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The Third World Debt Crisis: Are There Opportutnies for Forestry?

by

Jeffrey P. Prestemon and Scott E. Lampman

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THE THIRD WORLD DEBT CRISIS:

ARE THERE OPPORTUNITIES FOR FORESTRY?

by

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June 2, 1989

for the

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The total external debt of developing countries reached slightly over $1.2 trillion by the end of 1988 (Cody 1988). Worldwide, the 15 most indebted Third World nations today owe $288 billion to foreign banks, including $85 billion to U.S. banks (Harwood 1988, page 8). The remaining debt is owed to foreign governments and multilateral lending institutions, such as the World Bank and the International Monetary Fund. The negative effects of this burden are many and pervasive.

Many of the world's Third World debtor countries are liquidating their natural resource base--their forests, minerals, and biological diversity--in order to meet the immediate need of debt servicing. In an effort to repay loans and meet interest payment schedules, Third World debtor countries are forced to promote local investments and activities which, in many ways, are unsustainable: crude oil is being pumped and sold at rates which ensure quick depletion, subsidies are given for forest clearing for export crop and livestock production, environmental laws go unenforced in order to minimize financial burdens on export businesses, and important programs that promote conservation and sustainable natural resource development are left with low budgets (Fuller and Williamson 1988, Hansen 1988).

Because the traditional measures of debt burden reduction, such as debt refinancing and debt restructuring, were not making major progress in resolving some of the problems associated with the debt burden, some organizations tried some new approaches. One approach was the use of commercial bank debt to finance new investments in debtor countries. Both environmental organizations and U.S.-based multinational corporations were among the first to finance investments with commercial bank debt (Intrados Group 1988, 1989). The approach taken has been popularly called "debt-equity swapping" and "debt-for-nature swapping." Many debt swap opportunities exist in the forest sector. These swaps can be either for-profit (debt-equity) or not-for-profit (debt-for-nature) investments. Accordingly, foresters, government officials, and private sector organizations and businesses need to understand how such agreements work, why forestry should play a role in such agreements, and how to get the forestry sector involved.

This article shall review how the debt problem is being confronted, the mechanics of not-for-profit debt swapping and some advantages and disadvantages to the key parties involved, and how the forestry sector has used and could use debt swaps to finance for-profit and not-for-profit forestry projects.

Confronting the Debt Problem

The Third World debt burden has left leaders of governments and banks searching for debt relief alternatives. Since 1982, when Mexico announced to the world that it could not make payments on its international debt, more than 40 other countries have had similar difficulty in meeting their own debt repayment obligations (World Wildlife Fund 1988). Banks and other lending institutions found themselves with billions of dollars of debt that was not being repaid. Additionally, the citizens of Third World debtor countries were experiencing government budget reductions in social, health, educational, and conservation and environmental programs.

As a result of this situation, both formal and informal adjustments to reduce the debt burden have emerged. Formal adjustments include such measures as interest rate reduction and rescheduling of debt payments (restructuring), and the purchase (refinancing) of old debt using a new loan, or the "turning over" of the debt (Bramble 1987). Due to a changing economic environment in the U.S. financial industry during the early 1980s, there appeared a "secondary market" for Third World commercial debt. This secondary market, which provides the basis for many "informal adjustments," formed when financial institutions began selling, buying, and trading portions of their Third World commercial loan portfolios, a process referred to as "debt swapping" (Bramble 1987)[1]. This process is similar to when financial institutions in this country "resell" mortgages, student loans, or factor accounts receivable.

Multinational corporations (MNCs) began purchasing the debt, as well. Many Third World debtor countries, strapped for dollars and experiencing declines in direct foreign investment by an average of over 60% (for the four biggest Latin American debtors) during the period 1979-1986, set up mechanisms which allow MNCs to purchase commercial debt from the banks at a discount on the secondary market and exchange it in the debtor country for an equity investment in that country. The effective result for the MNC is a favorable exchange rate for the conversion of dollars into local currency. Banks that sell debt to these MNCs get some cash for their inactive Third World debtor accounts. In addition, the debtor countries replace a hard currency obligation with an

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1 For a review of the origins of swapping, see the Appendix.

obligation in local currency, which is easier to come up with, and encourage local investment (Bramble 1987, Bergman and Edisis 1988).

Debt-equity swapping has become particularly significant for the forest sector of Chile. The forest products industry in Chile has experienced tremendous recent growth, fueled in part by a series of large debt-for-equity swaps. Foreign companies and banks have become involved in some very significant new investments in the forest sector of Chile. As of January, 1989, a total of $657 million had been converted for the purpose of financing forest sector investments by foreign businesses. These investments would involve silvicultural activities, solid wood products manufacture, and paper and allied products[2], all in Region XIII of the country. Investors to date have included American, Japanese, New Zealand, and Swedish firms. One debt-equity conversion, involving a joint agreement between Scott Paper of the U.S., Shell Overseas Investment Corporation, and Citibank of the U.S., involved an investment of $425 million over the next four years. This investment was aided by the investors' ability to finance $276 million via debt swaps (Intrados Group 1988). Simpson Timber Co. of the U.S. has been eyeing a $400-450 million debt-equity swap to help finance a $600 million project. The agreement would involve the participation of up to six U.S. commercial banks. Simpson is also considering similarly-financed investments in Guatemala and Mexico for the purpose of gmelina plantation establishment and management[3].

A door-exporting company was involved in a debt-equity swap in Costa Rica. There, Norwest Bank of Minneapolis worked with the Costa Rican company PORTICO in negotiating a swap to finance mill expansion and purchase several thousand hectares of lowland tropical rainforest, with the intention of managing the forest on a sustained-yield basis.

Equal opportunities are arising from debt-for-nature swaps. Like debt-equity swaps, in a debt-for-nature swap undertaken by nonprofit organizations, a Third World debtor country's foreign commercial debt is exchanged for a local investment. Under this method, however, the investment is in conservation. Typically, a U.S. private

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2 From unpublished data, courtesy of the Chilean Central Bank (Banco Central de Chile) and the Chilean Forest Service (Instituto Forestal).

3 Courtesy of John Walker, Simpson Timber Co.

voluntary organization (PVO) buys discounted debt in the secondary market from a private bank at, for example, 12 cents per dollar of face value. This debt is then exchanged for local currency of the debtor country at a rate closer to face value. The local currency usually is paid out to a local PVO in the debtor country, which spends that money in designated activities which promote conservation (Lamp 1988, World Wildlife Fund 1988).

To summarize, the following entities are needed in order to carry out a debt-for-nature swap: (1) a debtor country willing to participate in debt exchanges; (2) a commercial bank which owns debt of that country and that is willing to sell the debt at a low price to a PVO; (3) a PVO with the money and the desire for carrying out a development-oriented activity in the debtor country; (4) a local PVO in the debtor country which would receive the local money accruing from the exchange of the debt; (5) a funding source, which could be either the members of the U.S. PVO, a charitable foundation, a bilateral or multilateral assistance agency[4], or even the private bank which holds the debt; and (6) a financial intermediary, which could identify the source of debt purchase funds, negotiate the debt purchase, help set up the contractual arrangements, and otherwise provide professional expertise (Cody 1988, Bramble et al. 1988, Intrados Group 1988). Diagram 1 illustrates how one PVO from Ecuador (Fundación Natura) has proposed that such an agreement would work with the World Wildlife Fund of the U.S.

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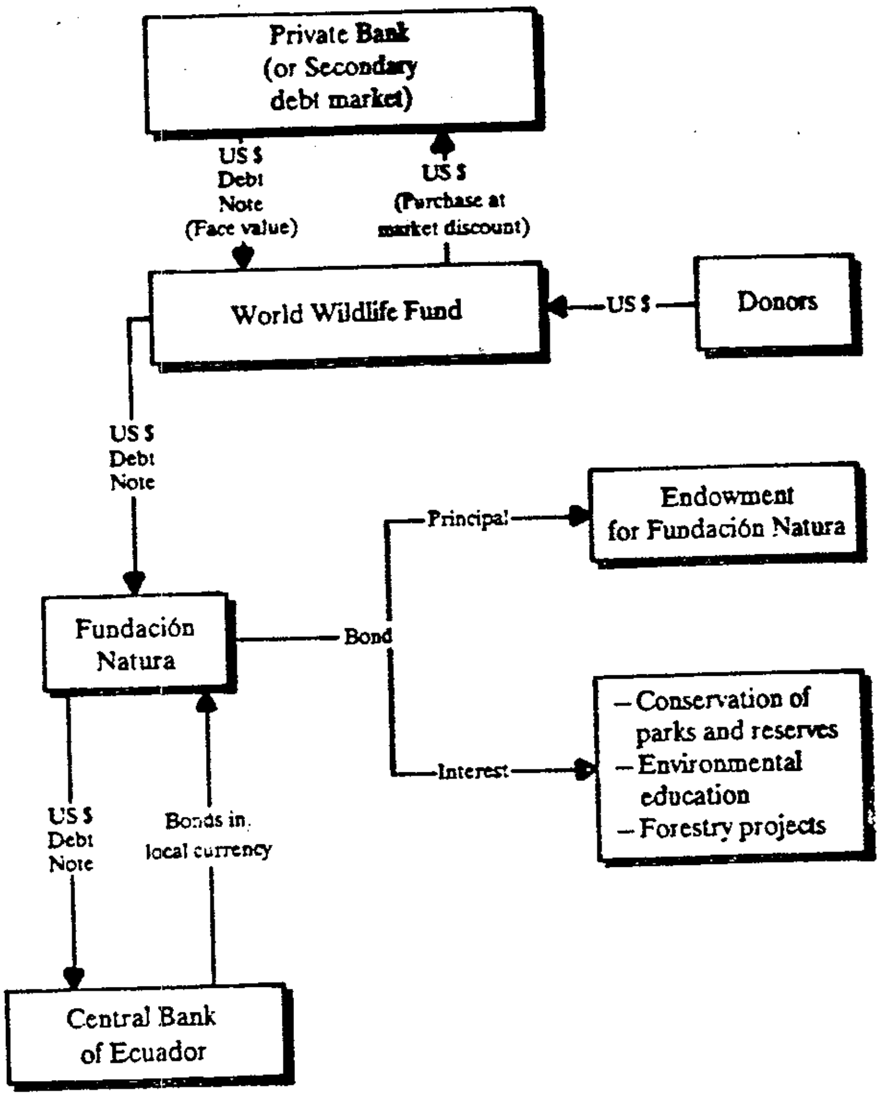
4. The U.S. Agency for International Development is one of the first bilateral agencies to become involved in debt-for-nature and other not-for-profit swaps. Guidelines distributed in early 1989 detail the Agency's role in encouraging such swaps. USAID's role would include giving funds to U.S. PVOs in order to carry out approved conservation and development projects. Multilateral lending agencies may be officially called to assist Third World debtor countries in promoting such debt-for-nature agreements, as well. Under this method, as proposed in a bill sponsored by U.S. Representative John Porter of Illinois, multilateral lending agencies would loan money to debtor countries in order for those countries to repay commercial banks and convert the new multilateral debt into local funds. Such loans would require that the country have plans for using funds toward specified conservation activities, which could include tropical research, tree nursery establishment and reforestation, conservation training and education, data management and information exchange mechanisms for conservation, and park management (U.S. Congress, House of Representatives, 1989).

MECHANISM FOR ECUADOR – WWF DEBT-FOR-NATURE SWAP*



*Based on the Sevilla Proposal: Financial Mechanisms for Conservation, by Roque Sevilla L., President, Fundación Natura, Quito, Ecuador (September 1987).

Source: Courtesy of World Wildlife Fund. From World Wildlife Fund Letter, 1988, No. 1.

Diagram 1. A representative Debt-For-Nature agreement.

Costs and Benefits of Not-for-Profit Exchanges

Each group involved in debt-for-nature exchange faces both benefits and costs from debt exchanges. In the interest of brevity, we shall confine discussion of these advantages and disadvantages to three major parties: banks, debtor countries, and PVOs.

For the Commercial Bank:

Advantages for commercial banks selling debt to PVOs include streamlining the bank's portfolios, providing immediate cash income, reducing their required amount of cash reserves, and possibly allowing for a tax deduction for its losses incurred as a result of the sale (Cody 1988, Lamp 1988, Hyde 1988).

Banks that sell debt at a discount do so in part because they perceive that there is a risk that the loan will never be repaid, so that a sale of this debt for hard currency, even if at a fraction of its face value, is often seen as better than no payment at all.

There are also significant disincentives for a bank to sell or donate its debt to PVOs. Future revenue can be lost if an inactive debtor account has a probability of receiving renewed payments. In addition, by selling the debt on the secondary market, the bank may be perceived as acquiescing and tacitly implying that the debt is unpayable. This implication might fortify the view of some that the Third World debt should be forgiven on a large scale. If debt-for-nature agreements are permitted on inactive debtor accounts, then debt exchanges may give the debtor countries an incentive to withhold payment on their other debts.

For the Debtor Country:

In the debt-for-nature agreements completed to date, the debtor country has experienced only a slight reduction in its foreign debt burden. The major advantage of such agreements is therefore not the debt reduction **per se**, but rather the conversion of a foreign currency debt into a local currency obligation. The debtor country also benefits by improving its international image, encouraging local investment in badly needed projects, increasing the awareness at home and abroad of the need to reduce Third World debt and the need to promote conservation or other development activities. (Cody 1988, World Wildlife Fund 1988, Bramble 1987).

Disadvantages cited for the debtor country focus primarily on two issues: sovereignty and inflation. Sovereign nations do not want outsiders dictating their environmental and monetary policy priorities (Cohen 1989, Cody 1988). Several groups and individuals, in both the U.S. and Third World debtor countries, have challenged the concept of debt-for-nature and for-profit debt-equity exchanges, focusing much attention on sovereignty issues (Potter 1988, Barton 1988, Cavanagh and Broad 1989). Agreements therefore must be sensitive to these concerns and negotiated with the participation of all affected parties (Cody 1988). Similar criticism can be found of for-profit debt-equity swaps (for example, see Tellez 1989, Potter 1988).

When a country agrees to participate in a debt exchange with any organization, the debtor country typically agrees to channel local resources (currency) into agreed-upon investments in return for the termination of the foreign debt obligation. This currency can be acquired by a number of methods, including the printing of additional money (Bergman and Edisis 1988). If currency is simply printed, inflation could result. The magnitude of resulting inflation depends on the ratio of the size of the economy (or money supply) to the amount of money printed for the swap. For most debt-for-nature exchanges, the impact is not great. In Costa Rica, it was estimated that the conversion of up to $50 million over a 12-month period would have changed the annual inflation for 1987 from 16.45% to 16.62% (Moreno and López 1988).

<u>For the U.S. PVO</u>:

The principal advantages for the U.S. PVO of carrying out a debt-for-nature agreement include an increase in the impact of its funds and an enhanced public image. When a U.S. PVO participates in a debt exchange, its funds for its international activities are effectively multiplied. In those countries with low-priced debt, this effect can be spectacular.

A potentially important disadvantage that a U.S. PVO encounters is the cost of negotiation and development of the transaction. The smaller the organization, and the fewer the funds available, the larger this disadvantage becomes. However, this can be avoided if many organizations band together to reach a multiparty exchange agreement with a Central Bank. Also, some private banks provide this service at no charge to the PVO (Intrados Group 1988).

Opportunities for Forestry

From the above discussion, it can be seen that there are two major categories of opportunities for forestry: for-profit and not-for-profit swaps. The for-profit swaps by definition generally entail debt-equity exchanges. Not surprisingly, MNCs are frequent debt-equity participants (e.g., the Scott/Shell/Citibank and the Simpson agreements in Chile). However, recently the commercial banks themselves have become independent forestry equity investors (the PORTICO/Norwest Bank agreement in Costa Rica).

These for-profit ventures usually entail large investments, into the hundreds of millions of dollars, and offer creditor country MNCs and banks a long-term investment in the forest sector at a comparatively low cost. Export-oriented investments are most likely to be approved by the host country government (Bergsman and Edisis 1988).

The second major category of opportunity for forestry in debt swapping are the not-for-profit swaps. Although no strictly "debt-for-forestry" agreements have been approved to date, these not-for-profit swaps have been proposed for financing some forestry-related activities. For example, an industry trade association in Ecuador, the Asociación de Industriales Madereros, has proposed a swap that would serve to finance wood research and reforestation (El Telégrafo 1989). Similarly financed forest sector investments are also being considered in Cote d'Ivoir and the Dominican Republic[5]. Other potential activities financed through debt-for-forestry might include technology transfer, training, environmental education, forest protection, and purchases of area reserves and their management.

Whereas wood industry associations have initiated not-for-profit swap proposals, it stands to reason that these debt-for-forestry swaps would appeal to corporations, as well as the international development community and debtor country governments. Consequently, the distinction between for-profit and not-for-profit interests in any particular swap can be less than clear. For example, a MNC need not simply invest in mills. In response to a local PVO, the MNC could buy on the secondary market the foreign commercial debt of a Third World country and donate it to a local PVO for designated

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5 Courtesy of Douglas Poole, of Development Alternatives, Inc.

forest sector development activities. One example of this could be a U.S. power company that donates debt to a debtor-country PVO, in order to fund tree planting that might help offset the "greenhouse effect" arising from CO_2 emissions from a new or existing power plant[6].

Another example could be that a MNC, which owns or plans to build a wood processing facility in the debtor country, finances reforestation efforts by local PVOs so that raw material supplies to its plants are more assured in the future. Conversely, local currency could be allocated by a local PVO to a corporation in exchange for promises to undertake specific conservation and/or research activities on forestlands owned by the company (Bramble 1987).

The U.S.-based PVOs that are concerned largely with conservation and sustainable development could play one-of several of roles in debt swapping. They could supply the funds for a debt exchange or serve as a facilitator for debt exchanges. The facilitator role could entail the identification of the groups in the debtor country that wish to carry out forest sector development using a debt exchange and the banks in the U.S. that would willingly participate.

The possibilities for using debt exchanges to finance forestry are many and varied. Whether profit-oriented or not, forestry and conservation efforts stand to be advanced through these swap mechanisms. The limiting factors are the willingness of commercial banks, debtor countries, MNCs, and the financial resources of interested PVOs. Forest sectors of developing countries need to identify vocal proponents in their own countries and in creditor countries who are willing and able to market their ideas to all parties concerned.

Although less than one percent of the foreign commercial debt of Third World countries has been actually sold or exchanged in secondary markets, there still remains a considerable amount of debt available for swapping (Cody 1988, Intrados Group 1989). Nonetheless, there is a limited time frame in which the best opportunities will be available. The secondary markets

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6 In the Massachusetts House, a bill is being considered that would require a company to address the carbon dioxide buildup issue, and support for tree planting in Third World countries may in fact help meet that requirement (Commonwealth of Massachusetts Congress, House, 1989).

are beginning to find the balance between supply and demand of exchangeable debt; consequently, the margin of leverage is narrowing. The sooner we in the forestry profession educate ourselves on debt-for-forestry opportunities, the greater the potential advantage to our industry and to conservation efforts in the Third World.

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Appendix: The Origin of Debt Swapping

Debt conversions that involve U.S. parties and Third World debtors have been around for over ten years. These transactions have encompassed loans to Third World governments by the U.S. government as well as by commercial lenders. Swaps have been used to refinance existing official debt and to finance profit-oriented and not-for-profit projects.

The first such swaps involved official debts of Third World governments to the U.S. government. Such swaps were permitted under an amendment to Public Law 83-480.

Public Law 83-480, (officially, the Agriculture Trade Development and Assistance Act), more popularly known as PL-480 and the Food For Peace program, was authorized in 1954 by the Eighty-third Congress. It was revised in 1966, under the 89th Congress, with Public Law-89-808. PL-480 was to serve two purposes: (1) allow the U.S. government to purchase part of the U.S. production of certain agricultural products (mainly wheat), and thereby maintain higher market prices for farmers; and, (2) allow for U.S. government grain sales and grain donations to selected Third World countries[7].

PL-480 contains several Titles. Title I is officially for food sales to developing countries. These sales can be paid back over the long-term. Title II is for food donations, done on a government-to-government basis, and supplying the World Food Program. Under this Title, Private Volunteer Organizations (PVOs) are contracted to distribute the U.S.-donated food to the "needy."

Title III was ratified and implemented in 1978[8]. One major feature of Title III is a mechanism called "Currency Use Offset," which is managed by the U.S. Agency for International Development (USAID). This mechanism allows a country that accepts U.S. commodities that are in the Food For Peace Program to sell those commodities domestically for local currency. The revenue from these sales goes into a special account. Money in the special account can then be used for so-called "self-help" measures, rather than be used to pay the U.S. for the

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7 Richard King, personal communication, Raleigh, NC, 12 April 1989.

8 Robert Heckman, personal communication by telephone, Raleigh, NC, to Washington, DC, 12 April 1989.

foodstuffs. These measures must be approved by the U.S. government. The special account can also be used to pay back old Title I debt and allow for refinancing of new debt, provided that the country is listed by the United Nations as a "Least Developed Country."

Few countries have been involved in Title III. Only Bolivia and Bangladesh are presently investing locally by using Title III local currencies. Egypt, Haiti, Honduras, Senegal, and the Sudan are the only other countries that have participated in this Title.

Some local funds from the special account have been used to invest in conservation. In Haiti, monies were used to fund a CARE-administered reforestation project. This program ended in 1987 due to domestic political problems in that country[9].

Title III has been operating in Bolivia since 1983, where up to 19 project categories are funded with that nation's US$10 million Title III local currency special account. One of the categories is natural resources conservation. Some of this money has been used to finance studies to investigate how government policies adversely affect the environment. LIDEMA, a local conservation organization (which participates in managing the Beni Reserve and buffer zone, as a result of the 1987 debt-for-nature agreement by Conservation International), has been granted some Title III money for its activities, as well. Also in the works is a $1 million reforestation program. For fiscal year 1989, however, there are about $500,000 budgeted for natural resources programs. Aside from the planned reforestation program, Title III-funded forestry sector development projects are few[10].

Within PL-480 there is another mechanism for funding development-oriented projects. That is through Section 206 of Title I, which allows for local investments by the government, en lieu of part of long-term grain sales repayment[11].

The first public suggestion that commercial debt, rather than Third World bilateral debt with the U.S.

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9 Joan Kotze, personal communication by telephone, Raleigh, NC, to Washington, DC, 12 April 1989.

10 Jorge Calvo, personal communication by telephone, Raleigh, NC, to La Paz, Bolivia, 12 April 1989.

11 Heckman, op cit.

government, be used to fund conservation in those debtor countries was in 1984 (Fuller and Williamson 1988). Thomas E. Lovejoy III, then executive vice president of the World Wildlife Fund, expressed the idea in a New York Times article (Lovejoy 1984). As of September, 1988, about $25 million of Third World debt had been arranged for conversion by private voluntary organizations for conservation and development in Bolivia, Costa Rica, Ecuador, and the Philippines (Cody 1988).

Could Title III set the stage for further U.S. government involvement in debt swapping, on a larger scale than presently exists? An indication that the answer to this question is "yes" is provided by two recent developments. First, new USAID guidelines promote and allow for USAID funding for not-for-profit conversions of Third World commercial bank debt swapping by PVOs. USAID will allow PVOs and other nonprofit organizations to submit proposals for development-oriented activities that could be funded through a debt swap. USAID agrees to pay the debt purchase price. Second, Treasury Secretary Nicholas F. Brady's Third World debt reduction proposal calls for increased use of both for-profit debt-equity and not-for-profit debt swapping mechanisms to help reduce Third World debt (U.S. Agency for International Development 1989, Silk 1989).

The slight reductions in Third World debt that have occurred through debt-equity and debt-for-nature type swaps have yet to make a significant dent in alleviating the crisis situation arising from debt problems that many countries presently face. The crisis has been made visible to the American public through media coverage of uprisings in Argentina, Venezuela, and other countries, which were fueled in part by austerity measures imposed as a result of these debts by multilateral lending institutions. It therefore may be only a matter of time before creditor country governments and multilateral lending institutions implement further creative solutions and seek a more significant alleviation of the debt problems facing the developing countries.

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