Debt swaps for development

Creative solution or smoke screen?
EURODAD report

Marta Ruiz
October 2007
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- Support the empowerment of Southern people to chart their own path towards development and ending poverty.
- Seek a lasting and sustainable solution to the debt crisis, promote appropriate development financing, and a stable international financial system conducive to development.

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This report has been written by Marta Ruiz, of EURODAD, broadly based on the work of the SES Foundation and in close collaboration with the Latindadd network. We are grateful for the collaboration and valuable comments provided by Esteban Serrani and Alberto Croce from SES Foundation; Humberto Ortiz from Jubileo Perú; Hugo Arias from Jubileo Ecuador; Jürgen Kaiser from Erlassjahr.de; Susanne Luithlen, Global Fund consultant; Eddie Boelens, from the Belgian Ministry of Finance, Marta Filipowicz, University of Warsaw and Gail Hurley and Alex Wilks of EURODAD among others. This is a EURODAD document but the analyses presented do not necessarily reflect the views of all member organizations of EURODAD.
EXECUTIVE SUMMARY

Debt swaps are not a new idea. Via a swap operation the creditor country cancels a debt at its nominal value and the debtor, in return, invests part of the cancelled amount in development projects as previously negotiated and agreed between both parties. During the eighties, debt swaps were widely used, especially in emerging economies. These swaps principally offered private investment for shares in national companies (debt for equity swaps). After a period of stagnation and with the arrival of the Millenium Declaration and with it the commitment of United Nations member states to seek new resources to finance development, debt swaps resurfaced on the agenda of some donors as another alternative to help finance the Millenium Development Goals.

For many civil society organizations and governments, creditors as well as debtors, debt swaps offer an opportunity to be taken advantage of, given the urgent need for resources to finance key sectors such as health and education. They also offer opportunities for an increase in the participation of local civil society with regards to management and follow-up of local development projects. Nevertheless, others consider debt swaps as a way of legitimizing debts of doubtful origin which should be audited and cancelled. Beyond the debate of legitimizing debt, there is a general consensus that debt swaps are by no means the solution to the problem of debt of impoverished countries. Swaps are an insufficient mechanism which fall way below the needs for cancellation and moreover, they entail higher administrative costs as well as reinforcement of conditionalities, which in some cases have been beneficial only to creditors. Debt is one of the main dead weight burdens for impoverished countries and existing debt cancellation initiatives, such as the Heavily Indebted Poor Countries (HIPC) Initiative and its components, are insufficient. Debt cancellation is firstly a matter of justice which should be applied to many more countries. In addition, there is an urgent need to achieve, in many cases, the achievement of the Millenium Goals.

But apart from these considerations, debt swaps are not a theoretical debate, but rather, a present reality which is growing in importance on the agenda of some creditor countries such as Spain, Italy or Germany. It is for this reason that it is necessary to analyze in close detail how these are being carried out. By means of a debt swap for development operation, in an ideal situation, all actors come out on top: the creditor improves its level of Official Development Assistance (ODA), the debtor increases its social investment and reduces the volume of its external debt in currencies, while the most needy populations benefit from additional investments and can count on the monitoring and participation of civil society.

In order for swaps to have a true impact on the improvement of social conditions, these must be performed and conceived in a sovereign fashion, as well as integrated into national strategies for development. Notwithstanding, this report shows that in many cases, debt swaps for development fall far short of this idyllic context in which all actors turn out as winners, given that the benefits received by indebted countries have been quite limited and the price paid by them very high in terms of management and budget but also sovereignty and conditionals.

There are also multilateral initiatives worth pointing out such as swaps for nature, signed by several members of the Paris Club for Poland in 1992 (Eco-Fund) and more recently, a debt fund for health (Debt 2 Health), managed by the Global Fund. It is therefore fundamental to understand this form of operation and the way in which they are implemented. These initiatives respond in higher scale to many of the problems posed by development swaps implemented at a bilateral level.

This document analyses debt swaps for development, how they work and, determines, based on concrete experiences, the benefits and problems encountered in terms of reducing indebtedness and promoting development. The report proposes a series of criteria which should be applied in every swap operation so that these mechanisms be incorporated into a responsible financing model, in accordance with the principles of Aid Efficiency, as expressed in the Paris Declaration, to which donors from the international community have committed to.
THE ORIGINS OF DEBT SWAPS

Market swaps: from debt for equity swaps to debt for to nature swaps

Debt swaps have been carried out in developing countries for more than twenty years. Ever since the first debt for equity swap performed in Chile in 1985, some fifty countries have performed debt swaps with differing aims.

During the eighties, while at the peak of structural adjustment programmes following the debt crisis of 1982 – especially in Latin America – debt swaps for equity emerged as a means to promote privatization at the same time as reduce the burden of external commercial debt. The main objective was, in these cases, to improve fiscal solvency so as to give countries access to new international credits. In this way, countries would swap their commercial debt and in return, creditors or a private investor would acquire shares in publicly owned enterprises. This mechanism was widely used in countries such as Chile and Argentina where they acquired their highest levels at the end of the eighties, reaching a maximum of US$ 27 000 million in 1990. But since then, debt for equity swaps began to decline, due in great measure, to the revaluation of these countries’ debts within the secondary market and due to an improvement in the economic situation of the main countries involved: Argentina, Brazil, Chile and Mexico.

Mid eighties bring about as well nature swaps where the investor, was generally an environmental agency without profit intentions and the swapped amount was destined to projects involving the protection of biodiversity and natural resources. The nature swaps were performed at a much inferior scale than those of shares. Between 1987 and 1994, these represented a total of US$ 177,96 million an insignificant figure in comparison with the volume of the share swaps. The first nature swap was performed in 1987 with Bolivia and Conservation International, which acquired US$ 650 000 of the commercial debt of Bolivia with a Swiss bank at a value of US$ 100 000 and that it was swapped by Bolivian government at US$ 260 000, investing these resources in an investment fund for the protection of biodiversity. Since then, it is estimated that some 30 conversion operations for nature have been carried out. Among them Eco-Fund, established in 1992 stands out between Poland and a group of official creditors from the Paris Club, for a value of US$ 571 million. This is without doubt the most voluminous conversion ever made within the environmental domain and is, in this sense, an exception to the rule.

At the end of the eighties emerges just as well UNICEF as an important commercial debt conversion key player for children aid programs. Between 1989 and end of the 90’s, UNICEF carried on 21 swaps worth US$ 52 million out of a total of US$ 199 million annulled.

Swaps beyond the market: of the emergence of debt swaps and social investment

In a first instance, the swap operations were performed exclusively in the secondary market, with commercial debts of banks or export credit agencies, but as of the nineties, bilateral debt swaps begin to be carried on beyond the market.

On the initiative of the United Nations Secretariat, the Paris Club introduced in 1991, the debt conversion clause for social investment, which establishes the framework for concessional bilateral debt swap and non-concessional for social investment. From then on, the denominated social investment swaps or development swaps emerge, which operate externally beyond the secondary market, between the bilateral creditor and the debtor. Most of the Paris Club members have made or are making development swap conversions. Among the pioneers in the use of swaps, the following stand out: Canada; United States of America, which performed nature swaps in the nineties; and Switzerland, which launched a broad debt swap program for the occasion of the 700th anniversary of the confederation. Currently, Germany, France, Spain, Italy, and Norway are among the creditors that actively use this instrument as a mechanism to improve its levels of Official Aid for Development (OAD).

There are other official initiatives for paying off debts which we shall not consider as swaps in this document.
ANATOMY OF THE DEBT SWAPS FOR DEVELOPMENT

What is a debt swap?

A debt swap or conversion operation consists in the assignment of a debt by a creditor to an investor (agency without profit intention) which buys it with a discount and swaps it to the indebted country at a price that will enable it to obtain a margin of benefit. The swap is made in the form of shares in a local enterprise, in form of local currency destined to finance development projects directly or by means of an exchange value fund.”

Case study: Triangular swap between UNICEF, Senegal and Argentina in 1992

<table>
<thead>
<tr>
<th>UNICEF Dutch Committee</th>
<th>Senegalese Government (debtor)</th>
</tr>
</thead>
<tbody>
<tr>
<td>PHASE 1</td>
<td>PHASE 2</td>
</tr>
<tr>
<td>PHASE 2</td>
<td>PHASE 3</td>
</tr>
<tr>
<td>Argentinean Government ( creditor)</td>
<td>UNICEF Senegal Development Projects</td>
</tr>
</tbody>
</table>

Three Phases:
1. UNICEF’s Dutch committee bought US $24 million of debt at a nominal value from the Argentinean government (a creditor to Senegal) for US $6 million (25% of the price of purchase).
2. UNICEF transferred US $24 million of debt to the Senegalese government for its annulment.
3. The Senegalese government paid the equivalent to US $11 million (46% of the price of amortization) in CFA francs during three years as a support to UNICEF-Senegal projects for women and children.

Source: UNESCO, 2006

What sort of debt swaps exist?

Different types of swaps can be distinguished, according to its structure, its contents or goals pursued. A multitude of possibilities exist, yet, the main ones are:

Bilateral: the operation takes place directly between the creditor country and the indebted country. This type of swap has been the one to prevail in investments for development.

Triangular, tripartite or with a third party: the debtor sells to an intermediary (NGO, development agency or other agent) which will then negotiate with the debtor the value of repurchase (see diagram above).

Multilateral or multi-creditors: several governments perform the operation jointly and the swapped funds are deposited in the same exchange value fund. The most representative case study is that of Eco-
Debt swaps for development. Creative solution or smoke screen?

In this document we focus on debt swaps for development, where the swapped amount is used for social investment. Within this type of swap, there exist swaps for projects, where the investment is done directly in the financing of a specific project, and swaps for exchange value funds (FCV), where the swapped amount is deposited as national currency in a trust fund. The following chart synthesizes the main swap modalities:

<table>
<thead>
<tr>
<th>Type of swap</th>
<th>Parties to transaction</th>
<th>Eligible debt</th>
<th>Type and use of debt swapped proceeds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt-equity</td>
<td>Three party</td>
<td>Commercial (banking loans, bonds, promissory notes, ...)</td>
<td>Cash Bonds (monetary stabilization, debt conversion)</td>
</tr>
<tr>
<td></td>
<td>- creditor (government, bank, Credit agency for export (ACE))</td>
<td>Bilateral publicly guaranteed (ACE, Paris Club, ...)</td>
<td>Public sector assets</td>
</tr>
<tr>
<td></td>
<td>- private sector investor</td>
<td></td>
<td>Private sector investment (equity shares, fixed investments, privatization of public enterprises)</td>
</tr>
<tr>
<td></td>
<td>- debtor (government)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>For development (education, health, environment, nature, child development)</td>
<td>Three party</td>
<td>Commercial Publicly guaranteed Bilateral Concessional Bilateral</td>
<td>Cash (local currency) Development projects Counterpart fund Environmental fund</td>
</tr>
<tr>
<td></td>
<td>- creditor</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>- debtor government</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>- not-for-profit investor (UN agency, NGO, ...)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>- public sector investor</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>- private investor</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>- debtor (government)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Bilateral</td>
<td>Concessional Bilateral (ODA) Publicly guaranteed (and non guaranteed parties)</td>
<td>Cash (local currency) Development projects Counterpart fund Environmental fund</td>
</tr>
<tr>
<td></td>
<td>Debtor government and creditor government</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Multicreditor: various creditor governments</td>
<td></td>
<td></td>
</tr>
<tr>
<td>For exports</td>
<td>Three party</td>
<td>Commercial</td>
<td>Local currency payment for exported goods (non traditional exports)</td>
</tr>
<tr>
<td></td>
<td>- creditor government</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Debtor government</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Private investor</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Bilateral</td>
<td>Bilateral</td>
<td>Clearing arrangement (exportations)</td>
</tr>
<tr>
<td></td>
<td>Debtor government and creditor government</td>
<td></td>
<td></td>
</tr>
<tr>
<td>For offsets</td>
<td>Three party</td>
<td>Commercial</td>
<td>Offset against obligations to debtor government (taxes, customs duties, ...)</td>
</tr>
<tr>
<td></td>
<td>- Debtor government</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>- creditor, private investor</td>
<td>Commercial</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Debtor government</td>
<td>Domestic</td>
<td></td>
</tr>
<tr>
<td>Debt buy back</td>
<td>- Commercial creditors</td>
<td>Commercial</td>
<td>Cash (foreign currency) Long term bonds Debt/equity bonds / debt for development option</td>
</tr>
<tr>
<td></td>
<td>Financed by IDA debt reduction facility</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt for debt</td>
<td>- Debtor government</td>
<td>Commercial (Brady bonds)</td>
<td>Domestic bonds</td>
</tr>
<tr>
<td></td>
<td>- Commercial creditors</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Debt Relief International, 2001

Which debt can be swapped and until when?

Debt conversion for development has been carried on basically over bilateral debt.

In 1991, The Paris Club established the framework to be followed for swapping concessional bilateral debt (ODA) and publicly guaranteed commercial debt, through Credit agencies for export (ACE). The conversion clause which rules this framework has evolved with time and establishes nowadays the limits of swappable debt. In this way, a creditor country form the Club could swap up to 100% of the concessional bilateral debt (ODA) however, restrictions exist when the debt is non-concessional, as shown in the following chart:
Debt swaps for development. Creative solution or smoke screen?

| Maximum convertibles of non-concessional debt |
|-----------------|-----------------|-----------------|
| **Limits**      | **Low income countries** | **Medium income countries** |
| **Maximum convertible** | 20-30%*       | 10-30%*       |
| **Maximum alternative nominal** | US$13-18 million** | US$13-27 million** |
| **Maximum general nominal** | US$13-27 million** |

Source: Paris Club 2005

* In both cases, 30% is the maximum allowed only in exceptional cases.

** The Paris Club allows choosing the highest value between the % in the first row and the absolute figure given in the second row of the chart.

The Paris Club imposes these limits so as to guarantee its principles of equal treatment towards debtors and of solidarity among creditors, clearly expressing its intention of protecting in priority the interest of the creditors. This limits the debt swaps’ scope, which could, being more ambitious, answer in great measure the needs for relieving the debt of indebted countries. Despite these limits, in practice, few creditors reach this maxima, which leads to think that the swaps continue to nourish the logic of great announcements within the discourse but rather scarce in practice. As a result of these restrictions, the volume of swaps is generally highly reduced. According to a study performed on 60 swaps by the SES Foundation (Latinadd member), only six of them implied projects of over US$500 million, as it is the case of Eco-Fund with Poland: US$571 million.

Composition of external debt in middle income countries

Composition of external debt in low income countries

Source: Global Development Finance, 2007

Most of the swaps for development are performed on bilateral debt but this one represents only a small part of the external debt of countries in development, which limits the potential scope of the swap, as shown in the graphs above. According to the report delivered by the UNESCO's working group on debt swaps for education, “A huge proportion of the long term debt of countries in development is within private hands. This is significant within the context of a debt reduction, given that the debt swap for development is mainly linked to bilateral debt programs. It can be deduced from this reality that, even in the hypothetical case that countries in development could cancel or swap their debt with the bilateral creditors, this would have little effect on the overall debt issue.”

**Commercials**: Unpaid and not publicly guaranteed commercial debts can also be subject to conversion, given previous agreement between the parties though, in the case of conversion for development, the commercial debt is not generally subject for swap. If the commercial debt were to be swapped, what would be its supposed value? In 2005, the total value for arrears in debt with commercial creditors was of US$ 30 792 million for countries with a medium income and US$ 4 292 million for those of low income. Only in exceptional cases has there been commercial debt swaps for development; such was the case of Switzerland with Peru.
Debt swaps for development. Creative solution or smoke screen?

Commercial debt swaps: a means to launder illegitimate debts?

The main risk posed by swapping or any other sort of relief or restructuring operation over commercial debt, is to legitimize its origin. Swapping or restructuring it turns out into laundering debts which in their origin contain illegitimate components (white elephants financing, export promotions with no aims for development, etc.).

Thus, there have been several cases where the indebted governments have refused commercial debt swap proposals. For example, in 2004, Norway proposed to Ecuador to swap a publicly guaranteed commercial debt for the sale of boats, however, the pressure exerted by Norwegian and Ecuadorian civil society organizations succeeded in stopping this process, alleging on one side, the low annulment percentage of the operation, but above all, that these were commercial debts that had only served the Norwegian interests, and thus, were illegitimate and should be annulled. Shortly after, in October of 2006, Norway decided to annul the same debt to Ecuador recognizing that it refer to an irresponsible loan aiming to save the shipbuilding industry - which was in crisis - and not Ecuador’s development. This example gives two important lessons: first, the debt is not simply a mere financial issue but rather of justice. The origin of the debt is an essential component that should be analyzed in the debt swaps and especially in the commercial debt where abundant comparable cases are known. If Ecuador would have accepted the swap, the debt would have been “laundered” and nobody would know today that this debt was irresponsible and therefore should have been annulled. And second, this example shows that civil society can and should play a fundamental role as a pressure upon their governments and not to accept any sort of operation over debts.

Recently, the Kenyan government refused a publicly guaranteed commercial debt with Great Britain, an operation that involved the construction of bridges in the whole country by British enterprises. While no detailed information is available, the rejection leads to think that it is due to the entailment of British enterprises’ interest which are remote from Kenyan government priorities or unfavorable conditions.

Who benefits from the swaps for development?

The obtainment of an agreement to swap a debt will depend of the negotiation between the indebted government and the creditor, within the framework of the Paris Club. During this process, the creditor will determine if the debtor will be able or not to benefit from a swap depending if it can or not fulfill the criteria established by the Club. A fundamental criteria, aside from the fact to have renegotiation agreements with the Club, is that the indebted country have a program with the IMF. This supposes a serious limit for all those countries that are cutting links to the IMF.

Currently, some twenty non HIPC countries have benefited from concessional and non-concessional debt conversions, among which can outstanding: Côte d’Ivoire, Dominican Republic, Ecuador, El Salvador, Georgia, Guatemala, Indonesia, Jamaica, Jordan, Kenya, Moldavia, Morocco, Philippines, Peru, Serbia, Montenegro and Pakistan. Many more countries could benefit of conversions, but, as will be seen later on, it is political criteria that determine the decision, therefore leaving little transparency with regards to the eligibility of the beneficiaries.
**Phases of debt swap for development**

**Bi-national committee:** Once agreed the decision to swap the debt, a bi-national committee is established which will negotiate the sectors to which the swapped amount will be ascribed to and the modalities of implementation. This committee is usually composed by the Ministries of Economy from both countries, which supposes an important limitation given it excludes in most cases essential actors such as relevant ministries and civil society.

**Technical committee:** What follows, is the establishment of a technical committee, of consultive nature, composed of technical representatives of the ministries of economy and where there is in a more generalized manner, a civil society representation; this committee decides where the funds will be destined and will be in charge of monitoring and evaluation.

**Exchange value funds:** Generally, the swaps are operated through exchange value funds (FCV), which can be of different types but in essence refer to a fiduciary fund in which the indebted country deposits the swapped amount in local currency. In general, the amount is contributed to the FVC in stepped installments to prevent the creation of liquidity problems. In principle, the exchange value fund should be managed by a national organism, independent form the government, so as to guarantee a higher transparency.

The following schema resumes one of the mostly used models for debt swap for development. The creditor cancels a bilateral debt of US$100 million. This does not imply any payment but rather an accounting operation. The debtor deposits in an exchange value fund (FCV) the equivalent of 60 million US$ in local currency (in other words, with a 40% discount). This FCV is managed independently and destined to finance social projects operated by development agencies (such is the case of UNICEF). This last actor is not always present, rendering local NGOs or the creditor country the one to directly implement the projects.
**Conversion rate and discount rate**

Once the debt amount to be swapped is determined, depending on the limits of the Paris Club, the applicable discount rate is established. There are no predetermined restrictions for this, depending as a last resort on the creditor’s will. A 20% discount (or conversion rate of 80%) indicates that the debtor shall contribute 80% of the debt’s value swappable for social investments. In practice, the discount rates currently applied to the creditors is quite low going from a maximum of 50% generally applied by Germany or to a 0% applied by Spain or Italy.

So that a swap operation may have sense, both parties must become benefited. That is why it is necessary that a sufficient discount rate be applied which may be convenient to the debtor as well as the creditor. That is, the debtor looks to reduce his indebtedness and to invest more in development and the creditor to recuperate part of unpaid old commercial debts and improve his OAD status. From the debtor’s point of view, the bigger the discount rate is, more additionality exist in the operation, since it saves budgetary resources that could be used integrally in its national long-term planning and overall sovereignty, and at the same time, it saves the transaction expenses derived from the swap operation which are generally high. On the contrary, the less the discount is, more resources shall have to be destined to the countervalue funds, which not only involve implementation costs but also a greater conditionality due to the predetermination of the use of these funds. In short, a low discount rate means a greater budgetary pressure to the debtor that could increase his need of internal or external indebtedness worsening his sustainability level, contrary to what swapping seeks as an objective. From the creditors’ point of view, a smaller discount does not imply a smaller OAD accounting since it is generally done on the nominal value of the debt. However, it does imply a major influence in the decision to use the swapped funds, reinforcing the conditions. This poses a fundamental question in the debate regarding the transparency, corruption and sovereignty. While it is true that corruption constitutes a fatal restrain to development and that embezzlement would have to be fiercely fought, no focused reasoning should be abused on corruption to systematically justify smaller discount rates by the creditors and greater conditions. On the contrary, one would have to get out of the unending swirl of “corruption versus sovereignty” in order to go towards a focus based in the shared responsibility by both parties and a transparent transaction as many NGOs have been claiming.

Some authors, such as Oscar Ugarteche, establish that for a swap to be economically beneficial for the debtor country the discount should be such that the current net value of the swappable amount be lower to that of the debt, otherwise it would be too costly for the budget of the debtor country. In short, if the debt swap is presented as a financing development instrument with an unindebtedness component, it should contain a more important concessionality and additionality level, by means of much more generous applications of discount rates.

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**The secondary debt market**

Comercial debts may be swapped through the secondary debt market. In this case, the sale and repurchase price is given by the market with the purpose of a recovery probability of the same. Therefore, if a debt is of doubtful recovery, its price shall be lower than a debt whose reimbursement is more probable. The greater the recovery guarantee, the more it will get closer to the market price at the nominal value. In the field of debt swaps, the model used during the 80’s was that of an investor who acquired commercial indebtedness certificates at a secondary market price and would swap them to the debtor country gaining a margin of profit. The debtor government would change the amount negotiated by shareholdings in national companies, or would invest in a fund destined to environmental projects, which according to the investor, would be a private company or a non-profit organization. In this type of swaps, the discount rate is given by the market price of the swapped debt and by the negotiation between the investor and the debtor. Thus, a debt with a nominal value of US$100 million and worth US$80 million in the secondary market could be purchased by a nature conservation agency that negotiates a swap price of 90 million with the debtor country. The debtor pays this amount to the agency, which in turn invests the totality in nature conservation projects. However, the operations in the secondary market are not risk exempt since, while they facilitate the accomplishment of potentially beneficial swaps for the development, they also allow the performance of speculative funds that, such as vulture funds, purchase debts at a low price and demand their entire collection by means of judicial proceedings. In this sense, the secondary debt markets and, in general, the capital financing markets are a risk space due to its high volatility and the absence of regulation in which they prevail. That is why a regulation that allows avoiding this type of practices is necessary.
Final use of swapped funds

According to the swap survey made by Foundation SES\textsuperscript{[x]}x, most of the swapped amounts have been made within the framework of the HIPC initiative. This is quite regrettable since the interest in the swaps is mainly because it can be extended to other countries outside the HIPC framework, but in the exercise, just a minimum part of the existing swaps have been affected to non-HIPC countries. Likewise, the HIPC countries should benefit exclusively from anulments and not from swaps.

Secondly, although way behind, there are investments swaps or those by shareholdings that include all types of projects and are not focused exclusively on development. By nature, swaps with about US$900 million continue in third place even though it is worth remembering that the great majority is integrated by only one swap, the Eco-Fund in Poland, which involves an exception to the rule for its high volume and coordination of the creditors as shall be seen further on.

As the chart shows, aggregately, the total debt amount submitted to a swap is, once the HIPC is excluded, of US$3600 million, a totally insignificant amount in relation to the external debt levels of developing countries whose stock surpasses US$ 2 800 billion. The 15 000 millions indicated in the chart represent the total amount condoned (eliminated from the creditor’s accounts), but the amount paid out by the debtors and destined to projects is, according to the SES Foundation estimates, around US$7 000 million.

<table>
<thead>
<tr>
<th>Investment areas of the condoned amounts</th>
<th>Total debt condoned in US$ millions</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Development</td>
<td>660,18</td>
<td>4,4%</td>
</tr>
<tr>
<td>Education</td>
<td>217,48</td>
<td>1,4%</td>
</tr>
<tr>
<td>Education &amp; Public Investment</td>
<td>50,00</td>
<td>0,3%</td>
</tr>
<tr>
<td>Investment</td>
<td>1236,43</td>
<td>8,2%</td>
</tr>
<tr>
<td>Nature</td>
<td>872,50</td>
<td>5,8%</td>
</tr>
<tr>
<td>Objectives of the millenium</td>
<td>567,00</td>
<td>3,8%</td>
</tr>
<tr>
<td>HIPC</td>
<td>11 421,27</td>
<td>76%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>15 024, 87</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: SES Foundation, April 2007
WHY SWAP DEBT FOR DEVELOPMENT?

In the first place, it is worth asking oneself what is the interest in swapping debt for development. Why swap debts when the fastest and most legal, according to civil society organizations, is the annulment of the debt in all the poor countries that urgently need to finance their development. In this sense, the debt swaps appear as a half solution since they hardly reduce the indebtedness, do not release the additional resources by the donors, involve more conditions in the use of the resources contributed by the debtor and in addition, they entail high handling costs. Given that, the swaps may constitute a useful solution for those countries that have been left excluded from the operations of debt annulment. In a simplified debt swap outline, all the actors involved come out winning in principle: the creditor recovers in currency, part of an improbable collection debt (in the case of commercial debts), and improves his OAD figures (in case of bilateral or publicly guaranteed debts). The investor (if any) obtains a profit margin between the purchase price and sale price to the debtor. The debtor country pays in local currency a lower amount at the nominal value of the debt and assigns it to social investments. But evidently, everything depends on the amounts and conditions of the swap as well as the eligible debts.

Why do creditors swap?

Because it increases the probabilities to recover unpaid debts: In the event of non-concessional debts, it results interesting to the creditor to swap a debt when its recovery is unlikely, allowing him to avoid the accumulation of arrears. By means of a swap debt operation, the creditor recovers at least part of it in currency.

Why do they allow the increase of the OAD figures?: The creditor can enter the nominal value of the non-concessional debt as OAD. In this sense, the debt swaps contribute to the compliance of the objective of 0,7% of the GDP (gross domestic product), but without involving the disbursement of the additional funds by the donor countries which is a way of inflating the figures of official Aid by means of mere accounting operation. Even though it is a usual practice, this goes against the principle of additionality aid. Just as the 2007 report of the European NGOs shows regarding the OAD, 30% of the OAD contributed by the European donors is not a real aid since it includes debt annulments, as well as expenses from foreign students or asylum to refugees in Europe. This practice to the NGOs must cease and the debt relief operations including the swaps should be strictly additional to the OAD, due to the Monterrey Declaration.

Because it improves visibility: For the creditors, swaps are also a good instrument to increase the visibility of the shares of the donor country in a determined sector.

Because they guarantee the adequate use of the funds: The fact that the debtor country pays out with its own budget the funds to swap the debt, entails a major responsibility on his part in the use of the funds than if this was about a donation. But on the other hand, the swap operations may involve a bigger orientation by the creditor of the sectors in which he will invest, reducing the debtor's leeway in the decision regarding the use of the swapped funds.

Why do debtors swap?

Because they facilitate an open dialogue regarding the debt with the local civil society: Just as the African Debt and Development Network (AFRODAD) affirms, for this dialogue to be fruitful, it needs a political will by the governments and the energy and empowerment of organizations of the local civil society. “After having diverted national resources for decades to the payment of the debt, isn’t it fair that now these resources be re-oriented towards programs to erradicate poverty and social services?”

Because they strengthen the participation/involvement of the local civil society: the local organizations get involved in new projects of local development through the supervision of the projects approved by the governments. Just as the SES Foundation underlines, that for the social organizations in the beneficiary countries “the involvement in swap processes means a real qualitative jump when acquiring a role as a speaker with local authorities and ministries, strengthening significantly its incidence capacity in the public policies.” This opportunity that offers the swaps for development should be fully taken advantage by the local organizations and in this sense there is a lot to be improved.
Because they allow the increase of social investment: Instead of paying the creditor, the funds remain in the country and are invested in key social sectors. This advantage shall be directly proportional to the magnitude of the swapped amounts. The budgetary transfer of resources destined to the payment of the debt toward social sectors means an immediate relief from which tangible benefits can be obtained at a short term at the local development level.

Because they allow the reduction of the debt in currency: The debtor country reduces its indebtedness in currency when it swaps them for local currency. Just as in the previous case, the degree of unindebtedness shall depend on the amount of the swapped debt and the discount conditions applied. This way on determined occasions, if the debtor country pays 100% of the value plus interest, such as the swap case from Spain with Ecuador, the cost shall be clearly raised to the budget level.

Because they allow the relief of debts to the countries excluded from the HIPC initiative: The official initiatives of debt annulments benefit a very limited number of countries. Currently, only 40 benefit from the HIPC initiative and its Multilateral Debt Relief Initiative (MDRI) tendency, but there are many more that need debt annulments, since they direct a major part of their budgets to the payment of the debt service in detriment of the social sectors. For the United Nations Conference on Trade and Development (UNCTAD), even annulling 100% of the debt of the Sub-Saharan Africa countries, not even half of the necessary resources would be gathered to reach the Objectives of the Millennium. In this context, as long as the debt annulment initiatives continue leaving out so many countries, the debt swap in the non-HIPC countries can represent a temporary solution provided the swapped amounts are sufficiently significant so as to have an impact on the social sectors in which it is invested and the discount rates are sufficiently high so as to generate a budgetary incentive to the debtor government.

Because they allow the improvement of their reimbursement capacity, an advantage with secondary effects: This is about everything regarding swaps on commercial debts in arrears that are not being paid. When the reimbursement probabilities are increased and their creditability is improved as debtors, the price of the debts increases in the secondary market and the operations become more burdensome for the indebted countries. It can be concluded that this advantage has a cost for the debtor since while the swap shall continues to be profitable for the investors, which will affect the highest cost in a larger profit margin, it shall not be so for the debtors who, although they will see their accumulated arrears reduced and their debt revalued, they shall have to pay more for its refunding.

In short, so that the swap may be truly advantageous in terms of financial relief and social investment, it must be done on nonconcessional debts and that they are being reimbursed. Otherwise, the swap may exert a supplementary pressure by increasing the price of their other debts in the secondary market and the creditors’ pressure to recover other debts in arrears. With regards to the concessional debts, these on the contrary, should be subject to annulments.

Some examples and features of swaps according to the creditors:

<table>
<thead>
<tr>
<th></th>
<th>Switzerland</th>
<th>Canada</th>
<th>Germany</th>
<th>Italy</th>
<th>Spain</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Date</strong></td>
<td>90’s</td>
<td>80’s &amp; 90’s</td>
<td>90’s 2000’s</td>
<td>End of the 90’s-2000’s</td>
<td>90’s-2000’s</td>
</tr>
<tr>
<td><strong>Type of projects</strong></td>
<td>Social Infrastructure, promotion of small business</td>
<td>Nature, Children</td>
<td>Nature, Social investment</td>
<td>Nature, Small Business</td>
<td>Social Infrastructure,</td>
</tr>
<tr>
<td><strong>N° of Beneficiary countries</strong></td>
<td>45</td>
<td>7</td>
<td>12</td>
<td>9</td>
<td>12</td>
</tr>
<tr>
<td><strong>Discount rate</strong></td>
<td>50%-80%</td>
<td>50-75%</td>
<td>50-70%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td><strong>Type of swap</strong></td>
<td>FCV</td>
<td>FCV Projects</td>
<td>FCV Projects</td>
<td>FCV</td>
<td>FCV</td>
</tr>
<tr>
<td><strong>Type of debt</strong></td>
<td>ACE guaranteed</td>
<td>OAD</td>
<td>OAD</td>
<td>OAD</td>
<td></td>
</tr>
<tr>
<td><strong>Binded help</strong></td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>CSO</strong></td>
<td>Partial</td>
<td>Partial</td>
<td>High</td>
<td>Partial</td>
<td>Partial</td>
</tr>
<tr>
<td>participation</td>
<td>(Technical Execution)</td>
<td>(Binational Technical FCV)</td>
<td>(Technical Execution)</td>
<td>(Technical, execution)</td>
<td></td>
</tr>
<tr>
<td>--------------</td>
<td>-----------------------</td>
<td>-----------------------------</td>
<td>-----------------------</td>
<td>-----------------------</td>
<td></td>
</tr>
<tr>
<td>Others</td>
<td>Total amount swapped of 700 million CHF</td>
<td>Annual assignment of 100 mill € for swaps</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: O. Ugarteche, 2006
PROBLEMS FOUND IN DEBT SWAPS FOR DEVELOPMENT

Despite the potential benefits of debt swaps for development, civil society organizations have encountered many problems with the way in which they have been implemented. Latin American organizations (within the Latindadd network) and the Spanish section of the Global Campaign for Education have therefore published several reports presenting both the potential benefits and key limitations of swaps. The main problems raised by these organizations and by Eurodad are presented in brief here.

The origin of the debt is not taken into account: The debate around the illegitimacy of debt is taking shape in debtor countries as a result of citizens’ audits carried out on their foreign debt. The debate is also gaining ground as creditors begin to acknowledge their own responsibility. For example, in October 2006, Norway announced its decision to cancel US$80 million worth of debt with five countries which had resulted from a series of irresponsible loans aimed at furthering Norwegian export interests. In cancelling these debts, Norway assumed its part of the responsibility for them. Meanwhile, the World Bank and UNCTAD (United Nations Conference on Trade and Development) have recently published two studies on the issue of odious debt. Recent parliamentary initiatives elsewhere have also supported audits and tackled the question of odious debt head on.

It is crucially important that debt reduction mechanisms, such as swaps, do not undermine the growing number of initiatives challenging the root causes of debt problems — that is, the accumulation of loans of dubious origin by debtor countries, for which creditors need to acknowledge their responsibility. In the second UNESCO working group on debt swaps for education in 2007, the representative of the Philippine government recommended the incorporation of transparent audits on external debt to determine which parts of the debt were illegitimate.

Lack of additionality: Creditors have promised that debt relief should be additional to ODA. However, there are still doubts about how this is applied in practice. There needs to be a systematic evaluation that shows the extent to which debt swaps arranged by creditor countries represent funds that are above and beyond their ODA. From the debtor’s point of view, the swap is additional only if the funds finance investments over and above investments the country was going to carry out anyway. Additionality of resources will be greater the higher the discount rate applied. The larger the discount, the more additional funds can be used in a consistent and lasting manner, since the end aim is to guarantee the sustainability of social investment through a stable, long-term budget. In this sense, the counterpart funds provide only a temporary solution.

Use of funds: One of the problems that education and debt NGO’s have encountered in bilateral debt swaps for development is that a large part of the resources are assigned to cover current expenditures. This raises questions about the additionality of the swap in relation to national budgets. For example, in the swap for education between Spain and Honduras, a significant proportion of the budget was assigned to the ministry of security (police training) and financial services of the general administration, from which a large part was set aside to pay wages and salaries.

This problem indicates that budgetary deficits are still of primary importance and that beneficiary countries still need additional resource. As noted in the Sachs report of the United Nations, “We stress that no distinction should be made between funding capital and operating costs through official development assistance, since poor countries cannot afford to fund operating expenditures, which account for a large share of total costs in health, education, and other sectors. To maintain macroeconomic stability, external finance to low-income countries will need to be provided in the form of grants (Landau 2004)”. This highlights the urgent need for donors to contribute funding that is genuinely additional.

Low discount rate: Although some creditors, such as Germany, apply discount rates of 50%, other countries like Italy or Spain do not apply any discount or only a very low rate. In order to maximize the potential benefits of debt swaps for developing countries, the discount rate has to be considerably increased so that the debtor country has a real budgetary incentive to swap debt for social investment.

Little clarity in the eligibility of beneficiary countries: To date, there are few countries that have benefited from debt swaps. Some estimates suggest that around 50 have done so, but a large proportion of these are HIPC countries that should not have received swaps but cancellation. In order to benefit from a swap a country should, in principle, have an IMF program in place. But in practice, it is creditors who decide who benefits from a swap: although debtors may show an interest in swapping debts, some of them continue to be excluded on political rather than technical grounds.
Debt swaps for development. Creative solution or smoke screen?

The IMF: sole guardian of swaps?

In practice, the decision over whether or not to swap a country’s debt depends on creditors’ political will more than anything. This has led to double standards in a number of cases. For example, a country like Ecuador, which no longer has a relationship with the IMF, has signed debt swaps for development with Spain and Italy, thus violating the requirement of an IMF programme in place. On the other hand, a country like Argentina, which has also cut ties with the IMF, is facing many difficulties in obtaining a debt swap with Spain, despite actively requesting it. However, this is probably due not only to the fact that it does not have a programme with the IMF, but also to the ongoing tense relationship between Argentina and this institution. It is worth remembering that Argentina paid its debt to the IMF in advance and that in the latest renegotiations with the Paris Club it insisted on keeping the IMF out of talks. Moreover, the Paris Club recently refused a swap arrangement with a concessional component for Angola citing that it did not have a programme with the IMF. But likewise, in this case, the refusal was probably also about political tensions with this country.

High administrative costs: One of the main disadvantages of debt swaps is their high cost, due to each project being dealt with separately. This dispersal leads to a multiplication of transaction and management costs, which limits the efficiency of the mechanism at a global level. On top of this are the extensive political negotiations which accompany every swap that is negotiated bilaterally. One way of overcoming these obstacles is to use multi-creditor funds, thus minimizing transaction and negotiation costs and creating greater synergies.

High conditionality/tied aid: Another problem identified by civil society organizations is the strengthening of conditions by the creditor who can play a powerful role in defining investment priorities and in tying the involvement of their own domestic companies into projects that are financed through debt swaps. Despite donor commitments to reduce this kind of tied aid, it nevertheless continues to happen. For example, debt swaps for education implemented by Spain have been tied to the purchase of goods or services of Spanish companies. While the new debt law approved by Spain at the end of 2006 prohibits such actions, most of the swaps were signed before the law came into force, and thus remain outside the new legal framework.

Tied aid in the Ecuador–Spain swap

The swap for education signed between Spain and Ecuador under the previous Ecuadorean government resulted in a fund of €50 million, of which €20 million was assigned directly to the education sector and €30 million to hydroelectric projects. This second set of projects has since been blocked by the current Ecuadorean government due to the excessive level of involvement of Spanish companies. It is currently being renegotiated to include the involvement of the Ecuadorean public sector. This example highlights two fundamental issues: first, that tied aid involving a subsidy for Spanish exports occurred, and second, that strong political will combined with negotiation capacity, such as that expressed by the Ecuadorean government, can improve the conditions for debtor countries.

Lack of participation by civil society: The participation of civil society organizations, from both creditor and debtor countries, is essential throughout the swap process in order to guarantee greater transparency in the definition of priority projects, as well as in their implementation, evaluation and to ensure full accountability. Although civil society participation in the technical committees is increasing it is still not enough, especially within beneficiary countries. The swap survey carried out by the SES Foundation shows that in more than 60% of cases there is no participation by civil society at any stage in the process, whether in the negotiation phase, discussion on the use of funds, or in the management, implementation or evaluation of projects. On the creditor side, civil society participation mainly occurs at the level of technical committees. For example, a swap between Germany and Peru involved German civil society representatives in the binational committee in charge of negotiating and defining the swap operation.

Local NGOs: to what extent are they present?

In the debt swap for education between Spain and Ecuador, Spanish and Ecuadorean NGOs criticized the way in which civil society representatives were hand-picked by the binational committee for the technical committee. They also criticized the fact that it was being paid, thus creating a conflict of interests.

In Peru, the government designated the board of university chancellors as its civil society members, despite the fact that this organization had no experience in implementing and monitoring projects.

In the swap between Italy and Kenya, local civil society was excluded altogether, leaving only the representatives of Italian organizations.
Lack of coherence with national strategies/limited involvement of relevant ministries: It has repeatedly been shown that projects financed for swaps provide short-term measures that remain unconnected to national development programmes. For example, in Ecuador, the swaps for education have not been integrated into the national education plan. Bilateral negotiations have also invariably excluded key actors in the debtor country, such as the ministries of education in the case of swaps for education. In the Spain–Ecuador swap for education, the Global Campaign for Education reported that, “the Ministry of Education and Culture of Ecuador was initially left out of the operation altogether. Since then, it has been invited to the technical committee where its delegate will participate in discussions but will not have the right to vote.” An absence of any evaluation of the sustainability of the projects was also pointed out.

Lack of sustainability: Due to the temporary nature of swaps and their focus on concrete projects, debt swaps often provide only a short-term fix, a kind of one-off solution, which in the long run can prove counterproductive for developing countries. They can also end up contradicting donors’ commitments to providing efficient, predictable and lasting assistance – as set out in the Monterrey Declaration on financing for development and later in the Paris Declaration on aid effectiveness. Debt swaps have been carried out over varying lengths of time (according to some experts, an average of 5 years in the case of swaps for education) depending on the amount swapped. As previously seen, the amounts swapped are generally small, which suggests that the shelf life of the counterpart fund must also be relatively limited. Therefore once the debt that is eligible for the swap is exhausted, the counterpart fund will run out, thus compromising the sustainability of investments. In the case of the Peru–Germany swap the counterpart fund is an investment or endowment fund, so the projects are longer lasting. This kind of counterpart fund is an exception to the rule, but it is potentially a way of guaranteeing longer-term sustainability.

Very small amounts: Debt swaps for development have mobilized very little funding in the vast majority of cases.

Very little data has been collected regarding the total amounts swapped and so it is difficult to make comparisons with official figures. According to the SES Foundation survey, the amounts swapped have generated a total of about US$7 billion for social investment. This figure is insignificant compared to debt for equity swaps, which in 1990 alone reached US$27 billion.

The following chart illustrates the relative importance of debt swaps compared with other financial flows:

<table>
<thead>
<tr>
<th>Financial flows and stocks</th>
<th>In US$ billions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total debt swaps for development (amount generated up to 2007)</td>
<td>7</td>
</tr>
<tr>
<td>Debt repayments by developing countries (2005)</td>
<td>540.084</td>
</tr>
<tr>
<td>Debt repayments by low-income countries (2005)</td>
<td>34.811</td>
</tr>
<tr>
<td>Debt repayments by middle-income countries (2005)</td>
<td>505.274</td>
</tr>
<tr>
<td>Total Official Development Assistance (2005)</td>
<td>106.00</td>
</tr>
<tr>
<td>Amount cancelled via the HIPC framework (from 1996 to 2006)</td>
<td>17.088*</td>
</tr>
<tr>
<td>Developing countries migrant remittances (2005)</td>
<td>189.526</td>
</tr>
</tbody>
</table>


*Based on a total commitment of US$62.115 billion.
At the global level, the amounts involved in swaps are minor compared to the total burden of external debt. To make matters worse, swap funds are divided between numerous small projects, involving a multiplication of management costs and far greater inefficiency. According to the SES Foundation survey, more than a third of swaps are worth under US$10 million, just over a third are worth between US$11 and 50 million, and only 11% are worth more than US$100 million. The swap agreement between Spain and Peru signed in 2002 generated a fund of €7 million with annual maturities of US$1 to 2.5 million. The Italy–Peru fund created in 2002 for a total of US$127 million, pays out US$25 million annually, which, in the first round, has been assigned to 45 different projects of which more than half finance infrastructure development.

It is important to remember, however, that very few evaluations of swap experiences, either past or current, have been carried out. This makes it very difficult to measure the impact they have had on social and environmental development, as well as on reducing indebtedness.

Debt swaps can be seen as a double-edged sword, then. In theory, if applied efficiently, they have the potential to be highly beneficial, but in practice this rarely happens. Swaps will become much more efficient and effective only when they achieve a balance between their dual objectives: to reduce debt, and to increase much-needed social investment.

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**Swaps for development and principles of aid effectiveness**

In 2005, donors committed themselves to improving the quality and effectiveness of aid in accordance with a series of principles outlined in the Paris Declaration. These principles are:

- Handing over ownership of development strategies and resource management to beneficiary countries;
- Donor alignment around the development strategies of recipient countries;
- Donor harmonization to guarantee greater efficiency in the management of ODA funds,
- Ensuring results based assistance;
- Mutual accountability of both donors and recipients.

For swaps to be beneficial they have to follow these principles, thereby integrating themselves fully into national development strategies, promoting coordination and harmonization among creditors, ensuring that both parties are accountable and that the entire process is transparent – from the selection of beneficiary countries through to the evaluation of the projects.

Nevertheless, the implementation of swaps has, in many cases, failed to comply with these principles of aid quality and effectiveness. This has led to problems highlighted by civil society organizations, such as tied aid, incoherence with national strategies, limited participation of civil society, lack of coordination, and so on. For swaps to function effectively it is essential that donors apply the principles of the Paris Declaration at every stage of the operation.
SWAPS: NOT A SOLUTION TO THE DEBT PROBLEM

Debt swaps are becoming increasingly popular as a means of alleviating the pressure of external debt on developing countries – pressure that, for decades, has undermined governments’ ability to meet the basic needs of their population. But the impact of swaps in reducing debt has been marginal and everyone involved agrees that they are not an effective solution to the high levels of indebtedness of developing countries.

It is no coincidence that swaps appeared just after the debt crisis that engulfed developing countries. Highly indebted to private banks, most of these countries were incapable of repaying their debts after the exponential rise in interest rates and the fall in the price of raw materials on the international market. In order to avoid a world financial crisis and to guarantee debt repayments, creditors launched a series of restructuring plans. Debt for equity swaps appeared at this time as a way of substituting unpayable private debts for shares in national companies.

But in spite of these restructuring plans and of loans granted by international financing institutions, the problem of indebtedness still exists. The stock of the external debt of developing countries has grown from US$8 billion in 1960, to US$70.184 billion in 1970, and to US$540.923 billion in 1980. Currently it almost surpasses US$2,800 billion. Needless to say, therefore, resolving the endemic problem of debt in developing countries will require measures that are considerably more far-reaching than those put forward up till now, including the HIPC initiative and the recent MDRI.

There is a general consensus that debt swaps are not a valid instrument for resolving this situation. As the World Bank states, “There is no market solution for the debt crisis.” This confirms the arguments of civil society organizations who insist that the debt problem will continue to persist until more ambitious initiatives are taken that require stronger political will on the part of the creditors. Existing initiatives provide only short-term solutions that relieve the symptoms but do not deal with the root of the problem. As a result, they serve to reinforce the dependency and vulnerability of developing countries.

The structure of global debt is as significant as its size. Over the past ten years, the internal domestic debt of developing countries – mainly those of middle income – has reached around 50% of their total public debt, according to UNCTAD. This phenomenon goes some way to explain the slower growth of foreign debt in recent years and the limited scope of debt reduction initiatives. Another important implication of this relative growth of domestic debt is that there will be fewer and fewer debts that can be swapped in the future, especially bilateral ones.

Source: Global Development Finance, 2007
Comparison between debts swapped and the total stock of debt

<table>
<thead>
<tr>
<th></th>
<th>US$ billions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimate of debt swapped for development</td>
<td>12.480</td>
</tr>
<tr>
<td>Total stock of debt of low-income countries</td>
<td>379.239</td>
</tr>
<tr>
<td>Total stock of debt of medium-income countries</td>
<td>2,363.139</td>
</tr>
</tbody>
</table>

Source: Global Development Finance, 2007

While debt for equity swaps in the 1980s succeeded in reducing the indebtedness of developing countries, swaps for development have had an insignificant impact in this sense. They are only worthwhile, therefore, in so far as they can supplement social investment, as will be seen in the following section.
DEBT SWAPS AS A MEANS OF INCREASING SOCIAL INVESTMENT

Debt swaps for development can contribute valuable resources to social investment, but they have two major limitations: first, in financial terms, they are insufficient given the enormous needs; and second, they do not deal with the origin of the problem of indebtedness.

Many more resources are needed to finance priority sectors:

According to UN projections, it is unlikely that, at the present rate of change, any of the Millennium Development Goals (MDGs) will be reached in sub-Saharan Africa by 2015. With regards low- and middle-income countries, the increase in inequalities means that many of these goals are also out of reach for a large proportion of the population. Since 2000, the international community has repeatedly claimed that additional funds are needed to realise the MDGs. In this context, debt swaps can be seen as a way of channelling national funds into key social sectors such as education and health. The Sachs report suggests that, in order to accomplish the MDGs, a low-income country must invest between US$60 and 90 per person in capital expenditure from 2006, progressively increasing this investment up to US$120–160 by 2015. The report concludes that, “Even with this, the MDGs in most low-income countries will have a financing gap of between 10% and 20% of GDP (…) Not even a substantial increase in the mobilization of national resources by governments and families will be enough to finance (these) investments.” Consequently, external ODA funds will be needed. The same report estimates a financing gap of US$73 billion in 2006 and US$135 billion by 2015 in MDG financing. In other words, it is expected that US$253 billion will be needed to cover MDG costs in 2006, rising to US$348 billion in 2010, and US$529 billion in 2015. Given the magnitude of financial requirements, the contribution of debt swaps is clearly extremely limited.

The policies promoted by IFIs (International Financial Institutions), which created a chronic deficit in social sectors, still stand:

The IFIs have played a central role in dismantling the health and education systems in the majority of developing countries. Ever since the application of structural adjustments programmes in the 1980s, these countries have suffered a chronic financing gap in their social sectors. With the enforcement of the Washington Consensus, education and health expenditures were radically reduced to give budgetary priority to servicing debt repayments.

The following table shows clearly how Ecuador, for example, has prioritized debt payments since the implementation of structural adjustment policies in the 1980s. This has been at the expense of health and education, producing a permanent deficit in these sectors that has steadily deepened since 2000, the year of the financial crisis in this country.

Since the late 1990s, the IFIs have increasingly focused on fighting poverty and embracing national development strategies, but the macroeconomic framework of the structural adjustment programmes still largely stands. Recent studies show that the IFIs continue to implement policies that restrict social expenditure, despite an improvement in the macroeconomic indicators of most low-income countries that allow for more expansive policies in the public sector. According to a report from the Center for Global Development, “the IMF has tended to favour the further decrease of domestic debt and increase of...
external reserves instead of promoting the increase of public expenditure." The study also points to a clear disconnect between fiscal and budgetary policies and those of the education and health sectors.

Another recent study on education by Action Aid\textsuperscript{12} concludes that the IMF still decides where funds for education come from and still applies “ceilings” on public expenditure required for developing national education strategies.

### Quantity vs quality

Many governments have abolished enrollment fees for primary education, which has led to a significant increase in the number of children registered. However at the same time, they have not been able to recruit enough teachers to ensure a good level of schooling. This limitation results from IMF pressure to enforce policies aimed at keeping the rate of inflation below the level recommended by the Institution. “Governments do not have the necessary political space nor the technical support to make their own decisions about macroeconomic policies for promoting stable growth and achieving national development goals (...) As a result, their policies remain divorced from the reality on the ground, and fail to take into account the shortage of teachers and the devastating impact on the quality of education.”

### What can swaps do for social financing?

Due to the limited amounts of money involved, the short timescale of projects and the lack of coordination between donors, swaps do not stand up to the structural needs of social financing in developing countries. Such financing requires foresight, sustainability and coherence with national development strategies. However, there is no doubt that swaps offer much-needed extra contributions to chronically under-funded sectors such as health and education. In this sense, they are useful in so far as they provide additional or supplementary financing to that already budgeted by the government. Swaps are also worthwhile in terms of their role in strengthening civil society participation in local development projects – thus enabling civil society representatives to develop their role as monitors of government development policies. Positive examples include the Eco-Fund (see below), formed between Poland and the Paris Club, which is a long-term swap involving large amounts and in which the donors coordinated between themselves to create an independent common fund to bring down costs. More recently, Debt2Health (see below also), which is run by the World Bank, provides an example of an effective swap in the health sector. These examples deserve particular attention because important lessons can be learned from them that can be applied elsewhere.

### Need for predictable and good quality aid:

The lack of predictable and long-term aid is a key factor undermining the effectiveness of governments’ long-term budget planning. Health and education require long-term measures that may not be productive investments in the short run but will lay the foundations for a country’s sustainable economic development in the future. However, the financing of these sectors is invariably planned in the short term. One of the greatest difficulties faced by Southern governments is thus the unpredictability and lack of consistency in donor aid, which hinders long-term budget planning. Despite promises to make their aid more predictable and better coordinated, donors have done little to ensure this in practice. All mechanisms for financing development, including swaps, should follow the criteria of predictability and sustainability.
MULTI-CREDITOR SWAPS, AN EXAMPLE TO FOLLOW?

The Eco-Fund

After the fall of the Berlin Wall and the subsequent collapse of the communist block, Poland began renegotiating its bilateral debts with the Paris Club. Once it achieved the cancellation of 50% of its bilateral debt, the Polish government proposed the creation of an independent fund (the Eco-Fund) to finance environmental projects in exchange for an additional 10% cancellation of its bilateral debts. The ensuing swap proved exceptional, due to the large amounts involved and the advantageous conditions agreed upon – for which the Paris Club was later criticized for giving preferential treatment to Poland. This illustrates once again that favourable or unfavourable conditions in debt swaps are ultimately decided according to political agendas.

The fund, made up of 10% of the outstanding debt, was held in an account in the Bank for International Settlements. The fund was created in 1992 and will last until 2010. It has a total of US$571 million which is for private sector investments in four project categories: reduction of atmospheric and cross-border pollution, reduction of pollution in the Baltic Sea, reduction of greenhouse gas emissions, and protection of Poland’s biodiversity. The Eco-Fund is a pioneering debt swap because of its multilateral character: a number of creditors were involved in both its negotiation and implementation. The most important creditor is the United States, which represents over 70% of the total fund. The others are France, Italy, Sweden, Norway and Switzerland. In terms of coordination between donors and the consequent reduction of operational costs the Eco-Fund has been highly successful and provides a model for others to follow.

It has also, however, served to promote the interests of foreign companies in Poland. Research conducted at the University of Warsaw concludes that the Eco-Fund project had the clear intention of benefiting private companies from participating creditor countries. The study shows that Italian, Swedish and French companies received revenues worth more than double the amount that their countries contributed to the fund, and that there was a specific intention that creditors would receive such “compensation”. On the one hand, then, this swap shows that it is possible and worthwhile to improve coordination among donors; but on the other, it makes it very clear that such agreements can strengthen tied aid and indirectly subsidize exports from the creditor to the debtor country.

Debt 2 Health

The Global Fund against HIV/AIDS, tuberculosis and malaria was created in 2002, following the Monterrey Conference on financing for development. The Fund is an example of private and public sectors coming together, at a bilateral and multilateral level, to find the necessary resources to fight these pandemics, within the framework of the Millennium Development Goals. Since its creation, the Fund has received donations of US$10.8 billion and since 2007 has set itself the task of tripling these contributions, raising them to US$8 billion a year by 2010. Nevertheless, contributions have fallen far short of expectations and the Fund currently suffers a budget deficit of some US$2.5 billion. This is highly regrettable, as the Fund has had a very positive impact on health programmes in recipient countries and its financing gap undermines the possibility of carrying out more ambitious projects.

In searching for ways to increase its financing the Global Fund came up with the idea of launching a pilot project of a debt for health swap. It selected a series of countries that, between 2007 and 2009, will convert part of their debt into financing for projects carried out by the Fund at a national level. This pilot project includes four countries (Indonesia, Kenya, Pakistan and Peru) that are outside the HIPC framework and thus do not benefit from other debt cancellation initiatives. During the G8 Summit held in Heiligendamm in June 2007, Germany promised to contribute to this initiative by cancelling €200 million, thereby becoming the first official bilateral donor of Debt2Health. To start, Germany will swap €50 million worth of debt to Indonesia over the next two years, generating a fund of €25 million (with a 50% discount). In total, the pilot project in the four countries is estimated to amount to about US$250 million worth of debt, which should create a counterpart fund of about US$125 million, with a maximum 50% discount.

Advantages: The Global Fund has proven to be an effective body in managing and making use of funds, giving it credibility and legitimacy in managing debt swaps. It also has a flexible structure that allows it to adapt to the different levels of institutional development in each country. Furthermore, the Fund already contains of the structures needed for evaluation, monitoring and follow-up, which will enable a better assessment of the impact and relevance of financed projects. Having these mechanisms
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in place also allows for a faster disbursement of funds and a reduction in administrative costs, in contrast to debt swaps that are carried out bilaterally (in the latter case, the debt is cancelled only after the project has been implemented and evaluated). The Global Fund guarantees, to some extent, greater coordination between donors as well as ensuring that projects are properly aligned with the health priorities of beneficiary countries. The Fund also ensures the active participation of civil society representatives from the decision-making stage (they are present in the Board) through to monitoring the swaps. Tied aid does not figure in this swap, as creditors cannot at any point decide how swapped funds will be spent.

However another important point is that the question of the legitimacy of the debt remains ever present in Debt2Health due to the different actors involved. Civil society organisations have to keep this issue to the fore all the time while monitoring and evaluating the swaps.

Limitations: One of the key limitations of this fund is that it can only work with bilateral concessional debts, which considerably reduces its potential impact. One of the current challenges is to integrate non-concessional debts.

Through their active participation in Debt2Health civil society organisations have also noted some major difficulties with the programme. Additionality is one of the black spots they have detected: the money disbursed by the debtor as a result of the swap is deducted from the additional contributions that it receives from the Global Fund. The debtor country has little incentive to finance the Global Fund through Debt2Health as this means a reduction in resources received by the Fund.

Another issue raised is that of eligibility. What criteria have been used to choose the beneficiary countries? This point should be made more transparent.

But the most important limitation of this initiative is the uncertainty regarding the long-term financing of the Global Fund itself. The sustainability of the programme depends on this because even if the Fund opens up to other donors, Debt2Health itself will come nowhere near to making up its financing gap.

Once again, more efforts to find funding are required. For this initiative to work, then, the commitment of an annual US$10,000 million must be respected, since only consistent, long-term funding will allow it to function efficiently and have a real impact on the health sector.

Debt 4 Education

At its 33rd General Meeting in October 2005, UNESCO created a working group to evaluate the impacts of debt swaps in the education sector and the possibility of applying them in UNESCO’s field of work. The resolution stated that, “there should be support for agreements on debt swaps within the framework of a transparent and effective administration of general funds, with the participation of creditors, debtors, international organizations and civil society representatives in the follow-up and evaluation of educational programmes arising out of these agreements.”

Since then the working group, which brings together representatives from the finance and education ministries of creditor and debtor countries and civil society representatives, has met twice to discuss how best to implement debt swaps for education. The involvement of civil society in the working group and the leadership of both Spain (the creditor) and Argentina (the debtor) has been a positive force. But the process suffers from significant limitations: unlike the Global Fund, UNESCO does not have the capacity to administer resources effectively; more importantly, the initiative lacks funding. Despite these problems, the process could move towards creating a fund to finance education in the style of the Global Fund’s programme for health, or it could expand the fast track for education initiative (FTI) run by the World Bank. The main priority, however, is to obtain real financial commitments. It is worth pointing out that the FTI suffers from a financing and absorption problem – it received around US$32 million for 2005 and 2006, of which less than half has so far been used, and of this only US$7.8 million has been effectively distributed. In other words, only 15% of FTI funds have been used to date.

However, despite its financial limitations, UNESCO could and should perform an important role in debt swaps for education by participating in and monitoring swaps and ensuring that they respect national priorities and acceptable criteria. During the the working group’s meeting in July 2007, the SES/Latindadd Foundation therefore asked UNESCO to play an active role in: “legitimizing quality standards in the implementation of swaps for education and to propose them to countries, facilitate the relationship between creditors and debtors to carry out swaps for education, to accompany the processes that are in force and systematize experiences to identify best practice models to follow.”
CONCLUSION: TO SWAP OR NOT TO SWAP?

Swaps are not a solution for debt or poverty: They amount to an extra bit of help, which, if negotiated and carried out effectively, may make the investment worthwhile and help promote participative democracy at a local level. In short, swapping is a support mechanism that by its nature is only complementary and therefore not a sufficient solution on its own.

Despite their limitations, swaps can produce creative and participatory projects: Swaps can be beneficial in terms of local development and small-scale projects. As suggested by some civil society organizations such as Jubilee Peru, swaps that are well conceived and carried out “can re-energise local development and strengthen poorest communities by promoting projects that respond to local needs. They can also strengthen participative democracy by offering local communities good opportunities.”

Swaps have not always been carried out effectively: Swaps for development have invariably been very costly processes in terms of the conditions attached to them, transaction and negotiation costs, the lack of coherence with national development strategies, and the lack of additionality and sustainability.

More ambitious measures are required at the national and multilateral level: Beyond existing debt relief initiatives, a great deal more funding is required from donors, which has to be predictable, long-term and made good use of. Swapping, as a support measure, must be improved to make it a form of efficient, consistent and long-term aid.

Debtor countries should not have to accept any swap offered them: Debtor countries must continue applying pressure and using their negotiating power to demand better conditions and to reject swaps that are not beneficial to them, as in the Ecuadorean case. Analyzing the legitimacy of the debt should also be an integral part of any relief, restructuring and debt swap operation. The two processes are not incompatible. Likewise, civil society organizations have played and must continue to play a central role alongside their governments.

Swaps must adhere to principles of mutual responsibility and effectiveness: Donors have promised to adhere to aid effectiveness principles in all aspects of their development financing policy, which should therefore include debt swaps:

**Mutual accountability**

Analyzing the origin of the debt: Swaps should include first and foremost a debt audit in order to determine the legitimacy of debts. Since this process is long and swaps are only a short-term measure this could be problematic. However, solutions can easily be found, such as the creditor paying indemnities to debtors retrospectively based on the results of the audit. These kinds of proposals have been taken on board not only by civil society but also by debtor governments.

Transparency and widening the eligibility criteria: In order to have greater impact, the swap initiative must be expanded to include many more countries. So far, only a few middle-income countries have benefitted from it due to the eligibility criteria established by the Paris Club. IMF programmes should not be a *sine qua non* condition for obtaining swaps with a discount. Transparency in the selection of beneficiaries is essential in order to avoid the exclusion of some countries on politically motivated grounds.

**Participation**

Civil society participation: Civil society organizations in debtor and creditor countries must be represented at all stages of the swaps (negotiation, implementation, management and evaluation) and must guarantee transparency and accountability throughout the whole process. Many organizations (such as Jubilee Peru, SES Foundation, ActionAid, among others) actively work to promote best practice in civil society participation.

**Alignment of donors to national strategies**

Coherence and sovereignty: Swaps must be fully integrated into national development plans. The involvement of ministries corresponding to each sector of a swap – not only finance ministries – is essential.
Conditions/tied aid: Swaps must be exempt from all conditions regarding the purchase of goods or services from companies in the creditor country. Furthermore, they should not have to carry out policies that are inconsistent with nationally established priorities.

Harmonization

Harmonization and coordination among creditors: Coordination among donors must be strengthened in order to minimize costs and establish synergies and a long term vision. Swaps carried out by Debt2Health or Eco-Fund should be held up as a model for this.

Reducing administrative costs and streamlining the process: High management and operational costs have proven to be a major weakness of swaps for development. One way to reduce these costs is for donors to coordinate more effectively. In most bilateral swaps, debts have been cancelled only once the financed project has been carried out and evaluated. It is necessary to speed up this process and, as in the Global Fund, cancel the debt when the counterpart fund is set up.

Results-based management

Additionality/concessionality by the creditor: Swaps must be strictly additional to ODA funding. To guarantee greater additionality, swaps must be as concessional as possible; that is, with a high discount rate so that the actual net value of the amount swapped is the lowest possible given the actual net value of the debt.

Additionality by the debtor: The amount swapped must be additional to the national budget to ensure that swap investments are on top of already budgeted financing of the social sectors.

Size of swaps and increasing the number of eligible debtors: The limit on swappable debt must be higher, allowing beneficiary countries to swap the amount they consider necessary to reduce levels of indebtedness while also financing key social sectors. For swaps to have a greater impact on a debtor’s budget, they must be made primarily from non-concessional debts that are being repaid rather than from debt in arrears. There is the risk that private debts would be revalued, producing renewed pressure to repay them, which would worsen the situation of beneficiary country before a swap took place. Concessional debts, meanwhile, should be subject to cancellation.

Predictability and durability: Swaps must be predictable and programmed over the long term in order to guarantee their effectiveness and to enable better budget planning. In this regard, counterpart investment funds such as those agreed between Germany and Peru are a model to aim for.
USEFUL REFERENCES ON DEBT SWAPS

- Debt Relief International. Maye Melisa “Vue d’ensemble des conversions de dette”. 2001
Notes

i Kaiser Jürgen and Lambert Alain, “Debt swaps for sustainable development”, IUCN, SCDO. Eurodad
iv France, Italy, Norway, Sweden, Switzerland and the United States.
v Amount expected for the following period: 1992 until 2010
vii The debt swaps for development considered in this report are a process that involves three elements: debtor’s reimbursement of one part of the debt in a local currency, a swap price negotiated between two parties and the investment of paid funds in development programs previously defined by both parties. There are other debt reduction initiatives which, if seen from a very wide perspective, represent according to some sources within the definition of swap. However it involves restructuring operations with certain concessional component or relief or re-purchase initiatives within the framework of the Paris Club and as such we shall not take them into consideration in this document.

Bilateral Debt restructuring initiated in the late 80’s acquired progressively a reduction component according to Houston terms in 1990, London in 1991 [50%], Naples in 1994 [67%] and resulted in 1996 with the debt relief initiative of highly indebted poor countries (HIPC) reinforced in 1999 with the terms of Cologne which allow a 90% reduction. It involves a re-negotiation of the country with the Paris Club where the reimbursement terms are established with concessional components but not a swap per se.

The initiative of highly indebted poor countries (HIPC) may be considered in some manner a bilateral debt swap with a 100% discount since the beneficiary countries shall not reimburse funds. But this extension of the definition seems forced and may lead to confusion. HIPC countries benefit from cancellations although highly conditioned to the execution of FMI programs and World Bank. In 2005 the multilateral debt relief initiative (IADM) appeared and was launched in GB of Gleneagles, as an extension of the HIPC initiative to the multilateral debts with the World Bank, FMI, and African Development Fund and from 2007 with the InterAmerican Development Bank. To learn more about this initiative and the main critics that NGOs make regarding their real impact, please review the Eurodad report: “Multilateral debt; one step forward, how many back?”. At: http://www.eurodad.org/whatsnew/reports.aspx?id=1234

Repurchases: Within the framework of the re-negotiations with the Paris Club, the debtor country may request the re-purchase or payment in advance of its debt, but this operation does not imply an investment swap under development.

In 1991 begins the unindebtedness help/repurchase of the International Development Association (AID) which lends resources from the multilateral fund in order to repurchase the external commercial debt. The beneficiaries from this help are low income countries eligible to AID. This help began with a fund of US $ 100 million, supplied later with new multilateral funds and additional contributions from bilateral donors. At the end of 2003 the AIDhelp swapped a total debt of US $ 4 474 millions for a total of US $ 631 millions. This help has benefited almost exclusively HIPC countries. It involves a commercial debt repurchase mechanism but not a swap as understood in this report

vii It involves a fiduciary fund managed by a financial independent entity where swap resources are deposited.
x This is the case of the Debt2Health swap with the World Fund. As it shall be seen further on, it involves a multilateral swap which used bilateral concessional debt.
xii The original sum is established in SDR or special voting right. It involves a monetary unit used at international financial institutions. Its value has evolved with time and currently 1 SDR is equal to 0,89 USD.
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Consult the SES Foundation survey at: [http://www.fundses.org.ar/publicacionesdigitales.html](http://www.fundses.org.ar/publicacionesdigitales.html)


In general a PRGF (Facility for the reduction of poverty and growth, by its acronym in English).

To know more about the principles of responsible financing proposed by Eurodad see report: “Eurodad charter on responsible lending”.


More about vulture funds at: [http://www.jubileedebtcampaign.org.uk/?lid=2893](http://www.jubileedebtcampaign.org.uk/?lid=2893)


This chart gives a general idea of the main characteristics of the implemented swaps by the principle creditors that have used it actively. The data are not exhaustive and may have varied from the making of the report in which the information is gathered. (See Ugarteche, op.cit).

For more information, see the report “Lights and Shadows” of Help in Action, Entreculturas, Intermón Oxfam, SES Foundation. More critical analysis regarding swaps have also been made by the member organization of Eurodad, Observatory of the Globalization Debt. SES Foundation has produced another complete document regarding debt swaps for education at: [http://www.fundses.org.ar/publicacionesdigitales.html](http://www.fundses.org.ar/publicacionesdigitales.html).

In a very general manner, a debt is considered legitimate when it has not served the interests of the population and the creditors have full knowledge of this. The illegitimate debts thus incluce different types of odious debts (contracted by dictator regimes with the consent of the creditor and without Benefit to the population), the mega projects or white elephants (Duch as the Batam nuclear center in the Philippines), or the illegal debts (contracted against the constitution or legislation of the debtor). For more information regarding this subject, see: [http://www.illegalimatedebt.org/](http://www.illegalimatedebt.org/)

Ecuador, Egypt, Peru, Jamaica and Sierra Leona.


The study of the World Bank is not available yet at the close of this report.

Further information on this and other initiatives are available in “Parliamentary activity on debt. A growing challenge.”, at: [http://www.eurodad.org/whatsnew/reports.aspx?id=1346](http://www.eurodad.org/whatsnew/reports.aspx?id=1346)

Kaiser Jürgen y Lambert Alain, op. cit.

Another inconvenience, although more theoretical than real, is the inflationary risk. At first it was thought that the injection of local currency that the swap was contributing would have repercussions in the inflation increase. But due to the reduced volume of the swaps in general, this risk is above all theoretical since in practice, it has not been materialized. In case of swaps of great extent, an inflationary impact analysis shall be carried on although taking into consideration that contrarily to the orthodox precepts used by the IMF in the past, an inflation increase is not necessarily negative for the growth of a country.


Kaiser Jürgen y Lambert Alain, op. cit.


Data of Latindadd, April 2007.

Filipowicz Marta, Debt for environmental swap in Poland. Eco-Fund, 2007


According to the “Global Fund progress report” of 2007, some of the results after 5 years of existence are: 770 000 persons had access to anti-retroviral treatments, 1.2 million orphans have received help and medical care, 2 million cases of tuberculosis have been treated, 12 000 new treatments of resistant tuberculosis, which is 4 times more than before, 23 million of treatments against malaria. 108 million of mosquito nets for protection against malaria.

Australia could become the next bilateral donor after the declaration made by the labor party, currently in opposition, to participate in the initiative of an amount of US$75 million of bilateral debt with Indonesia. But elections at the end of 2007 shall determine if this commitment is made or not.


For each of these principles a series of targets and goals have been identified. See: http://www.oecd.org/dataoecd/57/60/36080258.pdf