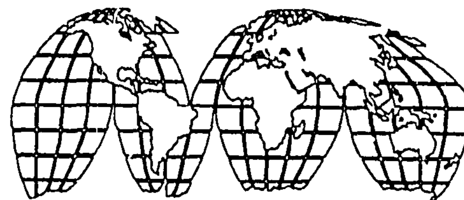
Innovative Development Approaches

Recycling Old Debt for New Ventures: Debt-for-Nature and Debt-for-Development Swaps



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Summary

Well-designed debt conversion programs can help highly indebted countries reduce their hard currency debt, enable U.S. and other foreign banks to reduce their exposure to potentially uncollectible debt, and most important, provide nongovernment organizations (NGOs) with a means of raising local currency funds to finance environmental conservation and other development projects in these countries. A debt swap basically involves a third party, usually an NGO, acquiring from foreign banks a developing country's hard currency debt and subsequently exchanging it with the debtor country government for local currency funds to finance development projects or local investments in that country.

A.I.D. grants have helped host countries and NGOs undertake debt swaps to raise local currency to finance environmental conservation projects. Between 1987 and 1990, A.I.D. funded four debt swaps with small grants totaling slightly more than $1 million. In response to strong Congressional support for increasing A.I.D. funding for debt swaps, the Agency is planning to sponsor more debt swaps. Between FY 1990 and FY 1991, A.I.D. grants for debt swaps will total almost $30 million if six debt-swap proposals currently being negotiated or planned are successfully completed.

Experience so far has identified two sets of implementation issues relevant to USAID Missions considering funding debt swaps. One set revolves around possible NGO constraints in addressing the fairly complex financial and legal questions related to debt purchasing and to establishing the appropriate mechanism needed to disburse local currency funds for project activities. In addition, in countries where the government has no existing debt conversion programs or owes little commercial debt, considerable time and resources are required to conduct debt swaps.

Another set of issues concerns potential macroeconomic effects of large-scale debt conversion programs. For example, officials and development specialists are concerned about whether subsidies implicit in each debt swap transaction are justified, how to control likely inflationary pressures on the host country economy, and how to ensure that debt swaps will not impose a fiscal burden on the host country government.

These problems are not insurmountable, however. There are measures that host countries and A.I.D. can take to mitigate them. For example, A.I.D. can sponsor workshops for senior government officials to help them understand how debt conversion programs can help resolve their countries' external debt servicing problems. A.I.D. can also fund technical assistance to help host countries establish debt conversion programs.

Despite the possibilities offered by debt swaps, there are constraints to the widespread use of this approach in developing countries. Much of the debt owed by these countries is not traded in the secondary market and therefore cannot be retired through debt swaps. Moreover, the transaction and recurrent costs associated with debt conversions might be unattractive to many NGOs and host countries.

The purpose of Innovative Development Approaches is to identify, describe, and assess the progress of promising, experimental approaches being tried by A.I.D. and other agencies to achieve priority developmental objectives and new policy thrusts. This series communicates the key ideas behind each innovative approach to A.I.D. Missions interested in how some of their colleagues are addressing these objectives.

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Introduction

Commercial banks, NGOs, and A.I.D. have something in common these days. They share an interest in exchanging developing countries' hard currency debt for local currency funds to finance conservation and other development projects. The mechanism that draws them together is an innovation of the late 1980s, a financial transaction popularly known as a "debt-for-nature" swap or "debt-for-development" swap.

Lacking foreign exchange, many developing countries have difficulty meeting interest payments on hard currency debt they have acquired over the years for development purposes. A significant amount of the debt is owed to commercial banks in the United States, Europe, and other developed countries. To reduce the risks of holding potentially uncollectible debt, many of these banks have been selling the debt at substantial discounts (often at less than 30 percent of the debt's face value or loan amount) to buyers in the secondary financial market (see Background, page 6).

A *debt-for-nature or debt-for-development swap* involves a third party, usually an NGO, entering the secondary financial market to purchase a developing country's hard currency debt and, subsequently, exchanging the debt with the debtor country for local currency funding for a conservation or development project in that country. The transaction is usually the culmination of a long process of negotiation with the debtor country government on the amount of debt to be redeemed, the discount rate that will be used for the debt conversion, and issues related to the project to be financed (see The Debt Swapping Process, page 9). To date, each debt-for-nature and debt-for-development swap financed by A.I.D. has generated an amount of local currency that is significantly higher than the purchase price, and often, equivalent, or close, to the face value of the debt. In short, swapping debt for development can be highly advantageous for NGOs wishing to raise local currency funding for a project, especially when the redeemed debt is donated or purchased at a substantial discount.

A.I.D.'s Role

To date, A.I.D. has played an indirect role in debt swaps: It has not been a signatory in the ultimate debt-exchange transaction. Instead, the Agency has played a catalytic role by providing financial assistance to host countries and NGOs engaged in debt swaps. As indicated in Table 1, between 1987 and 1990, A.I.D. grants totaling $1.4 million have sponsored four debt swaps that have been completed. In the first transaction—the 1987 debt-for-nature swap in Bolivia—A.I.D. contributed a small grant in local currency ($150,000) generated from the PL 480 food aid program to supplement the Government of Bolivia's funding of an endowment fund for the Beni Biosphere Reserve. In 1989, A.I.D. provided a small dollar donation ($45,000) for the purchase of Philippine debt. Since then, A.I.D. has provided two larger dollar grants to help the World Wildlife Fund and CARE with debt purchases.

In July 1989, A.I.D. provided a $1 million grant to the World Wildlife Fund to initiate a debt-for-nature swap program in Madagascar, the first such program in Africa. The World Wildlife Fund purchased $2.1 million of the Government of Madagascar's commercial debt for $950,000 and redeemed it for local currency worth approximately the debt's face value (i.e., $2.1 million). The funds generated are being used to finance the training of park rangers and related activities to protect and improve the management of several wildlife sanctuaries. An additional $900,000 worth of Malagasy debt will be purchased sometime during the implementation of the program.

In May 1990, A.I.D. provided $250,000 to match the same amount raised by CARE from private sources. The $500,000 thus obtained was used to purchase $3.5 million of the Government of Ecuador's commercial debt and to redeem it for $1.75 million worth of local currency bonds. The bonds will generate interest to support a project to introduce tree planting and soil conservation to farmers in the highland regions of Ecuador.

Over the next months, if other debt swaps being negotiated with governments in Ecuador, Ghana, Nigeria, Niger, Malawi, and the Dominican Republic are successfully completed, A.I.D. dollar grants for debt swaps will increase by $4.6 million. A.I.D. funding will increase even more dramatically if a $25 million debt-for-nature swap program being considered by USAID/Philippines (by far, the largest being proposed by a USAID Mission) is approved.

Apart from providing grants to assist with individual debt swaps, A.I.D. has also helped establish, and continues to provide grant assistance to, the Debt for Development Coalition Inc.—an umbrella organization comprising U.S. universities, private voluntary organizations, international agricultural research institutions, and cooperatives. The Coalition provides

Table 1. A.I.D. Support for Debt Swaps, 1987–1990

Year	Country	A.I.D. Grant ($000s)	Project
			Completed Transactions
1990	Ecuador	250	Sustainable Land Use Project. The A.I.D. grant to CARE paid for half the purchase price ($500,000) of Ecuadoran debt worth $3.5 million (face value). The debt was swapped for $1.75 million local currency bonds, which will generate interest payments to finance CARE/Ecuador's agricultural development projects. The Debt for Development Coalition provided technical assistance for the debt swap.
1989	Madagascar	1,000	World Wildlife Fund's Debt-for-Nature Program for Madagascar. The program will swap Malagasy debt for local currency financing of park management and training activities in major wildlife reserves. The first swap, transacted in November 1989, converted $2.1 million into local currency at face value. The debt purchase price was $950,000, of which $750,000 was financed by A.I.D. The balance of the A.I.D. grant will be used in a subsequent debt purchase.
1989	Philippines	45	A.I.D.'s small grant supplemented a donation by the Philip Morris Corporation for the purchase of $330,000 of Philippine debt at a discount of about 50 percent. The local currency funds generated are financing the operating and management costs of two national parks on the island of Palawan.
1987	Bolivia	150	A.I.D.'s grant was a contribution to the endowment fund established by the Government of Bolivia to finance the operating and management costs of the Beni Biosphere Reserve and the surrounding buffer zone. Creating the endowment was one of the conditions for the debt-for-nature swap between Conservation International and the Government of Bolivia.
			Debt Swaps Being Negotiated
1990	Ecuador	100	Coastal Resources Management Project. The University of Rhode Island (URI), which is implementing this A.I.D. project in Ecuador, is currently negotiating with A.I.D. to use $100,000 of the project's funds in a debt swap. The funds will enable URI to purchase $600,000 worth of Ecuadoran debt, to be converted to $300,000 worth of local currency bonds paying about 40 percent interest. The proceeds will be used to strengthen the institutional capacity of a local NGO, the Fundacion Maldonado, and to fund activities it will implement, including the development and training of a coastal ranger corps and the provision of various community-level public education and training to improve the management of coastal resources.

Table 1. A.I.D. Support for Dept Swaps, 1987–1990 (continued)

Year	Country	A.I.D. Grant ($000s)	Project
1990	Nigeria Niger Malawi	2,000	The grantee, International Foundation for Education and Self-Help, will use the grant to purchase debt worth $6.5 million at face value. The conversion rate for redeeming the debt is being negotiated with the government of each country. The funds generated will finance education and training projects in the three countries.
1990	Ghana	1,500	The A.I.D. grant will be used for a debt purchase to finance the local currency components of a park management and historical preservation project in the Central Region of Ghana. The grantees comprise five organizations: the Debt for Development Foundation, the Midwest Universities Consortium for International Activities, Conservation International, the Smithsonian Institution, and the U.S. Committee of the International Council on Monuments and Sites. The terms of the debt swap are currently being negotiated with the assistance of the Debt for Development Foundation. A.I.D. is also funding the technical assistance components of the project.
	Dominican Republic	1,000	USAID/Dominican Republic is supporting the Save the Children Foundation in a debt swap involving the purchase of private corporate debt with a $1 million A.I.D. grant. The local currency funds generated from the debt swap will finance child survival projects.
			Debt Swaps Planned
	Philippines		USAID/Manila is currently designing a $25 million debt-for-nature-swap program.
	Costa Rica		USAID/Costa Rica plans to support debt-for-development swaps to generate funding for medium- and long-term investments by private cooperatives supplying electricity to rural areas.
	Paraguay		The Nature Conservancy has submitted an application to A.I.D. for a $500,000 grant to augment $2 million of its own funds to purchase $9 million (face value) of Paraguayan debt. The swap will generate two long-term bonds worth $4 million and $1 million each. The bonds will be used to purchase and manage the Mbaracayu Nature Reserve, in conjunction with the Jejui Guazu River watershed development program. The beneficiary of the trust fund will be a local NGO, the Fundacion Moises Bertoni.
	Panama		USAID/Panama is considering allocating $8 million from a proposed $21 million A.I.D. project—the MARENA project—as a grant to help finance a proposed purchase of Panamanian debt. The grant will supplement $2 million raised from private sources by a local NGO, ANCON (Associacion Nationale de la Conservacion) and the Nature Conservancy. With the proceeds from the debt swap, ANCON will establish a trust fund to finance the operating costs of managing Panama's parks and protected areas, as well as related development projects in buffer areas.

information and advice to member organizations interested in swapping debt to generate local currency funding for their development activities. The Coalition's affiliate organization, the Debt for Development Foundation, implements a technical assistance program to assist NGOs and governments undertaking debt swaps. Box 1 describes the activities of the two organizations.

Two statutory enactments passed late last year, the Fiscal Year 1990 Foreign Assistance Appropriations Act (Public Law [PL] 101-167) and the 1989 International Development and Finance Act (PL 101-240), strongly support an increase in A.I.D. support of debt swaps initiated by NGOs (see Box 2). Specifically, the enactments authorize A.I.D. to initiate a pilot program to sponsor debt-for-nature swaps for conservation projects in Sub-Saharan Africa. The two enactments also resolved certain financial issues concerning the use of funds raised from A.I.D.-supported debt swaps. Given this Congressional mandate, A.I.D.'s support of debt swaps will likely increase in the future.

Debt-for-Nature and Debt-for-Development Swaps—the Tally

Since 1987, when Conservation International and the Government of Bolivia successfully negotiated the first debt-for-nature swap, swapping debt to generate funding for conservation projects has become a popular practice among NGOs. As indicated in Table 2, between 1987 and 1990, approximately $95 million developing country debt (mostly Latin

Box 1. Activities of the Debt for Development Coalition and Debt for Development Foundation

The Debt for Development Coalition, Inc.

Established: September 1988

Members: Composed of four groups: U.S. colleges and universities, cooperatives, private voluntary organizations, and international agricultural research institutions.

Purpose: To provide information and educational services related to debt-for-development swaps and the secondary market for developing country debt.

Major Activities, 1989–1990:

- Organized workshops and seminars for members and other interested groups (from the World Bank, Inter-American Development Bank, the African Development Bank) on debt-for-development swaps.
- Collaborated with other nonprofit organizations in publishing a guide on debt-for-development swaps and other issue papers.
- Assisted the governments of Costa Rica, Brazil, Mexico, Bolivia, Jamaica, and Ghana in analyzing policy and economic implications of debt-for-development programs in the respective countries.

Debt for Development Foundation

Established: June 1989

Purpose: To facilitate and negotiate specific debt-for-development transactions for clients (for a small fee).

Activities, 1989–1990:

- Formulated procedures for prospective debt buyers to pool resources to buy debt in the amounts offered for sale in the secondary market.
- Provided technical assistance for debt-for-development swaps being negotiated in several countries: Ghana, Brazil, Egypt, Ecuador, Venezuela, Mexico, Poland, Yugoslavia, and the Philippines.

Box 2. Congressional Mandate Related to A.I.D.-Sponsored Debt Swaps

Debt for Nature and Debt for Development Swaps Statutory Enactments, Foreign Assistance Appropriations Act, FY 1990, and International Development and Finance Act, 1989

Relevance of the Congressional mandates for A.I.D.-sponsored Debt Swaps:

- Allow private voluntary organizations and other NGOs to establish, and retain interest from, endowments with local currencies generated from A.I.D.-financed debt-for-nature swaps and other debt-for-development swaps.
- Provide specific authority for A.I.D. to finance debt-for-nature swaps through grants to NGOs to purchase discounted commercial debt.[1]
- Direct A.I.D., in cooperation with NGOs, to initiate a pilot debt-for-nature program for countries in Sub-Saharan Africa.

Source: A.I.D. 1990.

[1](A.I.D.'s Office of the General Counsel has issued guidelines on the implications of the two enactments for A.I.D.'s Debt for Development Initiative. Copies have been sent to all USAID Missions. They are available on request from the General Counsel's Office.)

American debt) has been retired through debt-for-nature swaps. The estimated amount for debt-for-development swaps completed to date is about $132 million (Debt for Development Coalition 1990). The debt retired will increase significantly when Argentina, the Dominican Republic, and Brazil proceed with plans to establish large-scale debt-for-nature and debt-for-development programs.

Background

Growth of a Secondary Market for Developing Country Debt

Debt swaps are made possible by the growth of a secondary (i.e., resale) market for Third World debt. The market developed in 1982, shortly after Mexico and other highly indebted developing countries (mostly in Latin America) declared that they were having difficulty paying their outstanding foreign debt. The countries were facing sluggish economic growth, high interest rates, and deteriorating terms of trade as prices of their export commodities plummeted.

Many banks were not optimistic about the prospects for successful economic recovery in highly indebted countries, at least to a point where these countries could fully meet their external debt obligations. These banks began to liquidate, reduce, and diversify their developing country debt portfolios by offering individual loans for sale at a discount. Because the banks differed in their perceptions of financial risk and long-term interests in individual countries, they began to exchange loans among themselves through a transaction known as an "asset swap" (sale with a purchase). A bank would sell, at a discount, a loan it wished to relinquish to another bank and in return would purchase, also at a discounted price, a loan from the latter's portfolio. In this manner, both banks would liquidate, reduce, or diversify their developing country debt portfolios, depending on how they perceived their risks of being exposed to bad debt in each country. Loans were also purchased by banks for their trading portfolios in anticipation that the loans could be resold for a higher price.

In addition to banks, private investors began to enter the secondary market. These investors were in part speculating on the long-term recovery of developing country economies and were lured by the substantial discounts of debt offered for sale. Because private buyers offered cash for their purchases, they in effect helped to expand the secondary market by creating a new demand for discounted debt.

By 1983, the secondary market for developing country debt was trading at a volume estimated at $1.3 billion.

Table 2. Debt-for-Nature Swaps, 1987–1990 ($000s)

Date	Country	Project	Purchaser	Face Value Of Debt	Debt Purchase Price	Value of Local Currency Bonds Generated
3/90	Costa Rica	Park Management	Kingdom of Sweden, WWF, Nature Conservancy	10,800	1,998	9,720
3/90	Dominican Republic	Fondo Pronatura. Protects crocodiles and endangered wildlife habitats	Conservation Trust of Puerto Rico and Nature Conservancy	582	116	582
1/90	Poland	Helps National Foundation for Environmental Protection (Warsaw) conduct a study for the Vistuala River Basin Program	WWF	50	12	50
7/89	Madagascar	Park Management Training	WWF USAID	2,100 (1,000 to be negotiated)	950	2,100
8/89	Zambia	Park Management	WWF, Bankers' Trust Bank of Netherlands	2,270	454	2,270
4/89	Ecuador	Biodiversity Conservation: Galapagos Islands, National Park System, Conservation Data Center	WWF, Nature Conservancy, Missouri Botanical Gardens	9,000	1,069	9,000
1/89	Philippines	Park Management and Tourism	WWF, Haribon Foundation	390	200	390
4/89	Costa Rica	Guanacaste National Park Land Purchase	Kingdom of Sweden	24,500	3,500	17,150
1/89	Costa Rica	Braulio Carrillo National Park, Guanacaste National Park	The Nature Conservancy	5,600	784	1,680
5/89	Costa Rica	Reforestation projects	Dutch Government bilateral aid to Costa Rica	33,000	5,000 (donation)	9,900
2/88	Costa Rica	Expansion of La Selva Tropical Forest Station	Donation by Nature Conservancy	240	Donation by Fleet National Bank	190

Table 2. Debt-for-Nature Swaps, 1987–1990 (continued) ($000s)

Date	Country	Project	Purchaser	Face Value Of Debt	Debt Purchase Price	Value of Local Currency Bonds Generated
2/88	Costa Rica	Expansion and Management of Convocado and Guanacastle National Parks	National Parks Foundation of Costa Rica	5,400	918	4,050
12/87	Ecuador	Endowment for Fundacion Natura, Management plans for Galapagos Islands	WWF	1,000	254	1,000
8/87	Bolivia	Beni Biosphere Reserve: Protection of park and surrounding areas	Conservation International	650	100	250

Programs Being Planned

Country	Program
Brazil	Negotiations underway with G-7 governments to include debt-for-development swaps in a debt rescheduling plan for Brazil.
Dominican Republic	4-year program approved for possible conversion of up to $80 million debt at face value into conservation bonds.
Argentina	Ecological Conservation: Fundacion Neuquén, Patagonia Watersheds, Neuquén Parks, Iguazu Falls Park (up to $60 million; no transactions yet).

Sources: Gerson and Page (1990), personal communication with staff, World Wildlife Fund, A.I.D./Washington, The Nature Conservancy.

Note: G-7, Group of seven (Canada, France, Federal Republic of Germany, Italy, Japan, United Kingdom, and United States); WWF, World Wildlife Fund.

The volume of debt traded grew to $2 billion in 1984 and to $4 billion in 1985 (Newman 1987).

Between 1987 and 1989, the growth of the secondary market for developing country debt was even more dramatic, with the total volume of debt traded increasing to $8-$10 billion in 1987 and to more than $20 billion by 1989 (Latin Finance 1990). Much of the growth was spurred by investors taking advantage of programs introduced between 1985 and 1987 by Latin American countries (Chile, Mexico, Brazil, Ecuador, Venezuela, Argentina) and the Philippines to buy back their commercial debt through debt conversions.

Debt Conversions

A debt conversion refers to any transaction whereby a developing country's hard currency debt (debt denominated and repayable in such currencies as U.S. dollars, British pounds, German marks or Japanese yen) is redeemed for local currency in the form of cash or bonds issued by the country's government, equity in a public sector enterprise being privatized by the government, or other local assets (Newman 1987).

Private investors and multinational corporations are attracted to debt conversion by the prospect of

purchasing debt at deep discounts and trading it almost at par (i.e., equivalent to the loan amount) for local currency or for an equity investment in the country. The latter type of transaction is known as debt-equity swaps. Many corporations use debt conversion programs to raise local currency to invest in their new or existing subsidiaries. In effect, private investors could receive a substantial subsidy on their investments.

Debt conversions have created a specialized business for major U.S. and European money center banks and brokerage firms. The institutions charge fees for acting as intermediaries in arranging deals between debt sellers and purchasers and in assisting investors to work through the debt conversion process. The banks and brokerage firms use their knowledge of the country in which they may have a substantial portfolio to help their clients (smaller banks and loan buyers) through the conversion process. A few banks and brokerage firms interested in environmental conservation have been motivated to donate debt or their services in brokering substantial debt-for-nature swaps.

What makes debt conversions especially attractive is that, since 1986, the secondary market prices of the debt of many developing countries have been falling. The Intrados Index, a weighted indicator that measures the average per dollar value of the total debt of 10 selected countries, indicates an almost 50 percent drop between January 1986 and January 1989, from 67 cents to 33 cents on the dollar. In 1989 (especially in November), many commercial banks offered their loans for sale, driving down the average price even further, to 28 cents in December. (Actual bid-offer prices may range plus or minus 15 percent, see Table 3.)

Debt-for-Nature Swaps

A *debt-for-nature swap* is a form of debt conversion, with several significant differences. First, the transaction is usually initiated by an NGO and negotiated with a developing country government, either on an ad hoc or individual basis, or through a subprogram of a government-sponsored debt conversion program. Second, the local currency funds generated are directed to a conservation project. Third, the conversion does not involve foreign ownership of local assets and therefore will not involve repatriation of profits and export of resources. A debt-for-development swap involves a similar transaction to raise local currency funds for education, health, and other development activities.

The concept of swapping debt for conservation projects was first proposed in 1984 by Thomas Lovejoy (then Vice President of World Wildlife Fund) in an op-ed article in the *New York Times*, October 4. Lovejoy argued that the secondary market for developing country debt offered a golden opportunity for conservation organizations to raise local currency to support conservation programs in Latin American and other highly indebted countries by purchasing and redeeming the foreign debt of these countries in local currency.

Lovejoy's idea became reality in 1987 when Conservation International (CI), a U.S. nonprofit organization, used a $100,000 donation from the Frank Weeden Foundation to purchase Bolivian debt worth $650,000 from an affiliate bank, Citibank of New York. In a subsequent agreement with the Government of Bolivia, CI cancelled the debt in return for an endowment fund in local currency worth $250,000 to pay for the operating costs of managing the Beni Biosphere Reserve in Northeast Bolivia. (A.I.D. contributed a grant, in PL 480 local currency funds, worth $150,000 to augment the Government of Bolivia's $100,000 contribution for the endowment.) CI thus obtained local currency two-and-a-half times the debt purchase price. More important, the Government of Bolivia agreed to provide maximum legal protection for the biosphere and demarcate a buffer zone of about 3.2 million acres around the protected area. In turn, CI agreed to provide additional financial and technical assistance for implementing the conservation program.

The Debt-Swapping Process

Four conditions must be in place before a debt swap can successfully take place. First, the debtor country debt must be available through a donation or a purchase at a substantial discount in the secondary market. Second, funds for the debt purchase must be available in dollars or other hard currency. Third, the host country government must agree in writing, or must have an existing debt conversion program, to convert the debt into local currency at a rate close to the face value of the debt, or at least at a rate significantly higher than the prevailing market rate. (Some countries are bound by legal agreements with their creditor banks prohibiting them from buying back their debt, whether through a direct purchase in the secondary market or through debt swaps with intermediaries that have purchased their debt in the secondary market.) Finally, the project to be financed through the proceeds of the debt conversion must be approved by the government and designed to

Table 3. The Intrados Index

Country	Jan. 86	Jan. 87	Jan. 88	July 88	Jan. 89	July 89	Sept. 89	Oct. 89	Nov. 89	Dec. 89
Argentina	62-66	65-67	30-32	26-26	18	17-18	18-19	15-16	13-13	12-13
Brazil	75-81	75-76	46-48	51	34-35	34-35	29-30	22-23	22-23	22-23
Chile	65-69	67-69	61-63	60-61	60-61	64-65	62-63	58-59	60-60	60-60
Ecuador	68-71	65-66	36-38	27	13	17-18	15-17	15-17	14-15	14-15
Mexico	69-73	56-57	50-52	50	37-38	44-45	42-43	35-36	35-36	37-38
Nigeria	NA	36-42	18-20	20-25	23-24	23-24	28-30	28-30	28-29	30-31
Peru	25-30	18-20	6-7	5-8	4-6	3-5	3-5	6-8	5-6	5-6
Philippines	48-52	72-75	48-50	54	44-45	52-53	49-50	48-49	46-47	50-51
Poland	50-53	42-44	41-44	40	34-35	40-41	37-38	29-31	20-21	15-17
Venezuela	80-82	74-75	53-56	55	37-38	40-41	41-42	38-39	35-35	34-35
Intrados Index*	67	61	44	44	33	36	34	28	28	28

Source: *SWAPS* (1990).

*The Intrados Index is a weighted indicator that at the end of each month measures the average value of the total debt of the 10 selected nations. Given the limited number of direct transactions that occur, indicative bid-offer prices are extrapolations based on debt swaps among banks. In addition, depending on the amount of activity in a particular country's debt, the bid-offer price may represent a range of plus or minus 15 percent.

address development issues as well as financial aspects of the debt conversion (see Implementation Issues, page 13).

From the precedent set by CI, NGOs have worked out variations on a negotiation process that basically comprises five steps (Konrad von Moltke 1990) (see Figure 1).

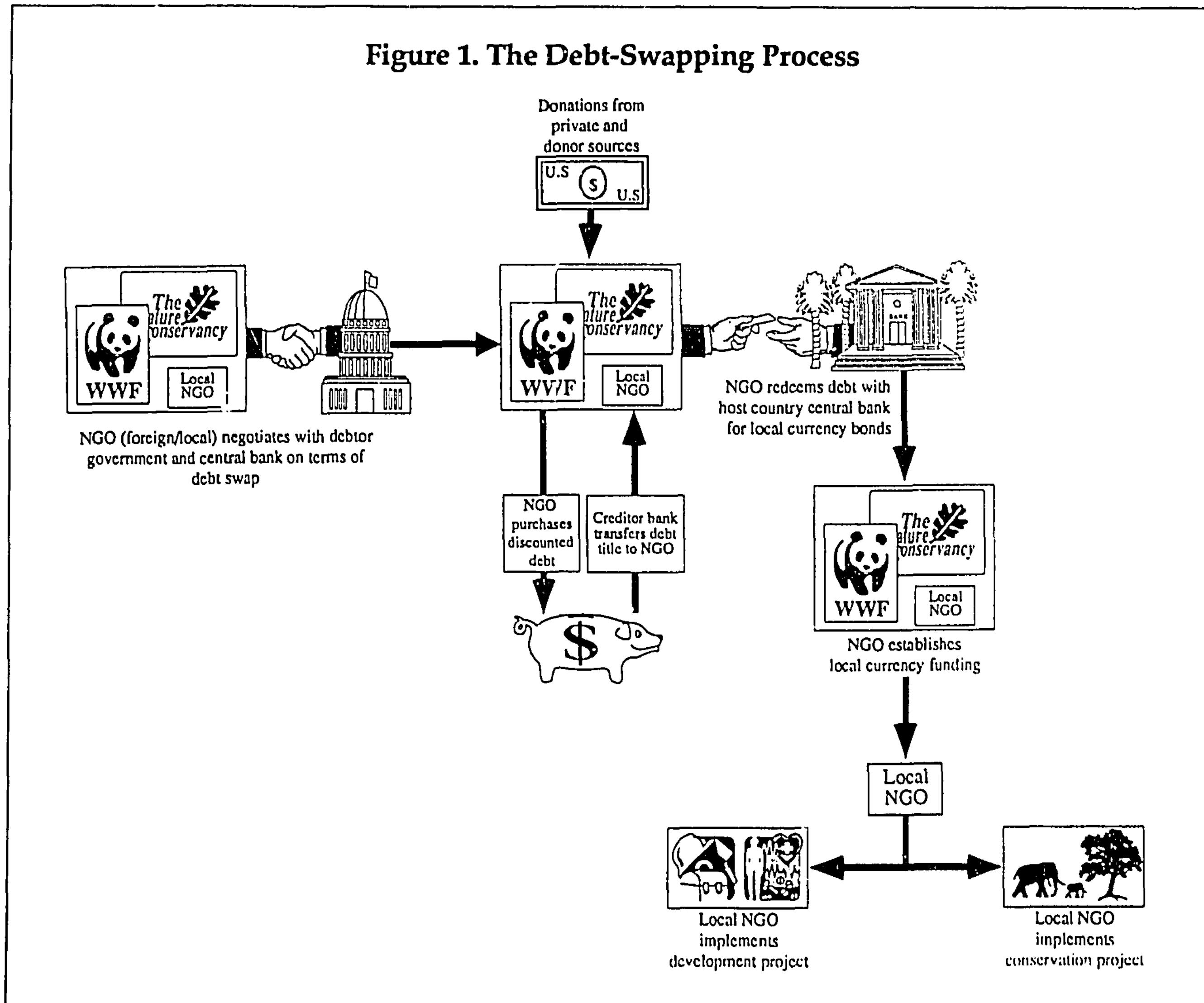
1. The NGO negotiates with the government and the central bank of the debtor country on such issues as the discount rate for converting the debt into local currency (in cash or bonds), the payout period and the interest payments if bonds are to be issued, and the design and implementation of the conservation or development project. In countries where the government has a debt conversion program providing regulations for debt-for-nature and debt-for-development swaps, the NGO needs only a written agreement that its project qualifies for the program.

Upon completion of this step, an NGO can plan its strategy to obtain the debt instrument either by soliciting a donation from a creditor bank or by raising funds from private sources and donors such as A.I.D.

An NGO wishing to apply for an A.I.D. grant for a debt purchase must submit a written proposal that includes the following: (1) evidence that it has received prior concurrence from the host country government to the terms of the debt swap; (2) a budget plan for the use and management of the local currency to be generated from the debt swap; (3) a description of the transaction costs to be incurred in acquiring and exchanging the debt; (4) an analysis of the financial and other advantages of acquiring the local currency through a debt swap rather than by direct purchase with dollars; and (5) an agreement that the debt will be purchased, at the lowest market price, only from established and reputable sellers, such as major commercial banks (A.I.D. 1990).

2. The NGO acquires the debt instrument through purchase in the secondary financial market for developing country debt or as a donation from the creditor bank. When a purchase is involved, the NGO has to determine the prevailing secondary market

Figure 1. The Debt-Swapping Process



price of the debt and shop around for the best offer. This is usually accomplished with the assistance of an agent (a bank or brokerage firm knowledgeable about the market conditions for the debtor country's debt).

3. The creditor bank transfers the debt title to the NGO.

4. The NGO redeems the debt with the debtor country's central bank for local currency to be repaid in accordance with the agreement reached with the debtor country government.

5. The NGO establishes a local currency fund to implement the conservation or other development project.

Negotiations with the debtor country might include addressing specific issues related to the implementation of the project to be funded. In the Bolivian debt-for-nature swap mentioned above, the creation of the buffer zone was a condition that went beyond the Government's financial obligation to CI in redeeming the debt. Under the Madagascar debt-for-nature swap agreement, park rangers recruited and trained by the project will be subsequently employed by the Government of Madagascar. Participants in the negotiation process might also include local NGOs—affiliates of U.S. and other international NGOs—responsible for implementing the conservation or development project. A.I.D. staff would participate in negotiations involving issues related to A.I.D. financing of the proposed debt swap.

Benefits of Debt-Swap Programs

Well-structured debt-swap programs involving nonprofit organizations should provide financial benefits for all parties to the transactions. With each debt conversion, the *debtor country government* cancels

its obligation to the creditor bank, with no payout in hard currency, and reduces the amount of foreign currency it has to pay for both principal and interest on the country's total external debt. The foreign exchange saved could be used for needed imports. The government also gains control over the terms under which it would redeem the debt in local currency, that is, the discount rate and the maturity and interest payments on the bonds issued. These benefits are especially important to debtor governments that have legal agreements with their creditor banks prohibiting the debtor governments from entering the secondary market to buy back their debt directly. However, the benefits are not without some cost to the government (see Macroeconomic Issues, page 16).

The government also benefits from donors sponsoring a debt swap by providing hard currency grants for debt purchases. Such grants are often additional to the donors' existing direct development assistance budget for that country. Consequently, they constitute a new source of development aid from donors to that country. Conversely, if donor assistance for a debt swap is in the form of local currency generated from an existing aid program in that country (such as A.I.D.'s PL 480 food aid program), the government would not be receiving new development aid. (For these reasons, host country governments would prefer donor sponsorship in the form of hard currency contributions toward debt purchases.)

Proponents of debt-swap programs point out that an equally, if not more, important benefit of such programs to the government is that debt conversions might stimulate increased investments in productive activities, thereby generating more employment, income, goods, and services. However, the extent to which debt swaps actually generate additional investment is a controversial issue (see Macroeconomic Issues).

From the perspective of *the commercial bank*, a loss is incurred when it donates or sells its loan in a debt swap. However, the debt conversion process allows banks to recover a portion of what might turn out to be uncollectible debt. (U.S. banks can claim a tax benefit for their donations or losses.)

For *the NGO*, a debt swap can yield a very favorable rate of exchange in local currency for every dollar spent on the debt purchase (payment for the debt instrument and transaction costs). If the payment is in cash, the NGO would have the advantage of a sizable amount of funds upfront to pay for a project with large start-up costs. If the repayment is in the form of bonds, interest payments on the bonds could guarantee a long-term source of funding for the project. More important, through the debt-swapping process, NGOs can negotiate directly with the debtor government on project-specific issues. In some cases, they might receive additional concessions and funding that otherwise might not have been available. In the Bolivian case, the creation of, and legal protection for, the buffer zone and A.I.D.'s assistance were direct outcomes of the negotiation between CI and the Government.

There are also nonmonetary, but no less important, benefits for using debt swaps. The host country engaged in a debt swap for the first time can assess from the process what is involved and whether it can support a larger debt conversion program. The publicity generated by a well-orchestrated announcement of a debt-swap agreement can, in itself, be a significant benefit for the parties involved. The debt swap provides the debtor government with an opportunity to demonstrate its commitment to manage its debt problem and target resources for specific conservation or development activities. For the government's creditor banks, the debt swap is a welcome sign of the government's willingness to make good on its debt, to allocate resources to stimulate development, and to strengthen its credibility with the international financial system. Other signatories to the debt-swap agreement—the nonprofit organization and benefactors, such as a bank or foundation that donated the debt, the brokerage firm that donated its services, or the bilateral donor that provided funds for the purchase—can demonstrate that they have contributed to a good cause. Furthermore, U.S. or foreign NGOs can use debt swaps to generate an international audience and support for the causes of their affiliate organizations in the debtor countries. This relationship is particularly important in countries where only local NGOs are eligible to receive the proceeds from debt swaps. In such countries, the local NGOs are usually the beneficiaries of endowments set up with proceeds from debt swaps.

The overall contribution of debt conversions to reduction of developing country debt (totaling $1.2 trillion in 1989) is less significant. The face value of hard currency debt that has been retired to date through debt conversions (debt-for-nature, debt-for-development swaps, and debt-equity swaps) in the 15 most heavily indebted developing countries (which include all the major debtor countries in Latin America) totals slightly more than $10 billion (Institute of International Finance 1990). The total commercial debt still owed by the 15 countries was $262 billion in 1989 (IMF 1990).

Experts agree that, in general, debt swaps are no panacea for solving developing countries' debt problem. As one writer points out, in major debtor countries, there simply is more debt than there are opportunities to make profitable investments (Segal 1987). Nevertheless, some economists concede that a larger amount of debt could be retired if debt swaps were used in conjunction with a comprehensive debt-management program involving restructuring of the economy and a refinancing plan (Bulow and Rogoff 1988, Sachs 1988).

Implementation Issues

Although the steps in a debt-swap process are fairly straightforward, there is no single formula for success in negotiating a debt swap. The process involves much more than simply reaching an agreement to redeem a developing country's debt for local currency. A review of the literature on debt swaps and interviews with the staff of the World Wildlife Fund, the Debt for Development Coalition Inc., the Debt for Development Foundation, and A.I.D./Washington staff who have successfully completed debt-swap transactions indicate that the process involves complex management and financial issues that can only be addressed on a case-by-case basis. Resolving these issues requires measures that must take into account the interests of the creditor bank, the host country, and other parties to the transaction, as well as the local currency requirements of the project to be funded. Experience so far suggests that efforts to promote debt conversions could be impeded by two factors: the capability of NGOs and the constraints in debtor countries.

NGO Capability

Many NGOs—foreign and local—lack adequate resources to function effectively as intermediaries in debt swaps. The process of working out a transaction acceptable to all the parties requires considerable time, negotiating skills, and technical expertise. Moreover, at each stage of the process, the NGO has to undertake and coordinate various tasks effectively. For example, in identifying and purchasing an appropriate debt instrument, the debt buyer must be familiar with the market of the country whose debt it wishes to acquire (e.g., types of debt available, price trends, key dealers) and it must proceed with a purchase offer without pushing up the market price. Furthermore, transactions must be completed promptly, often within days, once agreement has been reached with the sellers. If the funds for a debt purchase are from another source, such as an A.I.D. grant, discrepancies between the timing of a bid-offer and disbursement of promised donor funding can force an NGO either to forego a good price (and risk losing its credibility with the prospective seller) or draw on its own finances to make good on its offer. Several NGOs have had to forward substantial amounts of their own funds while waiting for the release of donor funding. Many NGOs are not able to afford such upfront expenses. Finally, the legal aspects of a debt-swap agreement can also be complex and require familiarity with the financial regulations of the host country.

Given the considerable staff resources, transaction costs, and time required to undertake a debt swap, it might be financially feasible for an NGO to proceed with a debt swap only if fairly large sums of hard currency are to be converted. Experts have noted that in many cases, it might not be cost-effective to convert amounts less than $1 million. Moreover, apart from charging a fee, central banks in most developing countries set minimum requirements for currency conversion in a single transaction. Most central banks would not consider converting less than half a million dollars, a sum considerably larger than most project accounts handled by NGOs or their local counterparts.

Under these conditions, the NGO must be able to design and implement a project that can absorb a large amount of local currency in a fairly short period of time (the duration of most projects is usually 3 years). Alternatively, the NGO could design a longer term project, for example, one that will require local currency funding for more than 3 years. In either case, the NGO and its local counterpart will need professional guidance to establish an appropriate trust fund in local currency for the project. The issues that they need to consider when establishing such a fund include inflation-protection measures, appropriate timing in disbursement of funds for the project's operating costs, and appropriate bookkeeping to meet project and external accountability requirements.

Constraints in Debtor Countries

In countries where the debtor government has a formal program covering all types of debt conversions, conducting a debt swap should only be a matter of following existing regulations and negotiating on specific issues concerning how the government would redeem a debt paper. In practice, however, only several countries in Central and South America and the Philippines have formal debt conversion

programs, all of which have been introduced only during the past 5 years. Because the programs are new, there is much trial and error in implementing debt conversion programs.

There are also differences among the programs that can be confusing. For example, some programs, such as the ones introduced in Chile and Peru, deal only, or primarily, with debt-equity conversions. That is, they are designed to encourage foreign or local investments in public companies undergoing privatization (debt-equity conversions). As such, these programs do not provide clear, if any, guidelines concerning debt-for-nature and debt-for-development swaps initiated by NGOs. The exceptions are the programs introduced by Costa Rica and Ecuador. In short, there are likely to be as many differences among debt conversion programs as the countries that sponsor them.

While programs will vary among countries to reflect the governments' priorities in sponsoring debt conversion programs, lessons are emerging concerning the basic features that a program should offer to attract both business investors and NGOs (foreign and indigenous) that wish to sponsor development projects. These lessons include strong government commitment to implementing policies favoring private investments and NGO-managed development activities; clearly stated ground rules for local currency payments (cash or bonds) and, in the case of debt-equity conversions, repatriation of profits; protection against inflation and local currency devaluation; and clearly defined criteria for development projects eligible for debt swaps. As indicated in Box 3, some of these features are contained in the programs introduced by the governments of Chile, Peru, Costa Rica, and Ecuador.

In countries where the government has no formal debt conversion program, the situation presents different, but no less challenging, constraints. In some of these cases, not having a government-sponsored program might indicate that the government is unwilling to use debt swaps as a means of repaying its external debt. The government might be concerned that debt conversions would aggravate inflation through the injection of local currency funds into the economy. It might also be wary of the negative publicity that debt swaps might generate. For example, following the debt-for-nature swaps in Bolivia and Ecuador, there was a public outcry in reaction to reports that wrongly concluded that debt-for-nature swaps could undermine a country's sovereignty by enabling foreigners to claim ownership of the country's parks and other natural resources.

In other countries, the government might simply regard a debt-swap program as irrelevant for two reasons. First, with the exception of those in Latin America, many developing countries owe relatively little commercial debt to foreign banks and do not have great difficulty repaying such debt. The debt problems in these countries arise from servicing debt owed to the World Bank and other multilateral institutions and developed countries. Such debt is not offered for trade or sale. Second, creditor banks of several developing countries have quietly, but unilaterally, written off small commercial loans (usually less than $50,000) and, therefore, the debtor countries feel little pressure to pay.

Countries with little commercial debt can also present another problem. The secondary market for the debt of such countries either does not exist or is thin (i.e., there is little trading in the countries' debt). Under such circumstances, it is difficult, if not impossible, to obtain information regarding fair market prices for the commercial debt of these countries.

This does not mean, however, that debt-for-nature or debt-for-development swaps cannot be conducted in countries in which the government has no existing debt conversion program or owes little commercial debt. Countries such as Bolivia and Madagascar have no formal debt conversion programs but have supported debt-for-nature swaps. The Madagascar Government plans to redeem all its commercial debt for environmental conservation programs. The Debt for Development Foundation is currently negotiating a plan whereby A.I.D. would provide a $1.5 million grant for the purchase of the Government of Ghana's commercial debt to support a park management and tourism project.

In the absence of a well-run debt conversion program, most debt-for-nature or debt-for-development swaps have been, and will likely continue to be, based on ad hoc negotiations on a case-by-case basis. This means that in many countries substantial groundwork and related expenses might be required prior to negotiation on the financial and implementation aspects of a debt swap—for example, educating and convincing senior government officials (especially the central bank authorities) on the merits and feasibility of funding a project with a debt-swap and identifying prospective debt sellers. Consequently, when negotiating a debt swap for the first time,

Box 3. Examples of National Debt-Swap Programs

CHILE

Year Program Began: June 1985

The program has separate provisions for debt conversions by Chilean nationals and foreign investors. Nationals can redeem Chilean debt bought overseas for immediate redemption at full face value in cash or debt bonds. However, foreigners can only purchase debt if they convert it into equity in a Chilean company. A portion of profits (no more than 25 percent) from equity generated in the first 4 years may be remitted in the fifth year. Capital may be repatriated after 10 years. Between 1985 and 1989, the total amount of debt retired amounted to almost $5 billion, $3 billion by foreign investors. Major investments include refinancing packages to revive Chile's mining industry, for example, a $62 million debt conversion by London's Midland Bank to raise $35 million to refinance a copper mine and a $300-$400 million debt conversion transaction with AMAX of the United States for a lithium mining project. Bankers' Trust exchanged a $60 million debt for a 51-percent stake in a privatized Chilean pension fund.

(Sources: Hannon and Gould 1987, Mark 1990.)

PERU

Year Program Began: July 1989

The program converts debt at face value into local currency using a commercial exchange rate. The funds can be deposited with the Central Bank, which offers dollar-denominated accounts and an inflation-indexed cap of 0.5 percent of Peru's GDP. Payments may be made in installments over several years. Local nonprofit organizations are eligible for the program, which provides explicit guidance on the debt conversion procedures and the types of development activities that the Government will endorse under the program. The program has been successful in attracting debt donations from foreign banks and nonprofit organizations. American Express liquidated its entire Peruvian debt portfolio with a $5 million debt donation to fund vocational training projects. Another $15 million debt conversion arranged by a U.S. nonprofit organization, PAID (Fund for Private Assistance in International Development), will finance health, education, and agricultural research projects.

(Source: Kline and Hager 1989.)

COSTA RICA

Year Program Began: 1987 - debt-for-nature program, 1989 - program expanded to include education and small business development projects.

In 1987, the Government created a Natural Resources Conservation Fund that allowed the National Parks Foundation to trade, in 1 year, up to $5.4 million in debt titles in exchange for 75 percent of the debt's face value amount in local currency government bonds, maturing in 6 years and paying 25 percent interest. The Costa Rica Cooperative Bank (BANCOOP) administered the program. The bonds cannot be sold but may be used as collateral for loans. The program was soon oversubscribed by donors and environmental conservation organizations donating debt to the National Parks Foundation. Proceeds from the debt swaps are used for park management and purchase to expand existing parks, deforestation control projects, and environmental research and education projects.

In 1989, a 3-year program was introduced to convert $45 million of Costa Rican debt, at a maximum of $15 million a year. Only Costa Rican foundations are eligible for the program, which offers 20-year bonds and a 15-year grace period on principal. Costa Rican debt titles may be redeemed in either U.S. dollars or local currency (colons). For debt paper redeemed in U.S. dollars, the conversion rate is 80 percent of the debt's face value in bonds paying 3 percent interest. Conversions into local currency are offered at full face value and at 8 percent bond interest. Proceeds from debt conversions may be used only for natural resource conservation, education, and small business development projects. The foundations have received debt donations from the Swedish and Dutch governments, A.I.D., and international nonprofit organizations. To date, the programs have retired $78 million of Costa Rican foreign debt.

(Sources: Ministry of Natural Resources, Energy, and Mines 1988.)

Box 3. Examples of National Dept-Swap Programs (continued)

ECUADOR

Year Program Began: October 1987 - debt-for-nature program, October 1989 - new program introduced; given authority to convert up to $50 million debt to fund social, cultural, amateur sports, and environmental projects.

October 1987 - August 1989

Ten million dollars of Ecuadoran debt was converted under the debt-for-nature program. Debt titles purchased by U.S. environmental groups were donated to the Fundacion Natura and other Ecuadoran nonprofit organizations, including a natural history museum. The organizations subsequently redeemed the debt titles, at full face value of the debt amounts, for "monetary stabilization bonds," each maturing in 7 years and currently yielding 40 percent interest per annum. Interest payments on the bonds will support the organizations' activities. Major beneficiaries, such as the Fundacion Natura, have set up endowments with the funds they have received.

October 1989 to June 1990

During this period, the Government (through the Monetary Board of Ecuador) introduced a new program to convert up to $50 million worth of debt at 50 percent face value into monetary stabilization bonds, paying interest pegged to market rates. Only Ecuadoran nonprofit organizations are eligible for the program. The organizations may each redeem up to $5 million worth of debt and use the proceeds to support social, cultural, educational, environmental, and amateur sport activities. Foreign sponsors of the debt swaps include CARE, Red Cross, Harvard University, and A.I.D. (see Table 1).

June 1990 to present

Since June 1990, the Government has extended the program described above for another year, with the amount of debt authorized for conversion raised to $150 million. The Government is considering adding other types of development activities to the current list of eligible projects.

(Source: Personal communication with staff from A.I.D./Washington, A.I.D./Bureau for Science and Technology, and Debt for Development Foundation.)

NGOs and their sponsors, such as A.I.D., should be prepared to devote as much time and resources to this process as they would if they were designing a conventional development project. This point is well-illustrated by the lengthy negotiations that preceded the signing of the first debt-for-nature swap in Bolivia (over 2 years) and in Madagascar (1 year). The A.I.D.-sponsored debt-for-development swap in Ghana will likely require a comparable period of time to complete.

Macroeconomic Issues

Although debt conversions help reduce the external debt of debtor countries, they are not cost free to the debtor countries and could engender unintended macroeconomic effects. There is a divergence of views concerning how to weigh the benefits of debt swaps against such costs as the subsidies inherent in debt conversions and risks of increasing domestic debt and inflation. The following section discusses the two key topics in the debate.

Subsidies and Additionality

The first topic in the debate centers on the question of whether the debtor government is efficiently allocating its resources by buying back its external debt at a price significantly higher than the secondary market rate, and thereby, subsidizing those who redeem its debt for cash payments, bonds, or other local assets. (This question applies only to countries whose legal agreements with their creditor banks prohibit them from buying back their debt directly in the secondary market, but who can do so indirectly through debt swaps with intermediaries who have acquired their debt in the secondary market.)

Supporters of debt conversions view these subsidies as justifiable costs to motivate private investors (both foreign and local) and development NGOs to invest in risky economies (Newman 1987, Sachs 1988 and 1989, Segal 1987). In particular, the subsidies might help in highly indebted countries, where little or no new foreign investments have been made. Furthermore,

proponents of this viewpoint argue that the costs of the debt conversion could be offset by targeting investments to certain development programs, restricting repatriation of profits, and curtailing inflationary pressures with appropriate repayment conditions (e.g., redeeming debt in bonds rather than in cash).

Skeptics, however, point out that the costs are unjustified because debt conversions provide little real debt relief for highly indebted countries. These economists contend that debt conversion programs, especially programs offering upfront cash payments, constitute a means for foreign investors to obtain unnecessary subsidies for trading debt they purchased at fire-sale prices in the secondary market (Bulow and Rogoff 1988).

Disagreement among economists centers on the issue of additionality—that is, whether the investments derived from debt conversions would not otherwise have been made and are, therefore, additional. If the investments are additional, they are clearly direct benefits of debt swaps. Furthermore, if the investments prove to be profitable, the subsidy borne by the government would be more than justified.

However, if the investments are not additional (i.e., they would have occurred anyway), then the government did not use its resources efficiently because it provided a subsidy that clearly was unnecessary. Moreover, the government has incurred an opportunity cost in two respects. First, it has deprived itself of the hard currency that would have been spent by foreign investors to buy local currency through conventional channels. Second, it could have used the subsidies for other purposes.

Increasing Domestic Debt and Inflation

The second topic concerns two issues: increasing domestic debt and exacerbating local inflation. A debt swap is essentially a transaction that converts an obligation to pay back a debt with foreign currency into one that can be paid with local currency—that is, a domestic debt obligation. The government would have to pay the debt obligation either through an upfront cash payment in local currency or through bonds, which will require payment in interest and principal on the bonds. To meet these payments, the governments will have to raise revenues or resort to deficit financing. The latter approach can impose a fiscal burden if the amount of local currency required is substantial and the payout period on the debt obligations is significantly shorter than the one for the original foreign debt obligation. In other words, the government ends up paying more for the converted debt.

Some economists regard the financial cost of a debt swap as an acceptable trade-off for transferring resources from the government to the private sector if the transaction results in stimulating investment in desirable development activities. Moreover, if the debt conversion involves the transfer of local currency generated under a PL 480 program or similar donor-sponsored program, there will be no increase in domestic debt. (Obviously, the economic benefits of this transfer will depend on whether the private sector is efficient in using the resources.)

If the investments generated with debt swaps are additional and the debt conversion involves redeeming huge amounts of debt made through upfront cash payments or rapid payment schedules, the government assumes another risk. In such cases the local currency generated by debt swaps enters the local monetary system as new money, thus expanding the money supply. If the total amount is substantial, the government could exacerbate local inflation with each injection of new money, particularly when this is done over a short period.

These potential fiscal and inflationary effects of debt swaps are not insurmountable problems. The inflationary effect will be small if the government raises the local currency through tax revenues or domestic borrowing (rather than through the expansion of the monetary supply by issuing new money) and structures the payout installments over a long period. Moreover, the government can reduce the amount of local currency it must pay with each conversion if it claims a large discount on the face value of the debt (in other words, if it converts the debt at a value significantly less than the original loan amount).

Recent Findings

A 1989 study of 101 debt conversions in Argentina, Brazil, Chile, and Mexico supports the argument that debt conversions can attract foreign direct investments (Bergsman and Edisis 1989). The study demonstrated that a third of the debt conversions resulted in investments by multinational corporations that were directly attributable to the the debt swaps—that is, the investments were additional. (More than 50 percent of investments in the export sector were additional.) Investors reported that the subsidies provided by the debt conversions helped reduce the initial cost of their investments, thus increasing the expected rate of return and making the overall

business risk more acceptable to the investor (especially with regard to manufacturing industries in the export sector).

Notwithstanding this positive finding, Brazil's recent experience presents a worst-case scenario that illustrates why many economists are concerned about the inflationary effects of large-scale debt conversions. In 1988, $6 billion of Brazil's foreign debt was redeemed in local currency worth $1.8 billion and paid over several months. Consequently, Brazil's money supply increased sharply and worsened the existing inflation (inflation rose from 360 percent in 1987 to 934 percent in 1988), subsequently setting off a frenzy of currency speculation that contributed to a capital flight totaling an estimated $7 billion (Cardoso 1990). As a result, the Brazilian Government was forced to suspend its debt conversion program in December 1988.

The fear of exacerbating existing inflation has also been cited as the reason for Argentina and Mexico suspending their debt conversion programs in 1989. Brazil's experience suggests that countries experiencing intense inflationary pressures should be cautious about setting up a large-scale debt conversion program.

Implications for NGOs and A.I.D.

In light of the implementation issues already mentioned, an NGO should consider carefully whether a debt swap is an appropriate mechanism for raising funds for a proposed project and whether it should undertake the debt conversion process at all. Furthermore, an NGO should be prepared to invest considerable time and technical expertise to address the issues mentioned above and to assume some risk in addressing the financial issues.

Large organizations, such as the World Wildlife Fund, CI, and CARE, have expanded their full-time staff to include financial specialists to manage their organizations' debt-swap program. However, recruiting a specialist might not be an appropriate solution for smaller organizations for whom a debt swap might be only a one-time endeavor and who cannot afford to increase their staff resources to manage a debt-swap program.

For smaller NGOs, organizations such as the A.I.D.-sponsored Debt for Development Foundation and other private nonprofit organizations can offer information and advisory and technical services on debt swaps to guide the NGOs' efforts. The Debt for Development Foundation is exploring ways in which to pool the resources of member organizations to purchase debt in sizable amounts and to act as an intermediary in negotiating with host country governments on the financial aspects of a debt conversion. The local currency generated from the swap transaction would be apportioned among the member organizations according to their respective "shares" in the pooling arrangement.

Before investing in a debt swap, an NGO should also weigh the costs of undertaking a debt swap against the costs of procuring local currency through other means. For example, purchasing debt owed to a multinational corporation that no longer operates in the host country or simply converting small sums of dollars using the official exchange rate as needed are two possible alternatives to the debt swap approach.

Equally important, A.I.D. should be prepared to address problems related to the disbursement and management of Agency funds for debt purchases. Some of the issues are being addressed on an ad hoc basis by individual A.I.D. Bureaus and Missions. For example, USAID/Ecuador devised a simple solution to the problem of synchronizing the disbursement of A.I.D. funds with CARE's purchase bid on the debt instrument used in the debt-for-development swap with the Government of Ecuador. Through a combination of telephone and facsimile communication with A.I.D./Washington and the Debt for Development Foundation, the Mission determined that CARE's proposed bid on the debt instrument corresponded with prevailing secondary market prices for Ecuadoran debt. When the debt purchase was to be made, Mission management authorized an advance payment from the Mission's dollar account to CARE.

Another approach that A.I.D. could consider is to help host countries establish debt conversion programs as part of a broader strategy (e.g., in conjunction with an economic reform program with other donors) to stimulate private sector development and improve external debt management. For example, in some circumstances, debt conversion programs can be used as a market-based mechanism to attract investments (domestic and foreign) to specific private industries and development projects. The programs would include monetary measures to offset inflationary effects and the costs related to the use of subsidies to investors.

A.I.D. could also sponsor workshops to educate senior government officials about the potential role

that debt conversion programs could play in stimulating investment in development activities. Subsequently, for interested governments, A.I.D. could fund technical assistance and training programs to assist with the establishment and implementation of debt conversion programs.

A.I.D. is beginning to take steps in this direction. In February 1989, a workshop jointly sponsored by the African Development Bank, Overseas Private Investment Corporation, and A.I.D. brought together 31 senior African government officials to discuss how debt conversions can help African countries address their external debt problems and stimulate private sector investments (ADB 1989). As a result, the African Development Bank is in the process of establishing a unit to help interested member countries set up debt conversion programs to privatize government-owned enterprises in key development sectors. Designers of the program are considering measures to set up private companies or foundations whose shareholders are drawn from a broad spectrum of the private sector.

Because of the small sums involved in debt-for-nature and debt-for-development swaps completed so far, the macroeconomic issues discussed above are less relevant. Nevertheless, analyzing the macroeconomic implications of debt swaps is important in assessing the extent to which debt conversion programs can be used to attract private investments in key development activities and to manage a debtor country's external debt problem.

Conclusion

Experience thus far indicates that well-designed debt conversion programs, including debt-for-nature and debt-for-development swaps, can provide a financially viable means for recycling developing country debt to support development projects. Such programs have helped a few countries, such as Chile, reduce their commercial debt significantly and attract private investors. The steady growth of the secondary market for developing country debt suggests that private investors, including NGOs, can continue to use debt swaps to finance development activities.

However, debt swaps are clearly not a panacea to solving the debt problem of many developing countries. One constraint is that a predominant amount of developing country hard currency debt is owed to multilateral institutions and donor agencies and cannot be traded. For heavily indebted countries in Latin America and the Caribbean, this constraint might be somewhat alleviated if the U.S. Congress fully supports the "Enterprise for the Americas Program" legislation introduced by President Bush in June 1990 (White House Press Release 1990). The bill proposes that the U.S. Congress approve the sale of outstanding bilateral commercial credit owed by heavily indebted countries in Latin America and the Caribbean to the U.S. Government under the Export-Import and Commodity Credit Corporation programs. Credits sold under the program would be used to support debt swap transactions aimed at financing foreign investment and environmental conservation projects.

Another limitation is the extent to which debt swaps can meet the interests of the various parties involved. In light of the limited capabilities of NGOs, it is likely that many, especially smaller, organizations, will not regard debt swaps as a cost-effective means of raising local currency funds for their projects. Given the macroeconomic issues related to debt conversion programs, debtor governments might also regard formal conversion programs as unsuitable for their needs and confine their support to individual conservation or social service projects. Private investors, foreign and local, will only be attracted to debt swaps so long as the debtor governments are willing to offer discounts significantly higher than the prevailing debt prices in the secondary market and there are profitable investment opportunities in a debtor country.

For NGOs, the host country, and other sponsors of a debt-for-nature or debt-for-development swap, exchanging a debt instrument for local currency funding for a development project is only one part of the bargain. The other part is achieving the project's development objectives. It is still too early to determine the impact of projects funded through debt swaps. If the projects achieve their objectives, the host countries will gain tangible development benefits while reducing their debt burden.

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