation and management training for potential final DFES fund recipients.

**Box 11. Why Narrow the Range of Priorities?**

The amount of money that will become available through a DFES will always be smaller than what people would like to obtain. Public funds that do not have a focused expenditure programme and eligibility criteria run the risk of spreading their limited resources too thinly, financing many random efforts but cumulatively failing to achieve any significant environmental results (OECD, 2002). Generally, funds that focus on a small number of strategic objectives can deliver results in the field and build a good track record more quickly than those that start out with an “open door” policy based on reacting to whatever is proposed. If the selected priorities fall into the environmental interests of creditors and donors, a well-focused DFES facility is much more likely to attract additional contributions and debt swaps. The scope can be broadened later, if appropriate. Alternatively, if a facility starts out with a fairly broad mission and purpose, it can declare a “pilot phase”, in which it concentrates on a focused area before beginning to accept proposals from other areas.

If the focus is very broad, the DFES facility is likely to be swamped with more proposals than it can reasonably process. For example, the Mgahinga Bwindi Impenetrable Forest Conservation Trust Fund (MBIFCT) in Uganda, in its first call for proposals, had enough money to support approximately 50 community projects at USD 5 000 each. It received 4 750 applications and felt obliged to give all of them serious consideration – a process that took several months and left them with 50 “winners” and 4 700 “losers” – not a good public relations position, to say nothing of efficiency.

*Source: IPG, 2000.*

### 6.3. Administrative Expenditure

It would not make sense to establish a DFES scheme that would generate barely enough resources to pay for its own administrative costs. Therefore, we have estimated the future costs of setting up and running a DFES expenditure programme in order to determine how much money would be left for projects.

The bulk of regular annual administrative costs of the DFES facility would be attributable to salaries. Choosing the right salary policy for the facility will not be a trivial issue. On the one hand, the salaries should be comparable with the salaries in the private financial sector in order to attract and maintain in the job highly skilled and experienced professionals. With high salaries, staff will also be less tempted to look for additional sources of revenue elsewhere. On the other hand, the DFES facility should not offer salaries that are totally at odds with the salary scales of officials in the high-earning ministries – such as the Ministry of Finance. For example, in the Polish DFES facility, the EcoFund – which is internationally recognised for highly professional, highly committed and very stable personnel – the salary scale is linked, through a coefficient, to the salaries in the Ministry of Finance, but is below the remuneration offered in the banking sector.

For the DFES facility in Georgia, we are assuming that the following administrative structure would be appropriate:

- Director (1);
- Technical Project Managers (3);
• Accountant (1);
• Assistant (1); and
• Office manager, support person (1).

The DFES facility would need at least a minimum of three project managers—one responsible for each of the main priority areas—climate, water, and biodiversity. Certainly, not all three would need to be employed during the first year of operation of the DFES facility. A facility could be launched in Georgia with just one sectoral specialist—to develop the first project portfolio in just one priority area. In addition, one of the staff members will need to have knowledge in financial/economic analysis or, when such expertise is needed, the task could be outsourced to local consultants.

Hence, in the expenditure forecast below, we have assumed that the DFES facility would have one technical project manager in the first year of operation (2006), another one will join in 2007 and eventually, a third one will be hired in 2008. Under the assumptions described above, the total administrative costs of the local facility should be about Euro 73,800 in the first year of operation, Euro 84,000 in the second year, and will increase eventually to Euro 94,000 thereafter, all in 2005 costs and prices.

Table 4. Estimates of the Annual Current Expenditure of the Debt-for-Environment Facility in Georgia, as a Share of Annual DFES Revenue (Percentage)

<table>
<thead>
<tr>
<th>Year</th>
<th>Administrative Costs (2005; 1,000 EUR/Year)</th>
<th>US Alone</th>
<th>Germany Alone</th>
<th>Austria Alone</th>
<th>US and Germany</th>
<th>Austria, USA, Germany</th>
<th>Plus EU</th>
<th>Plus Turkey</th>
<th>Plus Russia</th>
</tr>
</thead>
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<tr>
<td>2006</td>
<td>73</td>
<td>173.49</td>
<td>53.82</td>
<td>122.17</td>
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<td>3.60</td>
<td>3.09</td>
</tr>
<tr>
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<td>84</td>
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<td>38.39</td>
<td>8.67</td>
<td>16.03</td>
<td>5.63</td>
<td>5.29</td>
<td>3.74</td>
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</tr>
<tr>
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<td>94</td>
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<td>12.92</td>
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<td>6.47</td>
<td>6.08</td>
<td>4.30</td>
<td>3.97</td>
</tr>
<tr>
<td>2009</td>
<td>94</td>
<td>31.70</td>
<td>16.50</td>
<td>12.38</td>
<td>10.85</td>
<td>5.78</td>
<td>3.60</td>
<td>2.91</td>
<td>2.75</td>
</tr>
<tr>
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<td>94</td>
<td>32.17</td>
<td>15.51</td>
<td>11.91</td>
<td>10.46</td>
<td>5.57</td>
<td>3.54</td>
<td>2.88</td>
<td>2.72</td>
</tr>
<tr>
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<td>94</td>
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<td>14.79</td>
<td>19.01</td>
<td>10.18</td>
<td>6.63</td>
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<td>6.37</td>
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<td>3.65</td>
<td>3.26</td>
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<tr>
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<td>14.02</td>
<td>68.18</td>
<td>9.80</td>
<td>8.57</td>
<td>4.68</td>
<td>4.30</td>
<td>3.77</td>
</tr>
<tr>
<td>2014</td>
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<td>33.08</td>
<td>11.16</td>
<td>65.96</td>
<td>8.35</td>
<td>7.41</td>
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<td>2015</td>
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<td>6.67</td>
<td>6.67</td>
<td>5.85</td>
<td>4.82</td>
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<tr>
<td>2017</td>
<td>94</td>
<td>25.66</td>
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<td>2018</td>
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<td>26.09</td>
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<td>52.16</td>
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<td>6.68</td>
<td>6.68</td>
<td>5.78</td>
<td>4.68</td>
</tr>
<tr>
<td>2020</td>
<td>94</td>
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<td>53.41</td>
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<td>6.71</td>
<td>6.71</td>
<td>5.77</td>
<td>4.64</td>
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<tr>
<td>2021</td>
<td>94</td>
<td>27.46</td>
<td>10.79</td>
<td>51.36</td>
<td>7.74</td>
<td>6.73</td>
<td>6.73</td>
<td>5.75</td>
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<tr>
<td>2022</td>
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<td>7.03</td>
<td>7.03</td>
<td>6.20</td>
<td>5.38</td>
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<tr>
<td>2023</td>
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<td>10.93</td>
<td>63.19</td>
<td>7.96</td>
<td>7.07</td>
<td>7.07</td>
<td>6.21</td>
<td>5.37</td>
</tr>
</tbody>
</table>

Source: Own estimates.

The results shown in Table 4 below suggest that swapping 15% of the debt that Georgia owes to the US alone would hardly justify the administrative costs of operating the facility and managing related project pipelines. The added participation of Germany in the DFES improves the picture, with administrative costs decreasing steadily to below 8% (as a share of the expected revenue stream) after 2015. In turn, if Austria joins the US and Germany in the swap, the administrative costs would represent on average 6-7% after
2015, while the participation of Austria and the EU would further decrease average administrative costs to about 6%. The entry of each new creditor would further improve the efficiency of the transaction.

Most likely donor grants would be needed to finance some of the start-up activities. Some initial costs would also need to be covered by the Government of Georgia. Table 5 below shows the estimated start-up costs needed to launch the DFES scheme in Georgia. We have also identified possible preliminary sources of financing.

Table 5. Estimate of Initial Start-up Costs of the Debt-for-Environment Swap Facility (Euro, 2005 Prices)

<table>
<thead>
<tr>
<th>Item</th>
<th>Cost (EURO)</th>
<th>Financing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Office furniture and equipment</td>
<td>8 542</td>
<td>State budget (swap)</td>
</tr>
<tr>
<td>Computers (hardware and software)</td>
<td>12 813</td>
<td>State budget (swap)</td>
</tr>
<tr>
<td>Initial one-time payments (installations, bank fees, etc.)</td>
<td>854</td>
<td>State budget (swap)</td>
</tr>
<tr>
<td>Vehicle</td>
<td>17 084</td>
<td>State budget (swap)</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>3 417</td>
<td>State budget (swap)</td>
</tr>
<tr>
<td>Training of staff (by external consultants)</td>
<td>50 000</td>
<td>Donor</td>
</tr>
<tr>
<td>Development of a detailed project cycle manual, internal</td>
<td>100 000</td>
<td>Donor</td>
</tr>
<tr>
<td>operational documents, data bases, other operational</td>
<td></td>
<td></td>
</tr>
<tr>
<td>tools</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>192 710</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Subtotal financed from the budget:</strong></td>
<td></td>
<td><strong>42 710</strong></td>
</tr>
<tr>
<td><strong>Subtotal financed with donor support:</strong></td>
<td></td>
<td><strong>150 000</strong></td>
</tr>
</tbody>
</table>

*Source: Own estimates.*
Creditors will typically require that the revenues generated by the debt-for-environment swap be “additional” to the debtor country’s environmental expenditures. It would not be acceptable for creditors if Georgia simply reduced its existing environmental protection budgets as a result of a DFES. However, Georgia could propose a strategic reallocation of its public environmental expenditures by focusing its baseline environmental budgets on areas for which swaps are less likely to be available. This chapter reviews the historical environmentally-related expenditures in Georgia. This can serve as a baseline against which “additionality” can be defined.

In Georgia, the collection of environmental expenditure statistics largely collapsed after the break-up of the Soviet Union. In 2001 and 2002 – within the framework of the OECD EAP Task Force and with support of the Danish Environmental Protection Agency – COWI (Danish consulting firm) and local consultants collected Georgian environmental expenditure data, almost entirely through surveys. They also helped to re-establish a regular data collection system. Table 6 below presents a summary of the environmental expenditure data collected in Georgia in 2002.

Pollution abatement and control (PAC, as defined by OECD methodology) investment expenditures in Georgia were small both in absolute and relative terms compared to OECD countries and Russia. In 2001, they amounted to almost USD 1.7 million. Expenditures on environmentally-related natural resource management activities, however, were almost two times higher. This category also includes water supply, which received most of the funding. The overall structure of environmental expenditure in Georgia is also presented in Table 6 below.

Data on sources for financing environmental investment suggest that the business sector provided most (about 90%) of the financing for environmentally-related purposes, which indicates possible under-funding of public goods elements in environmentally-related projects.

Foreign financing of environmentally-related investments plays an important role in Georgia. As can be seen from Figure 2 below, the share of foreign financial sources in environmentally-related investment expenditure carried out by the entities included in the sample amounted to approximately 50%-70% in 2001 (IFI loans are included in “other”). Of the domestic sources, domestic subsidies were by far the most important financial source, with the domestic financial sector playing only a minor role. Overall, the data show a very heavy reliance on subsidies in financing environmentally-related capital investments in Georgia.

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30 This chapter is based on the most recent comprehensive survey of environmental expenditure in Georgia, which was carried out within the framework of the EAP Task Force in 2002.
31 PAC activities are activities aimed directly at the prevention, reduction and elimination of pollution or nuisances that arise as a residual from production processes or the consumption of goods and services. Excluded from PAC are expenditures on natural resources management and prevention of natural disasters or hazards, or nature protection. When both types of expenditure are bundled together, they are referred to as environmentally-related expenditure.
Table 6. Environmentally-Related Expenditure in Georgia, 2001 (Thousand USD)

<table>
<thead>
<tr>
<th></th>
<th>Pollution Abatement and Control</th>
<th>Drinking Water Supply and Other Natural Resources Management</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public sector</td>
<td>779</td>
<td>750</td>
<td>1 529</td>
</tr>
<tr>
<td>Business sector</td>
<td>4 978</td>
<td>24 627</td>
<td>29 605</td>
</tr>
<tr>
<td>Total</td>
<td>5 757</td>
<td>25 377</td>
<td>31 134</td>
</tr>
<tr>
<td>Of which investment expenditure:</td>
<td>1 707</td>
<td>3 046</td>
<td>4 753</td>
</tr>
</tbody>
</table>

Notes: 1) According to average annual exchange rates for 2001.
Source: National Statistics.

Figure 2. Sources of Financing of Environmentally-Related Investment Expenditure in Georgia, 2001 (Percentage)

Source: National Statistics.

The analysis of available information on expenditure in Georgia on environmental and water supply investments leads to the conclusion that a DFES could trigger their significant increase. Under the assumption that Austria, Germany, the EU and the US would agree on a 15% swap of Georgia’s debt, environmental capital investments, in the strict sense, could increase annually by approximately 30% on average in the period 2006-2013, and by almost 20% thereafter until 2023. Under the most optimistic creditors’ response (with the EU, Turkey and Russia joining the swap), the figures would be 42% and 27%, respectively.

With an already high share of environmentally-related investments financed by foreign sources, particular care should be taken to prevent further replacement of present domestic environmental expenditure with new financial resources. The design of the expenditure management mechanism should ensure that the DFES mobilises (leverages), rather than substitute, domestic spending. Also, because of Georgia’s heavy reliance on subsidies, new public funds should not displace debt financing and retained earnings further, but leverage them. International experience – e.g. the EcoFund in Poland, the Global Environmental Facility (GEF) – shows how to ensure that expenditure supported by DFES funds will be additional to what the debtor country would have spent anyway. The Polish EcoFund is internationally recognised for achieving a particularly high leverage ratio, effectively mobilising additional domestic finance, and using relatively modest annual expenditures generated by the swap. In Georgia, using DFES funds to leverage still fragile bank credit for environment and development purposes can foster the development of more sustainable financing solutions.
8. ALTERNATIVE MODELS OF SWAP TRANSACTIONS

Different models and different institutional arrangements have been used worldwide to manage resources made available through debt-for-environment swaps. Some of the major issues that the Georgian government will need to consider in this context include the type of transaction (bilateral or trilateral), the life-cycle of the financial facility, and the type of institution that will manage the resources; governance and management issues will also need to be resolved. The final choice will depend on both Georgia’s and the creditors’ preferences, the existing legal framework and market conditions in Georgia, and the potential financial envelope that can be expected from the swap. All these issues, with their respective advantages and disadvantages, are discussed in the sections below.

8.1. Bilateral Swaps versus Swaps through Intermediaries

Two general forms of debt-for-environment swaps have been tried in the world, depending on the number of negotiating parties involved in the transaction. These are:

- Bilateral (direct) swaps; and
- Trilateral or multilateral swaps (through an intermediary).

Bilateral, Direct Swaps

Bilateral debt-for-environment swaps have been applied mainly in official (government to government) debt. In a bilateral swap, a debtor country enters into a transaction with its creditor directly. The creditor country agrees to forgive a portion of the foreign currency debt it holds, while the debtor country spends an agreed amount in domestic currency for environmental protection measures on agreed terms. Bilateral swaps can also be made through a multilateral swap facility, which gives the debtor a standardised transactional framework for swapping several bilateral debts for one expenditure programme.

The amount of local currency may or may not reflect a discount, relative to the face present value of the original debt, and this discount can be subject to negotiations between the two countries. Other variables that need to be negotiated include the exchange rate at which local currency payments are made, the payment schedule (a one-time transfer or instalments as repayments are due), as well as the mode of payment (e.g. cash, government bonds or in-kind contributions). All these variables determine the rate of debt forgiveness, or relief, embedded in a transaction.

<table>
<thead>
<tr>
<th>Box 12. Examples of Bilateral Swaps</th>
</tr>
</thead>
<tbody>
<tr>
<td>The best known and most advanced case of a bilateral debt-for-environment swap is the swap that Poland made with Paris Club creditors (US, France, Switzerland, Norway, Sweden and Italy) in the years 1990-2000. By 2000, the Polish EcoFund had mobilised resources equivalent to <strong>USD 571 million</strong> through swaps with its creditors and grants from donor countries (<strong>OECD, 1998, Polish EcoFund web-page</strong>). This is roughly equal to the value of all other debt-for-nature and debt-for-environment swaps worldwide so far. Another case of a bilateral DFES is the deal negotiated between Bulgaria and Switzerland. In 1995, Bulgaria set up the National Trust EcoFund in order to swap 23% of its debt owed to Switzerland (equal to Swiss francs 20 million).</td>
</tr>
</tbody>
</table>
Figure 3 below illustrates the typical transactional scheme of direct, bilateral swaps.

![Figure 3. Bilateral Debt-for-Environment Swap](image)

**Creditor**
- Transfers local currency to a financial facility
- Controls expenditure

**Debtor**
- Writes-off part of foreign exchange liability
- Transfers local currency to a financial facility

**Financial Facility**
- Selects and finances projects

**Environmental Projects**

**Trilateral Swaps through Intermediaries**

In a trilateral debt-for-environment swap, a third party buys the country’s bad debts on the secondary market at a discount and retires them if the debtor makes a commitment to finance agreed environmental projects. By swapping the debt acquired at a discount rate on the secondary market, the third party can mobilise more resources in local currency for environmental protection than it would obtain through direct payments (official aid) for that purpose. The third parties in these transactions are usually environmental, non-governmental organisations (NGOs).

The transactional scheme for a debt swap through an intermediary is illustrated in Figure 4 below.

Since the 1980s, examples of trilateral swaps have been more common in Latin America, South Asia and the African Countries (see Annex II). Through trilateral swaps, both official and non-official debt can be reduced.

**Box 13. Example of a Trilateral Swap**

The first debt-for-environment swap was implemented in Bolivia in 1987, where USD 650,000 of Bolivia’s debt (a fraction of a percent of the country’s substantial indebtedness) was bought by Conservation International for USD 100,000 (roughly 15 cents on the dollar) on the secondary financial market and retired. In exchange, the Bolivian government agreed to expand protected areas around the Beni Biosphere Reserve by 1.5 million hectares. The Bolivian government contributed USD 100,000 to the expenditure programme, which also received a USD 150,000 grant from the US Agency for International Development.
Trilateral swaps usually involve relatively small amounts and one-time financial transfers to create the endowment of a trust fund. Trilateral swaps usually are used to finance a portion of the running costs of nature protection areas or small non-investment NGO projects. Trilateral swaps rarely have the potential to generate the critical mass of resources needed to support capital investment projects, e.g. rehabilitation of deteriorated environmental infrastructure. They also introduce an additional constraint into expenditure planning – the interests of the intermediary must be taken into consideration. This may or may not be compatible with the preferences of creditors and/or the Georgian government. Trilateral swaps have been a solution in countries with corrupt, dictatorial governments that could not be trusted. One can argue that since Georgia is making progress in building democracy and civil society, and in improving governance, it will not be necessary to take expenditure management out of the hands of government institutions and put it into the hands of international NGOs. In any case, international environmental NGOs have so far shown little interest in Georgia and in other smaller, low-income countries of the former Soviet Union. It is unlikely that in the foreseeable future they will be willing and able to raise funds to buy Georgia’s official debt from its creditors. As for Georgia’s domestic NGOs, they can and should play the role of watchdogs, but not necessarily of intermediaries.

International experience summarised in the Annex II speaks for itself. The most sizeable swaps have been bilateral swaps of government debt without intermediaries. A single bilateral swap of Polish debt has diverted more debt money for environmental purposes than all trilateral swaps worldwide taken together. Bilateral swaps can generate a critical mass of predictable environmental financing over a longer period of time. The important progress that has already been achieved in opening up a window for bilateral debt-for-environment swaps within the framework of Paris Club countries makes such transactions feasible in the near future. It should be noted, however, that bilateral DFES transactions can be designed so that they can also accommodate any number of one-time transfers from single swaps of public or private debt facilitated by potential intermediaries.
**RECOMMENDATION:** Direct, bilateral swaps with individual creditor countries, rather than swaps through intermediaries, should be Georgia’s first choice. The institutional framework for bilateral swaps, however, needs to be designed so as to foster a multilateral framework for bilateral transactions that can also accommodate additional trilateral swaps, should they be arranged by interested third parties.

8.2. Institution for Expenditure Management: Project-by-Project or Domestic Intermediary?

Both bilateral and trilateral swaps can be disbursed locally, either directly for specific projects agreed with a creditor, or transferred to an established financial facility that selects projects under the supervision of relevant stakeholders, including creditors. Two main institutional arrangements are possible:

- **Swaps on a project-by-project basis,** with transactions that tie individual swaps to specific projects from the outset; or
- **Swaps through a domestic financial facility** are transactions that transfer money to a domestic facility that manages the expenditure programme and project pipelines (including project appraisal and selection) according to agreed procedures and criteria.

The choice between the two options is not straightforward. It depends on the preferences of creditor countries and on the size of the overall envelope of the swap transaction. Any successful transaction must be a win-win operation for both parties.

Creditors’ preferences will be fully revealed only when negotiations actually begin. International experience, however, has already shown that a project-specific DFES may be attractive to some creditors for a number of reasons:

- It gives creditors a stronger assurance of how exactly their money will be spent.
- It makes it easier for creditors to enforce tied procurement, hence to partly recuperate their financial losses by having the debtor country purchase goods and services from creditors’ suppliers.
- As an *ad-hoc* arrangement, it usually requires lower transaction and administrative costs. It does not involve setting up and operating a specialised institution to manage the project cycle. The function of overseeing the implementation of *a priori* agreed projects can be incorporated into the existing operations of government and/or non-government institutions at a low incremental cost. Project cycle management can also be contracted out to short-term consultants.

**Box 14. Example of a Project-Specific, Tied Procurement Debt-for-Environment Swap**

In 1990, a bilateral Polish-Finnish agreement was reached to swap a substantial portion of Poland’s official bilateral debt for a subsidy (up to 30% of the contract price) for Polish importers who buy Finnish environmental protection and energy saving equipment. This was a typical bilateral agreement with all disadvantages of tied procurement and of an *ad hoc* institutional structure. Initially, the implementation of the agreement was slow due to bureaucratic and procedural failures on the Polish side. Eventually, however, it became clear that because of the lack of appropriate incentives for competition (a result of tied procurement), Finnish suppliers had marked up their prices. The potential projects were not competitive compared with their open-market alternatives even after taking into account the 30% budgetary subsidy for Polish importers. Hence, the project pipeline remained virtually empty for more than a year.

*Source: Lauren et. al*[^32], Zylicz (1998).*

The alternative option is to swap the debt for environment through a specially established, local financial facility that manages the whole project cycle (project identification, development, appraisal, financing and monitoring) under the rules and controls agreed between the parties to the transaction. Project selection and procurement tend to be much more competitive in this arrangement. Also, the option of establishing a financial facility to select projects on a competitive basis has several advantages, specifically for Georgia. Some of these advantages are:

- The selection of projects on a competitive basis encourages a more efficient use of resources and increases the environmental benefits of the swap. In the absence of competition, as is the case with project-specific swaps, suppliers from the creditor country tend to mark up their prices, which may render many projects financially non-viable, even with a significant subsidy component (see the example in Box 14 above).
- The establishment of a locally managed facility to administer DFES funds also augments the development benefits of the swap. When properly designed, such a local facility can contribute to the better management of local and global common goods not only by channelling resources to the right projects, but also by creating the necessary institutional infrastructure in Georgia. Establishing a model institution, in line with best international standards, can contribute (through its demonstration effect) to improving the governance of public finance in Georgia and in other EECCA countries. As Zylicz has noted, the argument in favour of project-specific swaps and of procurement tied to creditor country firms tends to be flawed because it…
  …assumes that environmental protection, or sound resource management is a technical question which can be solved once the money is there. It overlooks the fact that protection and management are carried out by institutions. Moreover, if they are to be carried out on a self-sustained basis, these institutions should be local ones, run by local professionals, and contributing to the emergence of local constituencies for environmental and resource stewardship.33
- Having in place a transparent and credible institution, which effectively and efficiently selects and finances environmental projects, can attract additional financing from donor countries, international institutions, NGOs or other financing sources (grants, trilateral debt swaps, loans, etc.). There are many examples worldwide that good governance and effective expenditure management attract public and private finance.

The value added of transferring swapped funds through a financial facility (efficiency gains, leveraging potential, institutional strengthening) must be weighed against the incremental transaction and administrative costs of setting up and operating this facility. In Chapter 6, we estimated the transaction costs of establishing and the annual costs of running DFES facility in Georgia. We also calculated the threshold of DFES revenue that would have to be reached to justify this option under the assumption that the average annual administrative costs of the facility should be a reasonably small portion (around 5-7%) of average annual DFES expenditures, excluding start-up costs. We concluded that swapping the debt of relatively small creditors alone (e.g. Austria, Germany, or the US) would probably not justify a permanent DFES facility with a relatively sophisticated project cycle. However, if these three countries would enter the swap together, annual administrative costs from 2007 on would come to about 6.6% which is an acceptable rate.

prepared for the Environment for Europe Ministerial Conference, Sofia, 25-27 October 1995 under the auspices of the EBRD.

33 Zylicz, Tomasz (1998).
RECOMMENDATION: An efficient, accountable, transparent and professional local expenditure management institution, prepared to deal with multiple bilateral swaps and able to select projects in a competitive manner, would be more supportive of the environment and development objectives of a DFES in Georgia. Swapping debt for specific projects can be considered, if the value of the transaction is small and tied procurement cannot be avoided. But in this case, the Georgian government may want to decide if the DFES would be worth the effort.

8.3. Determining the Life-Cycle of the Domestic Financial Facility: Endowment, Sinking or Revolving Fund?

Once the decision to establish a local financial facility has been taken, an important choice will have to be made about the life-cycle of the institution – should it be designed to exist perpetually, sink gradually over a specific period of time, or receive periodic injections of funds?

- **Perpetual funds** are created on the basis of single, discrete transfers of financial assets. These assets are kept in a bank account as an endowment or are invested in other revenue-generating assets (e.g. government bonds, stocks). The DFES facility can disburse only the net income earned on these assets.

- **Sinking funds** are also created on the basis of single, discrete transfers of financial assets, but are designed to disburse both the income from these assets and the entire principal over a fixed period of time. Perpetual and sinking funds are created by a one-off injection of capital from creditors, donors or other investors and are not intended to replenish this initial capital.

- **Revolving funds** are designed to be replenishable. They receive more or less regularly new resources, which are added to their assets to replace the funds that have been spent. Newly added funds thus replenish or augment the original principal. New injections of funds may come as external transfers in instalments or as revenues from earmarked fiscal instruments (taxes, fees). They may also be generated through lending, or by any combination of the options listed above.

Revolving funds are applicable when a debt swap transaction provides revenue in regular instalments as an agreed percentage of the debt service obligations, falling due periodically over a specified period of debt amortisation. The Polish DFES fund (EcoFund) is an example of a revolving fund, although its resources are disbursed as non-returnable grants. The EcoFund receives bi-annual transfers from the Ministry of Finance, and knows the payment schedule of its core revenue several years in advance. Certainly, when new and additional funds are no longer added, the revolving fund has the choice of either sinking or establishing itself as an endowment and living on the net income for perpetuity.

Perpetual (endowment) and sinking funds are usually applicable in trilateral debt-for-environment or nature swaps, where a one-off debt purchase by a third party is converted into an asset of a conservation trust fund or a foundation. The argument in favour of an endowment-type fund is the lower political risk of this arrangement, as there is no fear that the debtor government will fail to transfer the agreed amounts of money for agreed purposes at an agreed time. The disadvantage is that the amounts of money that this type of fund can make available for projects are usually small compared to the large amount of capital that must be locked into investments to yield annual income. This may involve trade-offs with the urgent need to spend this money in order to prevent the degradation of environmental infrastructure, which requires rapid and significant capital investments. And last but not least, managing the principal (endowment) requires a sophisticated and costly asset management infrastructure. In the Georgian case, where there may not be enough long-term, low-risk investment opportunities, it would be necessary to employ off-shore asset

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34 We have adopted a definition of “revolving fund” that is wider than the one used in the literature.
managers. This would further reduce resources available for original environment and development purposes.

Ultimately, the choice of the type of fund will depend on the strategic objectives and the funding needs of the programme envisaged. If the main objective is to finance recurrent costs of nature conservation activities and provide small, non-investment grants, then an endowment-type of fund may be appropriate. If, however, the objective is to finance larger projects, including capital investments, then a sinking or revolving fund would be a more suitable financing vehicle.

The Georgian facility could also be designed as a modular fund, with a few separate accounts and financing "windows" under one umbrella - some with endowment, some sinking, others revolving, depending on contributor/investor/donor preferences. The only constraint of such an arrangement may be the high transaction costs of managing multiple accounts, cash-flows and pipelines.

**RECOMMENDATION:** Establishing a "core" debt-for-environment swap facility as a revolving fund to manage rolling spending programmes would be the recommended first choice for Georgia. This should ensure predictability of core revenue over a longer period of time, which is needed to develop a reasonable project pipeline. The revolving nature of the facility should initially be designed by swapping debt in instalments, as a fixed portion of the debt service falling due over the agreed period of time. However, it is recommended that the financial facility be able to operate parallel accounts and financing "windows" within the single, but modular organisation - some with endowment, some sinking, others revolving, depending on the preferences of creditors, contributors, investors or donors.

8.4. Governance and Management of a Local Financial Facility

Accountability to all stakeholders and shielding from ad hoc political interference will be crucial if the financial facility is to earn credibility both domestically and internationally. This can be achieved, in large part, by ensuring objective, accountable, transparent and highly professional operations. Credibility to stakeholders and a demonstrated ability to achieve stated objectives efficiently will also be decisive factors for the DFES facility’s ability to leverage additional local and foreign financial resources.

Donors normally do not accept anything less than a fully transparent governance structure, which ensures that annual disbursements are used for agreed purposes on agreed terms. Therefore, Georgia would most likely have to agree to relinquish to donors some measure of control over project appraisal and selection.

There are a number of examples of environmental funds worldwide, and specifically in the EECCA countries, that have proved to be largely ineffective in terms of facilitating real environmental improvements. The main reasons for these failures include a lack of transparent decision-making procedures and intrusive, random political influence from different institutions, such as the ministry of finance, ministry of environment or local authorities (OECD, 1999; OECD, 2002). Without clearly defined objectives and priorities, rules and procedures and an appropriate managing structure, and without transparency and accountability, there will always be ample opportunities to divert DFES resources to activities that breed vested interests rather than to projects that would bring significant environmental and development benefits.
Box 15. OECD Guidelines on Environmental Funds

Since 1995, the OECD has been monitoring and analysing the performance of several environmental funds in transition economies of Central and Eastern Europe, the former Soviet Union and China, including the debt-for-environment swap funds in Poland and Bulgaria. Lessons learnt from these funds identify the following essential factors for the successful operation of public environmental financial facilities (OECD, 1995, OECD 2003a):

- Clearly defined, stable and internationally understood legal status;
- Clearly defined environmental objectives and narrowly targeted spending priorities;
- Operational independence from ad hoc politics;
- Effective and accountable management structure with provisions for conflicts of interests, checks and balances, transparent decision-making process and operational procedures;
- Predictable, long-term revenues;
- Effectiveness and efficiency in achieving its objectives (appropriate incentives, strong leadership and highly qualified staff, cost-effective projects in the pipeline);
- Accounting, financial management and reporting procedures compatible with international standards and national laws;
- Capacity and incentives to leverage funding from other sources; and
- Reasonable transaction and administrative costs.

An essential factor for ensuring the accountability of the domestic financial facility will be the proper design of its governance structure and management system. These must make it possible for all main parties to participate in key decision-making processes, with balanced representation and voting power, and with effective powers to oversee the implementation of decisions. The organisational structure should allow creditor countries, the Government of Georgia and other internal and external stakeholders, such as NGOs, academic institutions, and contributing donors, to effectively incorporate their interests into the expenditure programme with appropriate control mechanisms.

The supervisory or governing body of the financial facility should be a platform where a variety of vested interests of different stakeholders are represented, checked and balanced to provide an efficient and credible outcome. Internationally recognised good practices of public expenditure management (PEM) show that for all governing bodies to be accountable, there must be a clear division of responsibilities between the governing body and the executive management board (OECD, 2000). In particular, responsibility for programming should be separated from the responsibility for project selection. The governing body should be held accountable for establishing strategic objectives, eligibility and appraisal criteria, “the rules of the game” and for supervision.

The executive body of the DFES facility should be responsible for the implementation of these established rules of the game in day-to-day operations. There will always be a strong temptation for different political stakeholders, represented in the governing body, to cross the line between governing and managing daily operations, and in particular to influence decisions on selecting individual projects. International experience shows clearly that if this happens, the public fund becomes a battlefield of vested interest groups, losing transparency, credibility, efficiency and effectiveness (Mikitin, 1995; OECD/Phare, 1999; Lovei, 1999; OECD, 2002). Very valuable guidance is provided by the Global Environmental Facility, which is funding a great number of environmental projects worldwide. Some of this experience is presented in boxes in this chapter, and more can be found in Annex VII.
Box 16. GEF Guidelines for Biodiversity Conservation Funds

The Global Environmental Facility (GEF) has provided grants for biodiversity conservation through several trust funds and foundations in developing and transition countries. In 1998, the GEF evaluated a number of conservation trust funds worldwide and identified some essential conditions for its future support to environmental funds. This information can be important when planning a debt-for-environment swap in Georgia, especially since the domestic financial facility may be allowed to attract additional contributions from donors, GEF or private sources. Some of these conditions include:

- **Active government support** — not just agreement — for creating a mechanism (sometimes mixed, public-private sector) that will function beyond direct government control. The support should be active and broad-based, from senior political leaders to regional and local bodies, extending beyond environmental ministries and departments to include ministries of finance and planning. A reasonable financial and/or in-kind contribution from the government, if not directly to the fund, then to project activities.
- **Critical mass of people** from diverse sectors of society who can work together, despite their different approaches to biodiversity conservation and sustainable development.
- **Basic fabric of legal and financial practices** and supporting institutions (including banking, auditing and contracting), in which people have confidence.
- **Agreement on a “charter” or “articles of incorporation”, describing the proposed objectives, governance structure and operating procedures of the management entity for the fund.**
- **General consensus** among government, NGOs and key environmental leaders regarding the objectives and proposed modus operandi of the new trust fund.
- **Appropriate national laws** that permit establishing a trust fund, foundation, or similar organisation, with sufficient flexibility.
- Tax laws that allow the fund to be tax exempt and provide incentives for donations from public and private contributors.

The day-to-day management of the project cycle, in particular appraisal and selection of individual projects, should be vested with an operationally independent executive management unit, staffed with non-political professionals and held strongly accountable for performance according to the rules established by the charter and by the governing body of the DFES facility.

Box 17. GEF Recommendations on the Governing Board of Financial Facilities

Designing the governing board is often the most challenging and time-consuming part of establishing a foundation. The GEF (Mikitin, 1995) recommends that the governing board:

- **Remain functional** (not too large, not too political, with reasonable meeting periodicity, etc.);
- **Have an internal checks and balances system** to prevent domination by one constituency (voting system, rotating membership);
- **Represent the critical stakeholders for the programme** (local government, local communities and NGOs, national government, environmental agencies, the private sector); and
- **Embody or have access to special expertise** (environmental and technical in eligible environmental sectors, financial and legal).

Annex V contains more detailed proposals of the responsibilities, membership and voting system of the governing body, and of the responsibilities of its executive management body. Designing a financial

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35 It is important to note that the environmental funds monitored by the OECD are very different from the environmental funds evaluated by the GEF. The former are usually government, earmarked tax funds that support a variety of different environmental projects (including large capital investments). The latter are usually small NGO/private trust funds, capitalised by direct transfers from donors/contributors, and specialised in financing the recurrent costs of biodiversity conservation.
facility to manage debt-for-environment swap expenditure in Georgia along the lines of these proposals would increase the credibility of the Georgian institutional arrangement in the eyes of foreign and domestic stakeholders.

**RECOMMENDATION:** In the DFES facility, responsibilities for governance and management should be clearly separated. Accountability and transparency must be the cornerstones of governance. A governing board should be set up and made responsible for programming, priority setting, performance evaluation, supervision and control. Creditor countries’ representatives should have a strong stake in the governing body. Professional executive management should have a high degree of operational independence, subject to strict accountability for performance. Governance structures should have the highest degree of compliance with international good practices in public expenditure management. International quality management systems (such as the ISO 9000 family) should be the benchmark for performance of executive management standards.

8.5. Disbursement Instruments

Because of the external benefits and common goods provided by projects supported under a DFES scheme, financing should be provided on terms more favourable than those available on the market. “Soft” financing can be provided in a variety of forms, such as direct grants, low-interest loans, low premiums, high-risk loan guarantees or equity with a low expected return and a higher accepted risk.

With regard to the financial sustainability of the domestic facility, **direct loans** seem to be an attractive option for disbursing its resources. Loans could provide some return on assets to replenish the facility. Moreover, loans for projects that have the potential to generate financial revenue could give project owners incentives to implement projects quickly and efficiently.

However, the use of loans, loan guarantees or equity financing requires significant capacity to manage associated risks. Some EECCA environmental funds have used direct loans, equity or loan guarantees without the appropriate skills and expertise, and have failed. Very few of these loans were repaid (OECD, 2002). Capacity to manage risks could be built in the DFES facility by establishing a loan department with at least two to three experienced credit analysts to analyse the creditworthiness and collateral of borrowers. This capacity can also be bought on the market by contracting out the credit analysis to commercial banks for a fee (and for some risk sharing). Without any up-front capacity, a loan portfolio usually quickly turns into a stock of worthless assets. Effective lending also requires a critical mass of legal and institutional infrastructure in the country for arbitrage and contractual settlements, to say nothing of a minimum level of maturity of financial markets. All these conditions are still being developed in Georgia. If investment lending is perceived as too risky even by commercial banks, it is unlikely that a DFES facility would have a successful loan portfolio. In some niches (e.g. agro-businesses or small and medium-sized enterprises in natural park support zones), a small DFES loan facility could be established by contracting a commercial bank to manage the entire programme and on-lend to final beneficiaries on behalf of the facility.

Before loans can be considered in any form, all risks should be identified and mitigated. In addition, a detailed market analysis should be carried out to determine if eligible beneficiaries would be willing to take out loans to finance environmental projects eligible under a DFES scheme. Even more risky instruments (loan guarantees, equity investments) should not be envisaged for the DFES facility at all, maybe only in the very distant future, but then the rationale for locating the DFES facility in the public sector will need to be reconsidered.
A direct grant is the most transparent, least risky and easiest to manage form of government financing. In the European tradition of public finance, it is also considered to be the most market-friendly form of government financing because it does not compete with financial products provided by the private financial sector. Therefore, the lowest risk strategy would be to launch the DFES facility as a revolving fund disbursing grants only. During the first two years of operation, it could accumulate experience with financial management, contracting, project appraisal and implementation monitoring. This would provide lead-time to gain a better understanding of the current environmental investments market, and of typical funding needs of projects and risks. Should conditions allow it, the governing body of the DFES facility could consider introducing other disbursement instruments, such as soft loans or interest subsidies.

To maximise its environmental effectiveness, the DFES facility should use its limited resources to catalyse additional finance for environmental improvements. This could be done by providing matching grants covering only a portion of a project’s financial needs. The grant share in the eligible project costs (rate of assistance) may be different for different projects, depending on the priority area, the type of project (e.g. its capacity to generate revenues) and the type of beneficiary. Criteria for determining the maximum grant rate should be relatively simple and transparent. Temptations to use sophisticated and costly models (e.g. incremental cost as used in GEF grants) should be cautiously treated, and considered only after sufficient experience and capacity have been accumulated in-house. For illustrative purposes, Annex VI contains a simple matrix of possible grant rate differentiation.

**RECOMMENDATION:** Designing the debt-for-environment swap facility in Georgia as a lending institution from the outset would be too risky, given the present level of capacity and market conditions in the country. Implementing safeguards to manage these risks would be possible, but at very high costs, which eventually would have to be passed on to beneficiaries, undermining their willingness to take funds for projects. Hence, a prudent strategy would be to begin with grant financing. As institutional capacity and financial markets develop in Georgia, other financial products can be considered. A DFES facility should never finance 100% of project costs. Co-financing should always be required to achieve financial leverage and additionality.

8.6. Project Cycle

A domestic financial facility needs to have an established project cycle with clearly defined stages, responsibilities, procedures and project selection criteria. The typical phases of such a project cycle, managed by a public financial facility, are presented in Box 18 below.

<table>
<thead>
<tr>
<th>Box 18. Typical Phases of the Project Cycle of a Public Financial Facility</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Identification of potential projects;</td>
</tr>
<tr>
<td>• Submitting applications;</td>
</tr>
<tr>
<td>• Appraisal and selection of submitted projects;</td>
</tr>
<tr>
<td>• Approval of selected projects;</td>
</tr>
<tr>
<td>• Contracting and financing (transfers of money); and</td>
</tr>
<tr>
<td>• Monitoring and evaluation of projects and of post-implementation results.</td>
</tr>
</tbody>
</table>

As the environmental investments market in Georgia is still underdeveloped, good projects may not be easy to find. Hence, any facility managing an expenditure programme financed by a DFES would have to be very proactive in identifying eligible and promising projects in each priority area. Owners of these projects would need to be clearly informed about funding opportunities and conditions. Otherwise, they may not apply and the project pipeline could remain empty.

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Some applicants may need assistance in preparing their projects for financing and in submitting good applications, especially in the first few years of operations of the DFES scheme. In principle, the preparation of individual projects should not be financed by the DFES. Assistance provided to some beneficiaries, and not to others, gives the former an unfair advantage over those who compete for grants on their own. This may also distort the development of a market for independent consulting services in project preparation. Instead, technical training in project preparation and application for funding, open to all potential beneficiaries, could be organised and financed by the DFES facility. However, if the need to assist in the preparation of individual projects persists (if, for example, project proposals continue to be of poor quality without training), then extreme care needs to be taken when designing a system for financing project preparation in order to ensure that it does not discriminate against some applicants and that it provides incentives to implement the projects afterwards.

Procedures and criteria for appraisal and selection of projects will be the cornerstone of credibility, accountability and transparency of the scheme to various stakeholders. The DFES facility will need to follow good international standards of project appraisal in the public sector. Also, the facility’s charter should define the principles and criteria of project appraisal and ranking, and further specify them in operational terms in documents approved by the facility’s governing board.

Appraisal cycles should have fixed intervals and deadlines for applicants to submit their proposals and for the DFES facility to take decisions on the applications. The frequency of the intervals and deadlines will need to be adjusted to the practical needs of the project pipeline. Large, capital investment projects may need to be appraised in two stages. In the first stage, short and relatively simple applications should be screened against eligibility criteria so that non-eligible projects can be rejected early on, saving time and resources of both the facility and the rejected applicants. Applicants who pass this first eligibility test should then be asked to prepare a more detailed application and submit all supporting documentation (e.g. feasibility studies, environmental impact assessments, environmental and construction permits, etc.).

On the basis of full and detailed project information, project proposals can be appraised by applying appraisal criteria, and by comparing them to other projects or some benchmark. Appraisal criteria should be few, relatively simple, measurable and objective. They should allow as little discretionary judgement as practically possible. Cost-effectiveness (the ratio of the discounted, lifetime costs of the project to its physical environmental/social effects) should be a prominent appraisal criterion to ensure that a maximum effect is achieved with the limited resources generated by the debt-for-environment swap. However, conducting a full cost-benefit analysis (CBA) of all eligible projects individually (where benefits would be valued in monetary terms) is difficult to justify in a DFES, as the cost of the CBA is bound to be high and the size of eligible projects rather small. Beneficiaries would have to demonstrate the financial viability of their projects (with grant support), and also give reasonable assurance that they will not go bankrupt during the implementation phase and during a reasonably long period of project operation (or give assurance of sustainability of environmental and social benefits in case of bankruptcy). During each appraisal session, all projects under consideration should be ranked from the highest to the lowest score until their cumulative value exhausts all money set aside for a given appraisal session.

After appraisal and ranking have been completed by the executive body of the DFES facility, the governing board (political body) should receive the entire, ranked project portfolio for final approval, with a merit-based written justification for each project. It is advisable that the governing board have a right to veto individual projects, but not the right to modify the sequence of projects on the ranking list or to add new projects, by-passing technical appraisal.

**Contracting and disbursement.** After approval of projects by the governing board, actual financing will be provided to the beneficiaries on the basis of a prior contract negotiated and signed between the beneficiaries and the appropriate party on the government side (depending on the chosen legal form of the DFES facility). However, larger sums for investment projects should be disbursed after the project has been implemented, and only upon receipt of the original invoices issued by the implementing firm/contractor which, in most cases, will be different from the beneficiary. Transferring money to the owner of fixed assets or advance payments should be avoided in principle; or, if applied, must involve strict safeguards against beneficiaries diverting money to purposes other than those agreed in the contract.

**Project monitoring and evaluation.** The role and responsibilities of the DFES facility should also include monitoring the implementation of projects and an ex-post evaluation of results achieved. The facility should retain the contractual right to terminate the agreement, as well as use instruments to revoke funds, if the beneficiary does not comply with the terms and conditions agreed in the contract.

The DFES facility should produce annual financial reports according to international accounting and reporting standards. Activity reports should also be prepared annually to allow for a fair assessment of the performance of the expenditure programme according to these OECD/EAP Task Force standards: environmental effectiveness, fiscal prudence and operational efficiency. The financial reports of the facility will need to be regularly audited by international independent chartered accountants. In addition, the DFES scheme should maintain its international credibility by occasional performance audits conducted by independent international consultants according to the above-mentioned OECD/EAP Task Force standards.

**RECOMMENDATION:** The project cycle should be managed according to written, transparent procedures. Project appraisal criteria should be objective, transparent and unambiguous. Cost-effectiveness should be a key quantitative basis for appraisal and selection of projects. Subjective, discretionary elements in project selection should be subject to procedures. For larger investment projects, a two-stage appraisal procedure should be used. In principle, the DFES facility should not finance the preparation of individual projects. Training and assistance in project preparation should ensure equal access opportunities for potential beneficiaries. Advance payments of grants should be avoided.

8.7. Procurement Rules

Grant agreements should include a clause on the procedures for purchasing goods and services financed by the DFES. Some creditors may insist on limiting competition in procurement to their own suppliers. As explained before, tied procurement would most likely increase project costs significantly. However, there may have to be some trade-offs between efficiency and incentives for creditor countries to make DFES transactions.

Georgia, at least, should insist on allowing competition between domestic and creditor country firms. Otherwise, the development objectives of the DFES scheme would be jeopardised. Moreover, if more than one creditor agrees to the swap, the Georgian government may propose procurement procedures similar to those used by the Polish EcoFund, where competition is open to both Polish firms and firms from all countries participating in the swap (OECD, 1998). This so-called geographical distribution rule – also widely applied in the European Community (EC) programmes – offers every participating creditor the possibility to recapture (in the form of contracts) some share of the foregone funds. Even though this is not a

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perfect solution, the geographical distribution of contracts is a more efficient alternative than tied procurement, and it has proved viable in EU practice (Zylicz, T., 1992).

**RECOMMENDATION**: Competition in procurement, as defined by the rules of the DFES scheme, should be maximised to boost efficiency. If trade-offs occur between efficiency and incentives for creditors to join the DFES, then the geographical distribution rule should be used as a basis for drafting detailed procurement procedures.
9. FURTHER ACTIONS

Preparation for the transactions and financial transfers of a debt-for-environment swap scheme is not going to be short, easy and cheap. However, several internal and external circumstances work in favour of Georgia. The country has a “swappable” debt structure and is in an enabling economic situation and debt management cycle. The government has undertaken the right steps so far, and there is a commitment for a DFES solution not only in the Ministry of Environment but in other government agencies as well, including the Ministry of Finance.

The international situation also seems to be supportive of Georgian efforts. Debt-for-environment swaps were identified as a promising area of international co-operation on environment and poverty reduction by the OECD Global Forum for Sustainable Development held in April 2002. As Georgia is covered by the International Initiative to Promote Poverty Reduction, Growth and Debt Sustainability in Low-Income CIS Countries, a DFES could be launched under this framework. It stands as a prominent objective in the East-West Partnership, the Environmental Strategy for Eastern Europe, Caucasus and Central Asia, which was endorsed by Environment Ministers at the Fifth “Environment for Europe” Ministerial Conference held in Kiev in May 2003.

The international community seems to be committed to supporting Georgia in its preparatory activities for a DFES. Co-operation within the framework of the OECD/EAP Task Force has begun, and this pre-feasibility study is the first result. The European Commission has contributed to this report through its Support to the Implementation of Environmental Policies and NEAPs in the CIS (the NEAP-2 Project). The Government of the Netherlands has provided funding for some preparatory work, including the first international seminar devoted to a DFES in Georgia, which took place on 12 February 2004 in Tbilisi. This seminar marked the beginning of a process of multi-stakeholder consultations conducted by the Georgian government in an effort to prepare itself for possible bilateral negotiations. The UNDP and the World Bank have both expressed interest in providing some form of assistance to Georgia.

In order to be effective, the preparatory process will need a strong, dedicated leader. The Ministry of Environment can provide this leadership. This is also the expectation of the Ministry of Finance expressed during a meeting with OECD representatives.

Table 7 below outlines some of the major steps in the preparatory process for launching a DFES in Georgia that the government has already taken or may wish to consider. The timing of the different steps in this process needs to be adjusted according to the realities existing in the country.
<table>
<thead>
<tr>
<th>Action</th>
<th>Timing</th>
<th>External Cost (Euro)</th>
<th>Financing</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Launch a process of official multi-stakeholder national and</td>
<td>13 February 2003 (Tbilisi Seminar) -</td>
<td>50 000</td>
<td>The Netherlands, OECD</td>
</tr>
<tr>
<td>international consultations, using the pre-feasibility study as a</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>background document.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Apply to donors or international institutions (e.g. World Bank,</td>
<td>March 2003</td>
<td>n/a*</td>
<td>n/a</td>
</tr>
<tr>
<td>OECD, UNDP) for technical assistance for the next steps in the</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>preparatory process.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Conduct additional analysis (expenditure programmes, institutional</td>
<td>May 2003</td>
<td>40 000</td>
<td>The Netherlands</td>
</tr>
<tr>
<td>issues).</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Reach agreement within the Georgian government on its initial</td>
<td>n/a</td>
<td>n/a</td>
<td></td>
</tr>
<tr>
<td>position in negotiations with potential creditors.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Launch informal consultations with targeted creditor countries</td>
<td>Travel costs</td>
<td>tbd*</td>
<td></td>
</tr>
<tr>
<td>(Austria, US, Germany, EU, Japan, Turkey).</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Begin formal negotiations with the first creditor(s).</td>
<td>Travel costs</td>
<td>tbd</td>
<td></td>
</tr>
<tr>
<td>7. Introduce a provision for a debt-for-environment swap into</td>
<td>n/a</td>
<td>n/a</td>
<td></td>
</tr>
<tr>
<td>the consolidated balance of financial resources and main directions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>of budgetary policy established by the Ministry of Economy, Ministry</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>of Finance, State Department of Social and Economic Reforms and the</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8. Sign first memorandum(s) of understanding with selected creditor(s).</td>
<td>Travel costs</td>
<td>tbd</td>
<td></td>
</tr>
<tr>
<td>9. Prepare a feasibility study with a business plan, detailed</td>
<td>200 000 - 300 000</td>
<td></td>
<td>Donor support</td>
</tr>
<tr>
<td>institutional design, and investment opportunities analysis.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10. Include the DFES in government information provided to the</td>
<td>n/a</td>
<td>n/a</td>
<td></td>
</tr>
<tr>
<td>President on the 2006 state budget.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11. Sign first DFES agreement(s).</td>
<td>n/a</td>
<td>n/a</td>
<td></td>
</tr>
<tr>
<td>12. Adopt an enabling legal and regulatory framework, including the</td>
<td>100 000 - 150 000</td>
<td></td>
<td>Donor support</td>
</tr>
<tr>
<td>charter of the DFES facility.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>13. Include a debt-for-environment swap in the 2006/2007 Budget Law.</td>
<td>n/a</td>
<td>n/a</td>
<td></td>
</tr>
<tr>
<td>14. Establish a DFES facility in Georgia, with office and equipment,</td>
<td>50 000</td>
<td></td>
<td>State budget (from swap)</td>
</tr>
<tr>
<td>and recruit director and staff.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>15. Train the facility’s staff, develop a detailed project cycle</td>
<td>100 000 - 150 000</td>
<td></td>
<td>State budget with donor support</td>
</tr>
<tr>
<td>manual, internal operational documents, software and other</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>operational tools.</td>
<td></td>
<td></td>
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<tr>
<td>16. Start project cycle – first project identification period,</td>
<td>tbd</td>
<td></td>
<td></td>
</tr>
<tr>
<td>information campaign, and training for applicants.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>17. First application period.</td>
<td>n/a</td>
<td></td>
<td>State budget (from swap)</td>
</tr>
<tr>
<td>18. First appraisal session.</td>
<td>n/a</td>
<td></td>
<td>State budget (from swap)</td>
</tr>
<tr>
<td>19. First financing agreements and beginning of implementation of</td>
<td>n/a</td>
<td></td>
<td>State budget (from swap)</td>
</tr>
<tr>
<td>first projects.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20. First disbursements for projects.</td>
<td>n/a</td>
<td></td>
<td>State budget (from swap)</td>
</tr>
</tbody>
</table>

Note:  

* n/a – Non applicable.  
* tbd – To be decided.
REFERENCES


**Websites:**

38. Bulgarian Trust Ecofund website: www.ecofund-bg.org
39. IMF website: www.imf.org
41. OECD website: www.oecd.org
42. Paris Club website: www.clubdeparis.org
43. Polish EcoFund website: www.ekofundusz.org.pl
44. World Bank website: www.worldbank.org
45. Ministry of Housing, Spatial Planning and Environment of the Netherlands: http://www.vrom.nl/international
46. TACIS web-site: http://europa.eu.int/comm/external_relations/ceeca/tacis/
ANNEXES
## ANNEX I. MAIN ECONOMIC INDICATORS, 1991-2004

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP at market prices (USD m)</td>
<td>n/a</td>
<td>15 252</td>
<td>764</td>
<td>823</td>
<td>1 897</td>
<td>3 046</td>
<td>3 575</td>
<td>3 620</td>
<td>2 803</td>
<td>3 042</td>
<td>3 201</td>
<td>3 392</td>
<td>3 984</td>
<td>4 453</td>
</tr>
<tr>
<td>Real GDP growth (%)</td>
<td>n/a</td>
<td>-44.9</td>
<td>-29.3</td>
<td>-10.4</td>
<td>2.6</td>
<td>10.5</td>
<td>10.6</td>
<td>2.9</td>
<td>3</td>
<td>1.9</td>
<td>4.7</td>
<td>5.5</td>
<td>11.1</td>
<td>8.5</td>
</tr>
<tr>
<td>Industrial Gross Output</td>
<td>n/a</td>
<td>n/a</td>
<td>-21</td>
<td>-40</td>
<td>-10</td>
<td>7.7</td>
<td>8.1</td>
<td>-1.8</td>
<td>3.7</td>
<td>5.3</td>
<td>-4.5</td>
<td>7.8</td>
<td>14</td>
<td>n/a</td>
</tr>
<tr>
<td>Unemployment (end-of-year; in % of labour force)</td>
<td>n/a</td>
<td>n/a</td>
<td>9.1</td>
<td>3.6</td>
<td>3.1</td>
<td>2.8</td>
<td>7.6</td>
<td>14.5</td>
<td>13.5</td>
<td>10.3</td>
<td>11.1</td>
<td>12.6</td>
<td>14.4</td>
<td>12.6**</td>
</tr>
<tr>
<td>Consumer Price Inflation:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(average; %)</td>
<td>78.5</td>
<td>887.4</td>
<td>3 125</td>
<td>15 607</td>
<td>162.7</td>
<td>39.3</td>
<td>7</td>
<td>3.6</td>
<td>19.1</td>
<td>4</td>
<td>4.7</td>
<td>5.6</td>
<td>4.8</td>
<td>5.7</td>
</tr>
<tr>
<td>(end-period; %)</td>
<td>n/a</td>
<td>n/a</td>
<td>7 488</td>
<td>6 473</td>
<td>57.4</td>
<td>13.8</td>
<td>7.2</td>
<td>10.7</td>
<td>11</td>
<td>4.6</td>
<td>3.4</td>
<td>5.6</td>
<td>7</td>
<td>7.5</td>
</tr>
<tr>
<td>Population (millions)</td>
<td>5.42</td>
<td>5.44</td>
<td>5.41</td>
<td>5.38</td>
<td>5.35</td>
<td>5.33</td>
<td>5.32</td>
<td>5.31</td>
<td>5.29</td>
<td>5.26</td>
<td>5.22</td>
<td>5.18</td>
<td>5.13</td>
<td>4.37</td>
</tr>
<tr>
<td>Current Account Balance (USD m)</td>
<td>n/a</td>
<td>-365</td>
<td>-308</td>
<td>-278</td>
<td>-281</td>
<td>-329</td>
<td>-375</td>
<td>-370</td>
<td>-218</td>
<td>-135</td>
<td>-209</td>
<td>-196</td>
<td>-286</td>
<td>-341</td>
</tr>
<tr>
<td>Trade Balance (USD m)</td>
<td>n/a</td>
<td>n/a</td>
<td>-448</td>
<td>-365</td>
<td>-338</td>
<td>-351</td>
<td>-786</td>
<td>-695</td>
<td>-534</td>
<td>-512</td>
<td>-550</td>
<td>-458</td>
<td>-636</td>
<td>-852</td>
</tr>
<tr>
<td>Current Account/GDP (in %)</td>
<td>n/a</td>
<td>-33.5</td>
<td>-40.2</td>
<td>-22.3</td>
<td>-7.5</td>
<td>-9.1</td>
<td>-10.6</td>
<td>-8.9</td>
<td>-7.7</td>
<td>-4.5</td>
<td>-6.6</td>
<td>-6</td>
<td>-7.9</td>
<td>-6.6</td>
</tr>
<tr>
<td>External Debt - Reserves (USD m)</td>
<td>n/a</td>
<td>n/a</td>
<td>596</td>
<td>957</td>
<td>1 055</td>
<td>1 194</td>
<td>1 342</td>
<td>1 518</td>
<td>1 590</td>
<td>1 473</td>
<td>1 551</td>
<td>1 660</td>
<td>1 763</td>
<td>1 769</td>
</tr>
<tr>
<td>External Debt/GDP (in %)</td>
<td>n/a</td>
<td>n/a</td>
<td>67.8</td>
<td>80.4</td>
<td>63.7</td>
<td>44.9</td>
<td>42.8</td>
<td>39.4</td>
<td>61.1</td>
<td>52</td>
<td>53.5</td>
<td>54.8</td>
<td>49.5</td>
<td>34</td>
</tr>
<tr>
<td>External Debt/Exports of Goods and Services (in %)</td>
<td>n/a</td>
<td>n/a</td>
<td>112.7</td>
<td>206.9</td>
<td>250.1</td>
<td>264.7</td>
<td>229.2</td>
<td>227.1</td>
<td>232.5</td>
<td>143.8</td>
<td>175.6</td>
<td>173.6</td>
<td>161.8</td>
<td>109.4</td>
</tr>
</tbody>
</table>

Source: EBRD, IMF, OECD.

* Up to 1996, unemployment is calculated based on registered unemployment. From 1997 onwards, International Labour Organization (ILO) methodology (strict criteria) is used.

** According to ILO soft criteria the figure is 15.2%.

n/a – Non Applicable.
## ANNEX II. EXAMPLES OF DEBT SWAPS WORLDWIDE

<table>
<thead>
<tr>
<th>Country</th>
<th>Start Year/Time Period</th>
<th>Domestic Participants</th>
<th>Creditors</th>
<th>Facilitator, Accelerator, Donor</th>
<th>Face Value of Debt Relief (USD)</th>
<th>Available Funds (USD)</th>
<th>Expenditure from Available Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bolivia</td>
<td>1987</td>
<td>Government</td>
<td>n/a</td>
<td>CI(^{38}), USAID(^{39}), Government</td>
<td>0.65 million</td>
<td>0.25 million</td>
<td>n/a</td>
</tr>
<tr>
<td>Bolivia</td>
<td>1992</td>
<td>Government</td>
<td>n/a</td>
<td>CI, WWF(^{41}), J.P. Morgan</td>
<td>11.5 million</td>
<td>2.76 million</td>
<td>n/a</td>
</tr>
<tr>
<td>Brazil</td>
<td>1992</td>
<td></td>
<td>n/a</td>
<td>CI</td>
<td>2.2 million</td>
<td>2.2 million</td>
<td>n/a</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>1995</td>
<td>National Trust Ecofund (NTEF)</td>
<td>Switzerland</td>
<td>IBRD(^{42})</td>
<td>CFr 23.5 million</td>
<td>Started with 7.5 million in 1996</td>
<td>NTEF(^{43}) agreed to finance and implement 21 projects totaling USD 36.5 million from which NTEF-contribution would be USD 6.67 million</td>
</tr>
<tr>
<td>Colombia</td>
<td>n/a</td>
<td>Government, Ecofondo</td>
<td>n/a</td>
<td>USAID, CIDA, Government, local and international NGOs, TNC(^{44}), WWF-US</td>
<td>n/a</td>
<td>18 million</td>
<td>34 grants to NGOs totalling USD 1.95 million (1994)</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>1988</td>
<td>Government, Central Bank, Bancoop, National Parks Foundation, Natural Resources Conservation Fund</td>
<td>n/a</td>
<td>CI</td>
<td>n/a</td>
<td>5.4 million</td>
<td>n/a</td>
</tr>
<tr>
<td>Ecuador</td>
<td>1987</td>
<td>Fundacion Natura de Ecuador</td>
<td>n/a</td>
<td>WWF</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Ghana</td>
<td>1991</td>
<td>n.a.</td>
<td>n/a</td>
<td>CI</td>
<td>n/a</td>
<td>1 million</td>
<td>n/a</td>
</tr>
<tr>
<td>Guatemala</td>
<td>1993</td>
<td>n.a.</td>
<td>n/a</td>
<td>CI</td>
<td>n/a</td>
<td>1.9 million</td>
<td>n/a</td>
</tr>
<tr>
<td>Madagascar</td>
<td>1990</td>
<td>Government</td>
<td>n/a</td>
<td>WWF</td>
<td>4.5 million</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Madagascar</td>
<td>1991-1994</td>
<td>n.a.</td>
<td>n/a</td>
<td>CI, WWF</td>
<td>n/a</td>
<td>3.48 million</td>
<td>n/a</td>
</tr>
<tr>
<td>Mexico</td>
<td>1991-1996</td>
<td>n.a.</td>
<td>n/a</td>
<td>CI</td>
<td>n/a</td>
<td>3.84 million</td>
<td>n/a</td>
</tr>
<tr>
<td>Panama</td>
<td>1992</td>
<td>n.a.</td>
<td>n/a</td>
<td>CI</td>
<td>30 million</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Peru</td>
<td>1993-1995</td>
<td>Government, FONCODES(^{45}), PROFONAMPE(^{46}) (funds), NGOs</td>
<td>Canada, Germany, Finland, NGOs</td>
<td>Over 230 million (20-25% of which must be paid for environmental purposes)</td>
<td>50 million</td>
<td>n/a</td>
<td>n/a</td>
</tr>
</tbody>
</table>

\(^{38}\) Governments and established funds.  
\(^{39}\) CI: Conservation International.  
\(^{40}\) USAID: United States Agency for International Development.  
\(^{41}\) WWF: World Wildlife Fund.  
\(^{42}\) IBRD: International Bank for Reconstruction and Development (or World Bank).  
\(^{43}\) NTEF: National Trust Ecofund of Bulgaria.  
\(^{44}\) TNC: The Nature Conservancy.
<table>
<thead>
<tr>
<th>Country</th>
<th>Start Year/Time Period</th>
<th>Domestic Participants*</th>
<th>Creditors</th>
<th>Facilitator, Accelerator, Donor</th>
<th>Face Value of Debt Relief (USD)</th>
<th>Available Funds (USD)</th>
<th>Expenditure from Available Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Switzerland</td>
<td>n/a</td>
<td>Government, Foundation for the Philippine Environment</td>
<td>n/a</td>
<td>USAID, Bank of Tokyo, WWF, USAID, “Philippine Business for Social Progress”, NGOs, academia</td>
<td>n/a</td>
<td>22 million</td>
<td>157 grants to NGOs and academic institution totalling USD 3.5 million (1992-94)</td>
</tr>
<tr>
<td>Philippines</td>
<td>1993</td>
<td>Government, Foundation for the Philippine Environment</td>
<td>n/a</td>
<td>WWF, IBRD/GEF</td>
<td>19 million</td>
<td>17.7 million</td>
<td>n/a</td>
</tr>
<tr>
<td>Philippines</td>
<td>1990</td>
<td>n.a.</td>
<td>n/a</td>
<td>WWF</td>
<td>0.05 million</td>
<td>n/a</td>
<td>n/a (goal: Mazurian Lake conservation)</td>
</tr>
<tr>
<td>Poland</td>
<td>1990</td>
<td>Government</td>
<td>Finland</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a (goal: up to 30% grant for import of Finnish environmental protection equipment)</td>
</tr>
<tr>
<td>Poland</td>
<td>1992-2010</td>
<td>EcoFund</td>
<td>France, Italy, Norway, Switzerland, Sweden, US</td>
<td>WWF, Friends of the Earth, other international and Polish NGOs</td>
<td>571 million</td>
<td>571 million</td>
<td>Grants (since 2001 also soft loans) for capital investment projects in priority areas. GHG emission reduction (including renewables and energy efficiency), trans-boundary air emissions, protection of biodiversity and international waters.</td>
</tr>
<tr>
<td>Senegal</td>
<td>1993</td>
<td>Government</td>
<td>Argentina</td>
<td>UNICEF</td>
<td>24 million</td>
<td>n/a</td>
<td>Senegal agreed to pay UNICEF the CFA equivalent of USD 11 million over three years to support UNICEF projects</td>
</tr>
</tbody>
</table>

* FONCODES: Social and Poverty Fund.
* PROFONAMPE: Protected Areas Fund.
* GHG: Greenhouse gases.
* n/a – Non applicable.
ANNEX III. RESCHEDULING OF GEORGIA’S EXTERNAL DEBT: 2001 AGREEMENT WITH THE PARIS CLUB

The total stock of Georgia’s public sector debt was estimated as of 31 December 1999 to be USD 1.7 billion (source: IMF document dated 6 December 2000, published on the IMF website www.imf.org). The stock of debt owed to Paris Club creditors as of 1 January 2000 was estimated to be USD 482 million (source: Paris Club creditors). Paris Club creditors’ stock of debt is divided into USD 153 million in official development assistance (ODA) claims and USD 329 million in non-ODA claims.

On 6 March 2001, Paris Club creditors agreed with the Government of Georgia to a restructuring of Georgia’s external debt. This agreement consolidates roughly USD 58 million due on loans contracted by Georgia before 1 November 1999 (“cut-off date”). This amount consists of principal repayment falling due from 1 January 2001 through 31 December 2002 (of which USD 1 million are ODA loans).

The rescheduling is structured on the following terms: ODA credits are to be repaid over 20 years, with ten years of grace, at interest rates at least as favourable as the concessional rates applying to those loans; commercial credits are to be repaid over 20 years, with three years of grace with progressive repayment, at market rates of interest. However, loans resulting from previous bilateral consolidations negotiated by the Georgian government will be rescheduled at an interest rate not higher than the interest rate of these bilateral consolidations. The tables below describe the repayment profile of the restructured amounts.

The cut-off-date is used by Paris Club creditors for the sole internal purpose of the Paris Club agreement. When a debtor country first meets with Paris Club creditors, the “cut-off date” is defined and is not changed in subsequent Paris Club treatments and credits granted after this cut-off date are not subject to future rescheduling. Thus, the cut-off-date helps restore access to credit for debtor countries facing liquidity problems. Concerning Georgia, the cut-off-date was set at 1 November 1999.

Interest rates to be applied on the restructuring will be negotiated with each creditor country by the Government of Georgia in bilateral agreements implementing the Paris Club agreement. ODA loans will be rescheduled at below-market interest rates not higher than the interest rates on the original credits. Loans resulting from previous bilateral consolidations negotiated by the Georgian government will be rescheduled at an interest rate not higher than the interest rate applied to these bilateral consolidations. Other loans will be rescheduled at a market interest rate (known as the “appropriate market rate”) defined on the basis of risk-free rates for the currency considered, plus a management margin.

As in any Paris Club agreement, Georgia agreed to seek comparable treatment from non-Paris Club creditors. In the present case, the comparable treatment shall imply an equivalent contribution of non-Paris Club official creditors to the financing gap during the consolidation period (2001 - 2002). The Georgian delegation indicated its willingness to meet these creditors soon in order to negotiate the terms of a future rescheduling.

49 This annex is based on data and information available at the Paris Club website.
Table III.1. Principal Repayment of ODA Debt

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>10%</td>
</tr>
<tr>
<td>2013</td>
<td>10%</td>
</tr>
<tr>
<td>2014</td>
<td>10%</td>
</tr>
<tr>
<td>2015</td>
<td>10%</td>
</tr>
<tr>
<td>2016</td>
<td>10%</td>
</tr>
<tr>
<td>2017</td>
<td>10%</td>
</tr>
<tr>
<td>2018</td>
<td>10%</td>
</tr>
<tr>
<td>2019</td>
<td>10%</td>
</tr>
<tr>
<td>2020</td>
<td>10%</td>
</tr>
<tr>
<td>2021</td>
<td>10%</td>
</tr>
</tbody>
</table>

Table III.2. Principal Repayment of Non-ODA Debt

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>1.17%</td>
</tr>
<tr>
<td>2006</td>
<td>1.54%</td>
</tr>
<tr>
<td>2007</td>
<td>1.94%</td>
</tr>
<tr>
<td>2008</td>
<td>2.37%</td>
</tr>
<tr>
<td>2009</td>
<td>2.84%</td>
</tr>
<tr>
<td>2010</td>
<td>3.36%</td>
</tr>
<tr>
<td>2011</td>
<td>3.93%</td>
</tr>
<tr>
<td>2012</td>
<td>4.54%</td>
</tr>
<tr>
<td>2013</td>
<td>5.20%</td>
</tr>
<tr>
<td>2014</td>
<td>5.92%</td>
</tr>
<tr>
<td>2015</td>
<td>6.70%</td>
</tr>
<tr>
<td>2016</td>
<td>7.54%</td>
</tr>
<tr>
<td>2017</td>
<td>8.46%</td>
</tr>
<tr>
<td>2018</td>
<td>9.44%</td>
</tr>
<tr>
<td>2019</td>
<td>10.51%</td>
</tr>
<tr>
<td>2020</td>
<td>11.66%</td>
</tr>
<tr>
<td>2021</td>
<td>12.88%</td>
</tr>
</tbody>
</table>
ANNEX IV. COMBINING DEBT-FOR-EQUITY AND DEBT-FOR ENVIRONMENT SWAPS

Debt-for-equity and debt-for-environment swaps can be packaged together under one transaction framework in a variety of ways. One option is a "debt-for-environmental equity swap" or a "debt-for-public-private partnership-swap". In such a swap, the creditor country’s firms retain ownership of assets or projects that produce social and environmental benefits in the debtor country (e.g., municipal and environmental infrastructure, such as water, wastewater, heating or waste management). Examples include swapping debt for:

- The management fee of foreign operators of municipal and environmental infrastructure to improve their performance over a period of time (e.g., four to five years);
- Concessions to operate this infrastructure and charge its users (e.g., for 10-20 years); and
- Shares in Georgian municipal utility companies.

However, swapping debt for a management contract held by a foreign utility operator may actually aggravate liquidity problems of the Georgian government. For example, the estimated management fee for a foreign firm to operate the Tbilisi Water Utility is USD 5 million over five years. This would imply paying the equivalent of USD 1 million a year in local currency from the state budget over the next five years, which is more than the expected debt service to any OECD creditor during this period. In the absence of competitive bidding, which is to be expected under the swap framework, this fee is likely to be even higher. A foreign operator could add an additional mark-up for payments in local currency – the only currency in which swaps are allowed by the Paris Club agreement. For Georgia, swapping debt for a utility management fee could be feasible only if it obtained a very high discount on the face value of the debt from a creditor in exchange for paying the fee to the utility operator from the creditor country in such a short time.

The debt for concessions or shares swap would be attractive to creditors on strictly financial terms, if the value of the swap were smaller or equal to the market value of environmental equity. Market value is equal to the risk-adjusted present (discounted) value of the future flow of the net, after tax profits from the facility or the project acquired through a swap. The high costs of rehabilitation and operation of the worn-out physical assets in the Georgian municipal and environmental infrastructure (DANCEE/OECD, 2001) shrink their market value. In addition, expected profits are slashed by low user charges, at least in some municipal infrastructure sectors. In the water sector, for example, the DANCEE/OECD report on the financing strategy for urban water supply and sanitation in Georgia shows that user charges cover, on average, merely 20% of the operational and maintenance costs of the currently used infrastructure. Yet the bulk of the wastewater treatment infrastructure has been lying idle for several years due to lack of money (DANCEE/OECD, 2001). There is room, however, to increase user charges and improve the financial sustainability of water and wastewater infrastructure. In Georgia, the average water bill accounts for only 0.8% of the average households’ disposable income. This is very low, even when compared to other medium and low-income countries in EECCA – e.g., 3.5% in Moldova and 3.8% in Kazakhstan (OECD, 2003). Moreover, the level of tariffs is not the only issue that needs to be resolved in order to make water utilities more attractive to investors. Equally important is the legal framework for collecting bills. If payment cannot be ensured, investors will obviously discount the value of the assets.
Unlike foreign firms, which are interested exclusively in financial returns, some creditor governments are also interested in environmental and social benefits that cannot be captured in monetary terms by a private investor. In this case, the creditor government might be willing to accept that the value of the swap be larger than the market value of the concession or shares. The difference would be the actual debt relief, or the price that the creditor government would pay for producing social and environmental benefits in the debtor country, some of which are trans-boundary or global in nature. The market value of environmental assets must, however, be greater than zero. Otherwise no foreign firm would be willing to accept the assets, even free of charge.

Market value depends on the commitment of the Georgian government at different levels, of the major political forces in the country and of the general public to allow the participation of foreign private firms in the operation of municipal environmental infrastructure. Broad consensus would also be needed to ensure that potential buyers would be able to recover the full cost of operation, maintenance and a reasonable profit from users of the infrastructure. Moreover, all relevant stakeholders would need to agree on how to provide capital investments in the rehabilitation of fixed assets and in the improvement of the level of service. Domestic spending could be mobilised if, for example, in addition to the swap for environmental equity (concessions or utility shares), creditors swapped an incremental portion of external debt for a capital investment programme of rehabilitation of the municipal environmental infrastructure. Such an expenditure programme could be incorporated into the DFES scheme considered in this paper.

Difficulties may arise from responsibilities for different aspects of the swap transaction vested with different levels of government. The central government is responsible for the swap, while the local government is the formal owner of the assets. Hence, very careful planning and co-ordination would be needed between these actors, so as to ensure the success of the operation.

It is also important to define some fall-back options from the outset, in case the whole scheme collapses or the conditions of the management or concession contract need to be renegotiated, which is quite frequent in private sector participation (PSP) arrangements. In any event, it seems that swaps for environmental equity and for a management fee would be extremely complex to implement and manage in Georgia, given the different actors involved and the uncertainties over key aspects of the deal.
ANNEX V. GOVERNANCE AND MANAGEMENT STANDARDS OF THE FINANCIAL FACILITY

The responsibilities of the governing body (e.g. Governing Board) should include:

- Approval of second order regulations;
- Defining the strategic plan of the financial facility and general policies and administrative guidelines;
- Approval of an annual operating plan and budget;
- Approval of fund-raising policies and any new revenue sources;
- Final approval of the portfolio of projects recommended for funding by the executive director on behalf of the executive management board;
- Approval of project implementation and monitoring reports and annual reports submitted by the executive board;
- Calling upon external regular audits by independent chartered accountants;
- Regular performance evaluation, appointing and dismissing of the executive director and the members of the executive management board (upon the proposal by the director);
- Determining the remuneration of the executive management board.

The two main considerations in designing the governing board are its membership and voting system.

Governing Board members may consist of persons representing the Georgian government, including the ministries of finance and environment, the parliament, non-governmental organisations, public opinion leaders, scientific institutions, governments of creditor countries that agree to negotiate a swap with Georgia, and donor countries and organisations that agree to contribute grant financing to the financial facility. Creditors and donors who make significant contributions to the facility would be represented with voting rights or ‘ex officio’. This will be important for gaining the credibility of potential contributors but international experience also shows that care must be taken that the facility is not excessively driven by creditors’ interests to the detriment of its efficiency and local ownership (IPG, 2000). If any external third party, e.g. international non-governmental institution, will be willing to arrange a trilateral swap with Georgia through the financial facility, it may be represented in the Governing Board as well. All members of the Governing Board will be appointed individually for a fixed term (e.g. three years). The framework composition of the Governing Board and the principles of appointment and dismissal will be set up in a charter (to allow for the first Governing Board meeting), and specific rules will be laid out in the secondary regulations, adopted by the Governing Board. The Governing Board will meet regularly (e.g. at least two times a year). Non regular meetings may be called for in special cases.

The Executive Director and the Executive Management Board will be the executive body of the financial facility, responsible for the management of the daily activities of the facility, which include:

- Project cycle management, including project identification, appraisal and selection;
- Preparation of a portfolio of selected projects to be submitted to the Governing Board for consideration and final approval;
- Conclusion of grant agreements for projects approved by the Governing Board;
Disbursement and monitoring of expenditures;
Ensuring proper and timely completion of projects by grant recipients;
Preparation of annual reports and evaluation of completed projects.

The Executive Director should be a strong leader with high reputation in the country and abroad. She/he should not be a political appointee in the sense that her/his appointment should be linked to personal qualifications and the security of her/his job should be linked to performance rather than to the changes in the political landscape of Georgia. The management board and the staff of the executive unit should consist of highly qualified professionals, recruited competitively, strictly on a merit basis. They should cover the key expertise needed to achieve the objectives of the facility in an efficient way. The staff should include an accountant, financial analyst, technical officers for each of the priority spending areas and one to two support staff. Legal counselling may be either hired in-house or out-sourced to independent lawyers.
ANNEX VI. POSSIBLE OPTIONS FOR GRANT SHARES IN ELIGIBLE PROJECT COSTS

Table VI.1. below illustrates possible options for the range and type of co-financing that could be provided to different recipients for different types of DFES projects. It is expressed as a share of grant in project costs. Eligible costs will need to be defined in the charter.

The table below serves only as an example to indicate how the grant shares in project costs can be differentiated and presented. Values are presented for illustrative purposes only.

Table VI.1. Possible Options for Grant Co-Financing Provided to Different Recipients for Different Types of DFES Projects (As a Share of Eligible Project Cost)

<table>
<thead>
<tr>
<th>Project Area</th>
<th>Biodiversity</th>
<th>Climate Change</th>
<th>International Waters</th>
<th>Capacity Building</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>I*</td>
<td>II</td>
<td>III</td>
<td>I</td>
</tr>
<tr>
<td>Central Government</td>
<td>0%</td>
<td>75%</td>
<td>75%</td>
<td>0%</td>
</tr>
<tr>
<td>Local Authorities</td>
<td>0%</td>
<td>75%</td>
<td>75%</td>
<td>0%</td>
</tr>
<tr>
<td>Utilities (e.g. vodokanals, district heating companies)</td>
<td>0%</td>
<td>75%</td>
<td>0%</td>
<td>75%</td>
</tr>
<tr>
<td>Budgetary Institutions (e.g. schools, hospitals)</td>
<td>0%</td>
<td>85%</td>
<td>75%</td>
<td>0%</td>
</tr>
<tr>
<td>Non-Governmental Organisations</td>
<td>0%</td>
<td>85%</td>
<td>75%</td>
<td>0%</td>
</tr>
<tr>
<td>Private Sector</td>
<td>0%</td>
<td>50%</td>
<td>75%</td>
<td>0%</td>
</tr>
<tr>
<td>Private Sector (SMEs**, small farmers, community groups)</td>
<td>25%</td>
<td>50%</td>
<td>75%</td>
<td>25%</td>
</tr>
</tbody>
</table>

* I – potentially commercial; II - cost-recoverable; III - non-commercial.  
* SMEs – Small and medium enterprises
ANNEX VII. GEF CONDITIONS FOR THE SUCCESSFUL OPERATION OF BIODIVERSITY CONSERVATION FUNDS

The Global Environmental Facility (GEF) has identified conditions for the successful operation of environmental funds for biodiversity. Some of these conditions are particularly relevant to Georgia; they include:

- Availability of one or more mentors – a donor agency with good programme support, a partnership with an international NGO, “twinning” with another, more experienced trust fund – who can provide both moral and technical support to the fund during the start-up and programme implementation phases.
- Realistic prospects for attracting a level of capital adequate for the fund to support a significant programme while keeping administrative costs to a reasonable percentage. In most cases, this means having clear commitments from other donors beyond the GEF, or debt swap mechanisms established, before starting the fund.
- An effective demand for the fund’s product, i.e. a client community interested in and capable of carrying out biodiversity conservation activities on a scale that will be sufficient to achieve significant impact.
- Clear and measurable goals and objectives. A “learning organisation” mentality and environment, oriented toward results and achieving objectives, with flexibility to make adjustments in objectives when necessary, and an approach based on feedback and experience.
- A governance structure with appropriate checks and balances, conflict of interest provisions, and succession procedures. “Ownership” of the fund by its board and other governing bodies, indicated by members’ commitment of time, engagement in policy and leadership, and building support of the fund with varied constituencies.
- Linkage between the fund and the leadership of any national environmental action plan, biodiversity or climate protection strategy.
- Ability to attract dedicated, competent staff, in particular a strong executive director. Harmonious and productive board-staff relationships.
- Basic technical and other capabilities that permit the fund to become a respected and independent actor in the community. Access to, and constructive use of, training, mentoring, and technical assistance programmes to build capacity.
- Constructive relationships with relevant government agencies, with intermediary organisations that provide services to grantees, and with other organisations in the community. The fund should avoid becoming an executing agency itself.
- Mechanisms for continuing to involve a wide range of stakeholders in the fund’s programmes and direction. Clear vision and leadership to avoid programme fragmentation and dissipation of its human and financial resources in many directions.
- Regular reporting to and oversight by the fund board comparing actual performance to benchmarks.
ANNEX VIII. LEGAL OPTIONS FOR THE STATUS OF THE LOCAL DFES FINANCIAL FACILITY

Four main legal forms of locally established institutions have been used so far in various countries to manage debt-for-environment swaps – government agency, trust fund, public foundation and association. Below we shed some light on these different legal forms and what they entail. However, to ensure that the most appropriate choice will be made for a DFES facility in Georgia, these options will need to be reviewed by a Georgian lawyer.

A. Establishing a government-owned agency (legal person in public law) requires a government (or presidential) decree or parliamentary act. Many comprehensive environmental funds, capitalised by earmarked environmental fees and fines in Central and Eastern Europe and EECCA, are (or have been) established in this way. Such an agency could be set up in Georgia jointly by the Ministry of Finance and the Ministry of Environment. The Ministry of Environment could manage the project cycle while the Ministry of Finance executes the financing transactions through an escrow account in the Central Bank of Georgia or in the Bank of International Settlements.

Advantages of this solution include its relatively light-weight structure and low cost to operate, as it can use the infrastructure of existing government institutions and their low-paid staff. The disadvantage is that this solution puts an additional burden on an already over-stretched and weak government infrastructure (staff time, office space, etc.). Another is that the government payroll may not permit the recruitment of staff with specialised skills. Moreover, this option is unlikely to attract creditors and donors since such a fund could not withstand ad hoc political interference. Creditors and contributors, as well as other third parties, could not effectively control project selection and transactions. Finally, this solution does not guarantee operational independence and quality of project cycle management (see Box VIII.1.).

Box VIII.1. Environmental Funds with the Status of Government Agency

FONAMA (the National Fund for the Environment) was created as a government agency in 1990 by the Government of Bolivia to develop funding for environmental conservation through international co-operation and debt reduction. FONAMA’s mission is to raise funds, both nationally and internationally, manage these assets and administer grants in the public and private sectors. During its first two years, FONAMA secured some USD 70 million in donor commitments and had highly qualified staff. But then, in 1993, the government changed hands, and FONAMA, which had been a high profile agency reporting directly to the president of Bolivia, became a third-level agency in what became the government’s smallest ministry. Professional staff were replaced by political appointees and FONAMA became mired in bureaucracy, and in internal and external conflicts. It developed a reputation for protracted bottlenecks and delays in its administrative processes (at least in its grant-making functions) and was unable to produce consolidated financial statements.


Trust funds exist for the most part in countries usually referred to as "common law" countries, i.e. essentially the current or former member countries of the British Commonwealth and the US. and are not applicable elsewhere, e.g. in Georgia, which is a "civil law" country.
The public foundation is the functional substitute for trusts in countries whose legal system is based on "civil law". Georgia, whose Modern Civil Code was passed in 1997, has a legal system based on civil law. Foundations exist in most continental European countries and are widely used by major environmental institutions there. For example, the Polish EcoFund has the status of public foundation, defined in the Polish Civil Code and in the special Law on Foundations. Other examples of public foundations include conservation funds in Mexico and the Philippines.

Foundations are established by a founder (or founders) who allocates an irrevocable donation for the purpose of serving some general public interest. Environmental protection, or nature conservation, is considered to be a legitimate public interest objective in most countries. The founder or founders must usually express their will in a written document. For its legal existence, the foundation needs a written charter that has been approved by a government agency and registered in court, and that follows the will of the founder(s). Subsequently, the relevant government agency exerts strict government supervision. Government officials and creditor country representatives may sit on the foundation’s governing board. The foundation may be subject to annual audits to ensure that its assets are used for non-commercial purposes, and that these purposes are consistent with its stated objectives. The government, or any other interested person, has the right (although this is rarely used) to request that the charter of the foundation be revoked through a formal public act or to change the objectives of the foundation, if the original objectives have become unattainable or unlawful.

Box VIII.2. Treatment of Assets in Trust Funds and in Foundations

An important difference of foundations, as compared to Anglo-American trust funds, is that foundations acquire a separate legal personality of their own, conditionally designated by the government and exercised by the governing board (the Council). Its separate legal personality gives the foundation the possibility to own property, whereas in a typical trust fund the trustees hold a legal (custodial) title to specific property and, under the fiduciary, have a duty to manage this property for the benefit of the trust's beneficiaries, who hold equitable title to this property (Mikitin, 1995).

The assets of the foundation must be completely independent from any member of the organisation, including the founder. This is aimed at shielding the assets of the foundation from creditors. It can be said that under civil law, foundations live under a regime of constant controls on the part of the administrative authority (IPG, 2000). Normally, foundations are not allowed to make profits; all proceeds must be used to serve the statutory purposes of the foundation (but this may include salaries of staff and the governing board).

The legal structures of foundations and the location of their assets can vary from country to country. Most environmental foundations established so far have been capitalised by discrete transfers (often raised from a combination of private and donor sources) and designed to provide long-term, sustained financing to meet recurrent costs of operating and maintaining protected areas. Thus far, most of them have been of the endowment type, i.e. disbursing only the net income earned from assets. The principal, or corpus, of the foundation remains intact and invested. The notable exception is the Polish EcoFund, which has a revolving character and (co-)finances also large capital investment projects in "brown" environmental sectors.

Foundations have the particular option of locating their accounts and legal headquarters abroad. Some donors have preferences for such a solution in order to shield the foundation’s resources from domestic politics. This can be, however, a double-edged sword. An offshore fund is very expensive to operate, does not involve local ownership and does not contribute to domestic capacity building (see Box VIII.3.). The Georgian government should be able to guarantee the standards of governance and the rule of law that are necessary to provide effective protection of the resources located and managed by the DFES facility in the country.
Box VIII.3. The Case of the Off-Shore Carpathian Foundation

The Foundation for Eastern Carpathian Biodiversity Conservation was created in 1994 as a financial mechanism to support conservation activities in the tri-national Eastern Carpathians Biosphere Reserve. It has its legal headquarters in Switzerland. This foundation started with only USD 600,000 in capital, which is invested conservatively – mostly in bonds – by a Swiss banking firm, and which yields some USD 30,000 per year. The McArthur Foundation provided a USD 45,000 start-up grant for operations, which paid for governing board meetings and other recurrent expenses during 1995-1998. The foundation has no staff and has been unable to raise additional capital. It incurs substantial expenses in convening meetings of the board (12 members from the three countries, and two international members) and on legal, translation, and accounting fees. Having its legal domicile in the Canton of Geneva in Switzerland, requires the foundation to produce all official documents in French, in addition to English (its operating language) and the three other national languages of Switzerland, and to use only Swiss-certified auditors. Given the small flows of income available, the foundation focuses its programme on small grants to NGOs, of which two grants have been disbursed and six more committed.


An association under civil law can be established by private individuals and institutions to serve a specified public interest or the common interest of the interested parties. In contrast to a foundation, an association usually requires a collective effort of a larger number of parties. Sometimes, a minimum number of people is required before a group can create an association (IPG, 2000). This is bound to be a limiting factor for the facility managing a debt-for-environment swap in Georgia. Too many decision makers could dissipate responsibilities for decisions, compromise operational efficiency and increase transactional costs.

The highest governing body of an association is usually the general assembly. Strategic oversight and supervision may be conducted by the board, which consists of representatives of the main parties that constitute the association. The day-to-day operations can be carried out by the executive board/secretariat.

Some restrictions may exist with respect to foreign membership in associations and their financial operations. In some countries, associations may also carry out incidental activity for profit in order to benefit the members of the group. Charitable associations generally receive more favourable treatment from the government than other types of associations (IPG, 2000).

The legal status of the institution that would be set up to manage the financial resources from a debt-for-environment swap transaction can only be selected after a thorough analysis of Georgian laws and regulations for legal entities and after a thorough consultation with potential creditors. This goes beyond the scope of this analysis. Therefore, no firm recommendation for the best legal form for the financial DFES facility in Georgia can be provided here, although preliminary findings seem to suggest that a public foundation located in Georgia has certain comparative advantages over other options.
ANNEX IX. THE PARIS CLUB AND GEORGIA AGREE TO A DEBT RESTRUCTURING
Paris Club Press Release, 21 July 2004

Paris Club creditors agreed on July 21, 2004 with the Government of Georgia to a restructuring of its external debt. This agreement follows the International Monetary Fund’s approval of Georgia’s arrangement under the Poverty Reduction and Growth Facility on June 4, 2004 in support of the Government ambitious reform programme.

This agreement consolidates roughly US$ 160.6 million due on debts contracted by Georgia before November 1, 1999 (of which US$ 12.7 million are ODA debts). This amount consists of arrears (including late interest) due as at May 31, 2004 as well as maturities falling due from June 1, 2004 up to December 31, 2006.

The rescheduling of the maturities and 50% of the arrears is structured on the so-called “Houston Terms”. ODA debts are to be repaid over 20 years, with 10 years of grace, at interest rates at least as favourable as the concessional rates applying to those loans; commercial credits are to be repaid over 20 years, with 5 years of grace with progressive repayment, at rates of interest at least as favourable as the interest rates set in the previous bilateral agreements. The remaining 50% of the arrears will be repaid over 3 years.

This agreement is expected to reduce debt service due to Paris Club creditors during the IMF supported programme from US$ 169.2 million to US$ 46.4 million (which consists mainly of interest on the rescheduled amounts and payments on the arrears).

This debt restructuring will make an important positive contribution to Georgia’s economic outlook. After a comparable effort from other creditors, this rescheduling will satisfy Georgia’s financing requirements for 2004 -2006.

On a voluntary and bilateral basis, each creditor may also undertake debt for nature, debt for aid, debt for equity swaps or other local currency debt swaps.

Paris Club creditors agreed in principle to meet at the end of the present Agreement in order to examine the situation of Georgia's debt under the Evian Approach.

Background notes

1. The Paris Club was formed in 1956. It is an informal group of creditor governments from major industrialized countries (i.e. OECD). It meets on a monthly basis in Paris with debtor countries in order to agree with them on restructuring their debts.

2. The members of the Paris Club which participated in the reorganization were representatives of the Governments of Austria, Germany, Japan, the Netherlands, the Russian Federation, the United States of America. The Republic of Turkey, a major creditor of Georgia, also participated in the debt rescheduling.
Observers at the meeting were representatives of the Governments of Canada, France, Italy and the United Kingdom. The International Monetary Fund, the International Bank for Reconstruction and Development, the European Bank for Reconstruction and Development, the Secretariat of the U.N.C.T.A.D., the Organization for Economic Cooperation and Development and the European Commission.

3. The delegation of Georgia was headed by Mr. Zurab Nogaideli, Minister of Finance. The meeting was chaired by Mr. Ramon Fernandez, Deputy Assistant Secretary at the Treasury of the French Ministry of Economy, Finance and Industry, Vice-President of the Paris Club.

**Technical notes**

1. The Poverty Reduction and Growth Facility in support of Georgia’s economic program was approved by the International Monetary Fund on June 4, 2004.

2. The total stock of Georgia’s debt was estimated as of end 2003 to be US$ 1.95 billion (source: IMF document dated May 14th, 2004, published on the IMF web site www.imf.org). The stock of debt owed to Paris Club creditors as at June 2004 was estimated to be US$ 525 million (source: Paris Club creditors). Paris Club creditors’ stock of debt is divided into US$ 225 million in ODA claims and US$ 300 million in non-ODA claims.

3. The cut-off-date is used by Paris Club creditors for the sole internal purpose of the Paris Club agreement. When a debtor country first meets with Paris Club creditors, the "cut-off-date" is defined and is not changed in subsequent Paris Club treatments and credits granted after this cut-off- date are not subject to future rescheduling. Thus, the cut-off-date helps restore access to credit for debtor countries facing liquidity problems. Concerning Georgia, the cut-off date was set at November 1, 1999.

4. As in any Paris Club agreement, Georgia agreed to seek comparable treatment from non-Paris Club creditors. In the present case, the comparable treatment shall imply an equivalent contribution of non Paris Club official creditors to the financing gap during the consolidation period (June 2004 – December 2006). The Georgian delegation indicated its willingness to meet these creditors soon in order to negotiate the terms of a future rescheduling.
<table>
<thead>
<tr>
<th>Date</th>
<th>Interest Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 March 2011</td>
<td>2.00%</td>
</tr>
<tr>
<td>1 September 2011</td>
<td>2.07%</td>
</tr>
<tr>
<td>1 March 2012</td>
<td>2.10%</td>
</tr>
<tr>
<td>1 September 2012</td>
<td>2.21%</td>
</tr>
<tr>
<td>1 March 2013</td>
<td>2.28%</td>
</tr>
<tr>
<td>1 September 2013</td>
<td>2.33%</td>
</tr>
<tr>
<td>1 March 2014</td>
<td>2.43%</td>
</tr>
<tr>
<td>1 September 2014</td>
<td>2.51%</td>
</tr>
<tr>
<td>1 March 2015</td>
<td>2.60%</td>
</tr>
<tr>
<td>1 September 2015</td>
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<td>1 March 2016</td>
<td>5%</td>
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<td>1 September 2016</td>
<td>5%</td>
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<td>1 March 2017</td>
<td>5%</td>
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<td>1 September 2017</td>
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<td>1 March 2022</td>
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<tr>
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<td>5%</td>
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<tr>
<td>1 March 2025</td>
<td>5%</td>
</tr>
<tr>
<td>1 September 2025</td>
<td>5%</td>
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</tbody>
</table>
ANNEX X. STATUS OF BILATERAL AGREEMENTS WITH CREDITORS AS OF 30 SEPTEMBER 2005

Paris Club 2004 Conditions

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td><strong>Cut-off date</strong></td>
<td>1 November 1999</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Consolidation period</strong></td>
<td>1 January 2003 – 31 December 2006</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Consolidated amounts</strong></td>
<td>Stock of arrears of principal and interest (including late penalties) (by 31 May 2004) and maturities of principal and interest (from 1 June 2004 - 31 December 2006)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Repayment schedule (Amount A)</strong></td>
<td>Semi-annual</td>
<td>50% of arrears</td>
<td>From 1 December 2004 – 1 December 2006</td>
</tr>
<tr>
<td><strong>Repayment schedule (Amount B)</strong></td>
<td>Semi-annual</td>
<td>50% of arrears and maturities (concessional ODA loans)</td>
<td>1 March 2016 – 1 September 2025</td>
</tr>
<tr>
<td><strong>Repayment schedule (Amount B)</strong></td>
<td>Semi-annual progressive</td>
<td>50% of arrears and maturities (non-concessional non-ODA loans)</td>
<td>March 2011 – 1 September 2025</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Creditors (currency)</th>
<th>Amount A</th>
<th>Interest</th>
<th>Amount B</th>
<th>Interest</th>
<th>Original Interest</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria (EUR)</td>
<td>0.000</td>
<td>3.00 %</td>
<td>20.340</td>
<td>3.00%</td>
<td>4.00 %</td>
<td>20.340</td>
</tr>
<tr>
<td>Germany (EUR)</td>
<td>0.000</td>
<td>0.75 %</td>
<td>1.480</td>
<td>0.75%</td>
<td>0.75 %</td>
<td>1.480</td>
</tr>
<tr>
<td>Japan (JPY)</td>
<td>0.000</td>
<td>1.30 %</td>
<td>258.820</td>
<td>1.30%</td>
<td>2.30 %</td>
<td>258.820</td>
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<tr>
<td>Netherlands (EUR)</td>
<td>0.368</td>
<td>4.50 %</td>
<td>0.368</td>
<td>4.10%</td>
<td>6.75 %</td>
<td>0.736</td>
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<tr>
<td>Russia (USD)</td>
<td>16.668</td>
<td>4.00 %</td>
<td>77.762</td>
<td>4.00%</td>
<td>94.430</td>
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</tr>
<tr>
<td>Turkey (USD)</td>
<td>4.375</td>
<td>3.25 %</td>
<td>22.152</td>
<td>3.25%</td>
<td>26.527</td>
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<tr>
<td>USA (USD)</td>
<td>0.673</td>
<td>2.25 %</td>
<td>7.644</td>
<td>2.25%</td>
<td>8.317</td>
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<table>
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<tr>
<th>Creditors (currency)</th>
<th>Amount A</th>
<th>Interest</th>
<th>Amount B</th>
<th>Interest</th>
<th>Original Interest</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Armenia (USD)</td>
<td>1.959</td>
<td>3.00 %</td>
<td>10.036</td>
<td>3.00%</td>
<td>4.00 %</td>
<td>11.995</td>
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<tr>
<td>Azerbaijan (USD)</td>
<td>2.024</td>
<td>3.00 %</td>
<td>11.262</td>
<td>3.00%</td>
<td>13.286</td>
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<tr>
<td>China (CHF)</td>
<td>0.597</td>
<td>4.00 %</td>
<td>1.324</td>
<td>4.00%</td>
<td>1.921</td>
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<tr>
<td>Iran (USD)</td>
<td>1.669</td>
<td>3.00 %</td>
<td>8.298</td>
<td>3.00%</td>
<td>9.967</td>
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</tr>
<tr>
<td>Kazakhstan (USD)</td>
<td>3.495</td>
<td>3.00 %</td>
<td>13.513</td>
<td>3.00%</td>
<td>17.008</td>
<td></td>
</tr>
</tbody>
</table>

**Source:** Ministry of Finance of Georgia.
Paris Club Creditors:

Austria: The Georgian government proposes to restore Euro 4.5 million, withdrawn earlier by Austria from the ESCROW account. After the restoration, the total amount (Euro 15 million) should be transferred to the Georgian budget, after which Georgia will treat the Austrian debt equally with other debts. The Austrian party does not agree to this proposal and suggests an agreement for signature, according to which the Georgian side does not have any stock of arrears of 2003 that can be restructured by Paris Club conditions. By a letter dated 29 March 2005, the Austrian side provided the Georgian government with the proposed text of this agreement for signature. The Georgian side does not agree to the proposed text and continues consultations. By a letter of 22 June 2005, the Austrian side again offered to sign the agreement.

Germany: The German side has sent to Georgia two draft agreements: an umbrella “inter-governmental” agreement, which covers 8 minor debt agreements (4 for the National Bank of Georgia (NBG), 1 for the United Georgian Bank (UBG) and 3 for the Government of Georgia) and the service agreement with the KfW on guaranteed credits. The Ministry of Finance has several comments on the agreements related to the state guaranteed credit, which is subject to restructuring (the credit is serviced by the National Bank of Georgia and is guaranteed by the Ministry of Finance). If Georgia signs this agreement, the government will become responsible for all the debt taken by the NBG, UBG and other subdivisions of the government. Negotiations are underway through the German embassy and the local office of the KfW. The parties have agreed on the text of the inter-governmental agreement and are negotiating the details of the service agreement. By its letter of 25 August 2005, the Embassy of Germany once again offered to sign both agreements, with the service agreement to be signed first, which is unacceptable to the Georgian government. A response is being prepared.

Japan: On 11 March 2005, the Minister of Finance of Georgia and the Ambassador of Japan signed an inter-governmental agreement on restructuring Georgia’s debt to Japan through an exchange of notes. The debt service agreement is to be signed between the Ministry of Finance and the Japanese Bank for International Cooperation (JBIC). The JBIC has provided the draft text of the agreement and preparations are underway to start relevant intra-governmental procedures leading to the signature of the agreement.

Netherlands: On 7 June 2005, a rescheduling agreement was signed. The National Bank of Georgia signed the agreement on behalf of Georgia.

Russia: An agreement with Russia was signed on 24 January 2005. On 1 February 2005, the signed agreement was forwarded to the Ministry of Foreign Affairs to start relevant procedures for the enforcement of the agreement. Currently the agreement is awaiting ratification in the Parliament.

Turkey: On 5 October 2005, a restructuring agreement was signed in Ankara, Turkey.

US: On 24 March 2005, the Ministry of Finance of Georgia received a draft agreement from the US embassy. Comments on this agreement were sent back to the US embassy. On 18 April 2005, during the visit of the Minister of Finance of Georgia
to the US Treasury Department, the Georgian side suggested changes. The US agreed to all suggestions, except for the interest rate. The Georgian side believes that the formula used by the US for calculating the interest rate accrued on the Georgian debt to the US is not accurate. Georgia has requested a reduction of the interest rate from 2.25% to 1.5%. The American side has not yet agreed to this reduction.

Non-Paris Club Creditors:

Armenia: A restructuring agreement was signed in Yerevan, Armenia on 29 September 2005.

Azerbaijan: Given the delay in signing the agreement, debt service has been temporarily suspended as of September 2004. On 22 June 2005, the parties initiated the process of signing a restructuring agreement on the Georgian debt to Azerbaijan. The Georgian side has completed all relevant procedures to sign the agreement.

China: On 29 September 2004, the Ministry of Finance sent a letter to the Ministry of Commerce of China informing it of the temporary suspension of debt service. So far there has not been any response and the debt service is still suspended. On 22 June 2005, the Chairman of the Georgian Parliament discussed the issue of debt restructuring during her visit to China. The Chinese party has not offered any concrete proposals yet. The Chinese party suggests holding negotiations on debt restructuring in China. In July and August 2005, consultations were held between the Deputy Minister of Finance of Georgia and the Trade Representative of China.

Iran: On 23 April 2005, an Annex to the agreement on debt restructuring was signed. The Georgian Parliament ratified the Annex on 15 June 2005.

Kazakhstan: In the framework of the CIS gathering of 5-6 June 2005, a meeting with the Deputy Minister of Finance was held at the Ministry of Finance of Georgia. During this meeting, the two sides agreed that issues of mutual indebtedness should be discussed in the context of financial and economic relationships between the two countries and that negotiations on these issues should be continued, in particular, in the framework of the visits of the Kazakh Prime Minister to Georgia in September 2005 and the Georgian Prime Minister to Kazakhstan in October 2005. Pending new arrangements, debt servicing has been temporarily suspended.

Source: Ministry of Finance of Georgia, World Bank.
ANNEX XI. GLOSSARY OF MAJOR TERMS

**Additionality:** New investment generated through debt conversion. Debt-equity swaps can be used to promote foreign investment in priority sectors of the economy and to stimulate privatisation or non-traditional exports. Debt-for-aid/environment swaps can attract additional donor assistance.

**Amortisation of Debt:** Reduction in the value of an asset over the period owned. The liquidation of debt through payments to a creditor or to a sinking fund.

**Bilateral Debt Conversion Agreement:** A legal agreement between a debtor government and a creditor government regarding the conversion of debt.

**Bilateral (Official) Debt:** Loans owed to bilateral creditor governments. Official development assistance (ODA) loans are typically owed to aid agencies. Publicly guaranteed loans (mostly export credits) are owed to export credit agencies (ECAs).

**Charter:** A legal document similar to Articles of Incorporation or a Deed of Trust, but used specifically when an entity is established by an act of the country’s legislation or an executive decree of its president, king, etc. (as opposed to an entity which is set up solely by private individuals or groups in civil society).

**Commercial Credits:** (i) Credits granted by a bank or a supplier to a debtor country for importing goods and services. When these credits are guaranteed by the appropriate institution of a Paris Club creditor, they are included in the claims treated in the context of the Paris Club. (ii) Non-ODA credits are sometimes referred to as commercial credits.

**Commercial (Private) Debt:** Debt owed to private sector creditors, including commercial banks, bondholders, and export and trade companies. Includes bonds, loans and promissory notes.

**Concessional Treatment, Concessionality:** Concessionality can occur either through a cancellation of part of the claims, or through a rescheduling of the claims over a long period of time with an interest rate that is lower than the appropriate market rate. When a debt treatment results in a reduction of the net present value of the claims rescheduled, it includes concessionality.

**Contingent Liabilities:** Contingent liabilities are costs that the government will have to pay if a particular event occurs. These are obligations triggered by a discrete but uncertain event. Relative to government policies, the probability of a contingency occurring and the magnitude of the required public outlays are exogenous (such as natural disasters) or endogenous (such as implications of market institutions and government programmes for moral hazard in the markets). Contingent liabilities are therefore not recognised as direct liabilities. However, contingent government liabilities are associated with major hidden fiscal risks. A common example of a contingent liability is a government-guaranteed loan. At the time a guarantee is entered into there is no liability for the government, since this is contingent upon the borrower failing to repay the loan as contracted. However, in the event of default, the lender can invoke the guarantee and the government will be obliged to repay the amount of the loan still outstanding. At that point, the contingent liability will become an actual liability of the government, and a payment must be made.

**Cut-off Date:** When a debtor country first meets with Paris Club creditors, the “cut-off date” is defined and is not changed in subsequent Paris Club treatments, and credits granted after this cut-off date are not subject to future rescheduling. Thus, the cut-off date helps to restore access to credit for debtor countries facing payment difficulties.

**Debt Buy-Back:** The repurchase by a debtor government of all or a portion of its external debt at a discount from face value. The World Bank's IDA Debt Reduction Facility (funded by the IBRD and bilateral donors) has financed commercial debt buy-backs for low-income countries. Some creditor
government have also sponsored buy-backs of officially guaranteed export credits from export credit agencies or the un-guaranteed portion of such credits (called “tail-ends”) from exporters and banks for conversion through bilateral debt reduction programmes (e.g., the Belgian and Swiss programmes).

**Debt-for-Aid (Development) Swap:** The cancellation of external debt in exchange for funding for development projects (child development, education, health, conservation/environment, etc.) in the debtor country. Also often called debt-for-development swap.

**Debt-for-Equity Swap:** The cancellation of external debt in exchange for equity investment in a domestic company or privatised public enterprise in the debtor country.

**Debt-for-Nature (Environment) Swap:** The cancellation of external debt in exchange for the debtor country’s commitment to spend an equivalent amount, or an agreed portion of the reduced, in local currency to finance conservation or environmental protection projects in the debtor country.

**Debt Reduction:** In the context of a concessional treatment, creditors can usually choose among a number of options to provide the required debt reduction in net present value. When the creditor chooses the debt reduction option, the net present value reduction is achieved through a cancellation of part of the claims.

**Debt Swap (Conversion, Exchange):** The cancellation of external debt, typically at a discount from face value, in exchange for payment in local currency or another asset (bonds, privatised public assets, etc.). The terms “conversion”, “exchange” and “swap” are used interchangeably.

**Deferral:** A debt treatment may defer (i.e. postpone, reschedule) some debt due immediately, or in the near future, to a later date. When a new long-term payment profile is defined, the treatment applied is not a deferral, but a reprofiling or a rescheduling.

**Discount from Face Value:** Percentage of reduction from the face value of debt. The inverse of the discount is the purchase price or the redemption price. Also referred to in colloquial terms as the "haircut".

**Eligible Debt:** Debt that may be treated in the context of a Paris Club agreement.

**Endowment Fund:** A fund that invests its capital and uses only the income from those investments to finance its activities.

**Emerging Markets Debt Market:** Also called the secondary debt market for trading commercial debt owed by developing country governments. “Emerging markets” refers to low- and middle-income countries that are pursuing political and economic reforms and a more complete integration into the global economy.

**Face Value:** The original amount of loans owed under a loan or other credit agreement, prior to debt rescheduling or reduction. Also referred to as the nominal value of debt.

**Flow Treatment:** A standard Paris Club agreement provides a way of tiding a debtor country through temporary balance of payments difficulties during a given period of time. This is referred to as a flow treatment, as opposed to a stock treatment.

**Heavily Indebted Poor Countries (HIPC) Debt Initiative:** Launched in 1996, the HIPC initiative is an agreement by the international community to help poor countries with good policy performance to escape from unsustainable debt burdens by providing them with comprehensive debt relief. The enhanced HIPC framework, agreed in 1999, lowers qualifying criteria, speeds up the delivery process and creates an explicit link to poverty reduction. About 36 countries, mostly in sub-Saharan Africa, are HIPC eligible.

**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 easier or cheaper access to money and therefore tend to buy more (increased demand). If the demand for goods and services increases,
prices increase, if prices increase, salaries tend to go up, if salaries go up, prices follow, etc. and this generates inflation.

**Moral Hazard:** The possibility that a signal or expectation of possible future government support may induce an undesirable change in behaviour by management of an enterprise or bank, for example by engaging in more risky activities because some of the potential losses are seen as being effectively underwritten by the government.

**Net Present Value:** The net present value (NPV) of debt is a measure that takes into account the degree of concessionality. It is defined as the sum of all future debt-service obligations (interest and principal) on existing debt, discounted at the appropriate market rate. Whenever the interest rate on a loan is lower than the market rate, the resulting NPV of debt is smaller than its face value.

**Non-Paris Club Creditors:** Bilateral creditors that are not members of the Paris Club of creditors.

**Observers:** Representatives from international financial institutions – or from countries that are members of the Paris Club but with no claims concerned by the debt treatment (de minimis creditors, creditors with only short-term or post-cut-off date claims, etc.) – may attend Paris Club debt negotiation sessions as observers. While they do not sign the Agreed Minute, they are referred to in it.

**ODA Credits, Non-ODA Credits:** "Official development assistance" (ODA) credits are defined by the OECD as credits with a low interest rate that are aimed at development.

**Official Creditor:** This covers a) official bilateral creditors (governments or their appropriate institutions), including Paris Club members; and b) multilateral creditors (international institutions such as the IMF, the World Bank or regional development banks).

**Paris Club:** The Paris Club is an *ad hoc* group of official bilateral creditors that meets once a month to negotiate rescheduling agreements with debtor countries. The French Treasury serves as the Secretariat for the Paris Club.

**Participating Creditor Countries:** Creditor countries that belong to the Paris Club or other official creditors that sign an Agreed Minute.

**Primary Balance:** The overall balance, excluding interest payments.

**Purchase Price:** The price, in percentage terms, paid to purchase debt from a creditor. The purchase price is the inverse of the discount from face value.

**Redemption Price (Rate):** The price, in percentage terms, at which debt is converted into another asset.

**Rescheduling:** (i) Consolidation, change of the terms of debt payment obligations; (ii) when opposed to concessional treatment, non-concessional consolidation; (iii) when opposed to deferral or reprofiling, the part of a consolidation with the longer terms of repayment; and (iv) when opposed to refinancing, consolidation through a change of the terms and conditions of the existing debt.

**Revolving Fund:** A fund that provides for the receipt of new resources on a regular basis – such as proceeds from special taxes designed to pay for conservation programmes – which can replenish or augment the original capital of the fund and provide a continuing source of money for specific activities.

**Secondary Debt Market:** A market for trading discounted debt instruments owed by developing country governments to commercial creditors. Also called the emerging markets debt market.

**Sinking Fund:** A fund that disburses its entire principal and investment income over a fairly long fixed period, e.g., 10 years or more.

**Stock Treatment:** As opposed to standard flow treatments, some Paris Club debt treatments apply not only to payments falling due in a particular period of time, but to the whole stock of debt from which those
payments fall due. The intention of any Paris Club agreement that deals with the stock of debt in this way is to provide a debtor country with a final debt treatment called an exit rescheduling.

**Sovereign Debt**: Debt owed by governments or by publicly owned agencies.

**Three-Party Debt Swap**: Debt conversions involving negotiations between a debtor government, an investor and a creditor.

**Trust Fund (also referred to as a “trust”)**: A legal structure by which money or other property is held, invested, and spent by a board of trustees or board of directors exclusively for a specific charitable purpose, as defined in a charter or deed of trust. Note: In common law countries, trust funds can also be established for specific individual beneficiaries, and be administered by an individual trustee, rather than by a board of trustees. A trust fund in this general sense can take one of several different legal forms, depending on the legal system of the country involved.