
**ENDOWMENTS, TRUSTS AND DEBT SWAPS IN THE
AGENCY FOR INTERNATIONAL DEVELOPMENT**

DISCUSSION PAPER

Anne Bodley
Agency Center for University Cooperation in Development
Bureau for Research and Development
United States Agency for International Development (U.S.A.I.D.)
December, 1993

Table of Contents

Acknowledgements	3
Acronyms and Abbreviations	4
Introduction	5
A Note on the Research Methodology	7
Endowments	8
Endowments in U.S.A.I.D.	9
Establishing the Endowment	10
Issues of Concern	13
Trusts	16
Conclusion	18
Debt Swaps	20
The Benefits of Debt-Swaps	21
Limitations to Debt-Swaps	24
Other Macroeconomic Issues	25
Endowments and Education: Experiences and Expertise	page
Appendix I: An Example of a Memorandum of Understanding	27
Appendix II: Endowments and Educational Development	35
Honduran Agricultural Research Foundation (FHIA), Honduras	35
Institute for Agricultural Strategies (IDEA), Ecuador	36
Pan-American Agricultural School (EAP), Honduras	37
Appendix III: The Debt-Swap Process	40
Appendix IV: Debt Schedules for Selected Nations	41
Footnotes	47

"Endowments, Trusts and Debt Swaps in the Agency for International Development" is the result of a research internship at the Agency Center for University Cooperation in Development and is intended to reflect the findings therein and the opinions of the author. It does not purport to represent the Agency's policies in all areas, or to represent the viewpoints of all Agency personnel. Please contact the appropriate bureaus and offices of U.S.A.I.D. for official policies and guidelines on working with these funding mechanisms.

Acknowledgements

Sincere appreciation is extended to the following people for their assistance in researching and drafting this paper.

*Ravi Aulakh, Bureau for Asia
Katherine Blakeslee, Bureau for Research and Development
Lark Carter, Center for University Cooperation in Development
Gary Hansen*, Center for Development Information Education
John Eriksson, Center for Development Information Education
William R. Miner, Center for University Cooperation in Development
Tony Pryor*, Bureau for Africa
Jack B. Ross*, Debt-for-Development Coalition
Gary Russell*, Bureau for Latin America and the Caribbean
Erhardt Rupperecht, Bureau for Latin America and the Caribbean
Robert Siegel, Office of Policy Analysis and Resources
W. Paul Weatherly, International Union for the Conservation of Nature
Gary Winter & Gail Lecce, Office of the General Counsel*

Special thanks to Gary Bittner without whom the paper would have been impossible.

**Denotes panelists at the September 30 presentation.*

Acronyms and Abbreviations

AFR	A.I.D. Bureau for Africa
ASIA	A.I.D. Bureau for Asia
CDIE	Center for Development Information Education
DA	Development Assistance Funds
DDC	The Debt-for-Development Coalition
ESF	Economic Support Funds
EUR	A.I.D. Bureau for Europe
FAA	The Foreign Assistance Act of 1961 as amended
FHIA	The Honduran Agricultural Research Foundation
GC	A.I.D. Office of the General Counsel
IUCN	International Union for the Conservation of Nature
LAC	A.I.D. Bureau for Latin America and the Caribbean
MOU	Memorandum of Understanding
MUCIA	Midwestern Universities Consortium for International Activities
NE	Bureau for the Near East
NGO	Non-Governmental Organization
NIS	Bureau for the Newly Independent States
POL	A.I.D. Office of Policy Analysis and Resources
PVO	Private and Voluntary Organization
R&D	A.I.D. Bureau for Research and Development
University Center or U.C.	Agency Center for University Cooperation in Development
U.S.A.I.D. or A.I.D.	United States Agency for International Development

Introduction

The purpose of this paper is several-fold: It has been written to explore and educate development assistance professionals about the nature and existence of endowments, trusts, and debt swaps; to trace their histories in the United States Agency for International Development ("U.S.A.I.D." or "A.I.D."); and to suggest uses of these funding arrangements for furthering the goals of international development agencies. As the idea for this paper was born out of the A.I.D. Center for University Cooperation in Development ("the University Center"), there is, in some cases, a bias towards the focus of this group.

The argument of the paper can be stated in relatively simple terms: endowments, trusts, and debt swaps, either singly or in conjunction with each other, can provide strong means for promoting the work of international development agencies. Further, with foresight and skill, they can provide a more stable and more independent means of promoting development than can more traditional means of financing, such as direct annual grants. Not only can these mechanisms be more effective, then, but their nature may better support the intentions of the international development agencies. For example, section 102 (b) (1) of the Foreign Assistance Act states that:

"Development is primarily the responsibility of the people of the developing countries themselves. Assistance from the United States shall be used in support of, rather than substitution for, the self-help efforts that are essential to successful development programs and shall be concentrated in those countries that take positive steps to help themselves."¹

As endowments, trusts, and, sometimes, debt swaps may provide more independent means of financing development projects, they can be used to "train" professionals in developing countries in the uses of the international financial markets, of program administration, of decision-making, and of means to develop and sustain their country's potential. With the establishment of endowments, trusts, and debt-swaps, the level of U.S.A.I.D. administration required by other financing methods can often be reduced. In addition, the use of endowments, trusts, and debt-swaps may increase the role of non governmental organizations (NGOs) and private and voluntary organizations (PVOs) in international development.

Thus, this paper will address the nature, uses and potential of these three funding arrangements and discuss how they may be beneficial to international development. The first section examines endowments, discussing how they are established and areas of particular concern; the second section looks at debt swaps and some of the

macroeconomic benefits (and drawbacks) to putting these in place. Finally, the appendices offer a sample Memorandum of Understanding from a functioning endowment, case studies of educational institutions where endowments have played a significant role, and some illustrations concerning the process of establishing debt-swaps.

A Note on the Research Methodology

The idea for this paper originally came from A.I.D.'s Center for University Cooperation in Development out of the interests of the staff for more effectively sustaining development initiatives. Gaining approval, the University Center hired a research intern to review the available literature and to conduct interviews with U.S.A.I.D. personnel with the aim of developing a study on the topic.

Anne Bodley was selected as a research intern through the Midwestern Universities Consortium on International Activities (MUCIA) and was hired to conduct this project over the summer of 1993. The process, resulting in a preliminary draft, consisted of an extensive literature review in U.S.A.I.D. library materials and a wide range of interviews with U.S.A.I.D. personnel in all bureaus, the policy and general counsel bureaus, administration, research and development, and the Center for Development Information Education (CDIE). During the summer, over 300 e-mail requests for information were sent out and responses were logged for information. The preliminary draft was a hard-won battle, reflecting the views and experiences of a large section of personnel familiar with the instruments.

To further the Agency's interest in and knowledge of these instruments, and Agency-wide panel was presented at the end of September 1993, inviting key personnel from the Agency to discuss their different perspectives on their use and application. Over 55 professionals attended the panel and requests for the paper numbered over 100. These requests, still coming in three months after the panel discussion, are an indication of the high level of interest in the topic and the importance of making information available about endowments, trusts, and debt swaps as instruments of sustaining international development initiatives.

The paper addresses some of the fundamental issues involved in the establishment of endowments, trusts, and debt swaps. Its ultimate purpose is to accurately and comprehensively educate international development professionals about the uses (and abuses) of these instruments, to demonstrate how they may be used effectively for the promotion of sustainable international development and what the (many) risks are in establishing them. Comments are welcome and may be sent to Anne Bodley, c/o Gary W. Bittner, Agency Center for University Cooperation in Development, United States Agency for International Development, Room 900 SA-38, Washington DC 20523.

Endowments

In its broadest sense, an endowment is a type of perpetual fund in which a capital base is invested to yield interest. Typically, the corpus of the endowment is invested at high interest (at least a couple of points above inflation) and the interest earnings provide financial support for the benefactor or program. Endowments can take many forms, however, including a capital base managed by the fund's beneficiary; a trust managed by independent trustees; or a separate operating entity, such as an endowed foundation like the Ford Foundation. In the latter example, investment advisers manage the endowment under the supervision of trustees or directors of the organization.²

Endowments may be used for a number of purposes, including the support of a single beneficiary, be that an individual or an organization, or for the support of a program or other goal, in which a number of individuals or organizations receive monies from the endowment to achieve part of the goal. In this paper, the focus is on employing endowment monies toward sustaining international development activities, directly or indirectly carried out by U.S.A.I.D.

Although the utilization of endowments has been slow at A.I.D., there are obvious implications for international development. Perhaps the most beneficial aspect of endowments is that the structure of an interest-generating perpetual investment can provide more stability than is typical in funding development projects. International development groups are generally funded through campaigns and private donations, or through annual grants from agencies such as A.I.D., itself dependent on the appropriations of the United States Congress. Although there are merits to these arrangements also, the disadvantage in these sources of funding is that they can fluctuate significantly, thus making long-range planning very difficult for the organization dependent on the funding. This can hamper not only development assistance projects themselves (often more successful with long-range planning), but staffing concerns, accommodations, equipment, and other aspects important to the stability of a successful organization.

A second important factor in the establishment of endowments is that they can be far more "hands-off" than grants or other funding mechanisms. This aspect can be very attractive to Missions and the Agency itself as they can require far less direct management while still providing strong support to the international development projects the Mission and Agency wish to promote. It is fundamental to realize that this is because endowments are essentially assets that are donated to another party to perpetuate a specific activity. In more legal terms, establishing an endowment usually requires a transfer of title over a group of assets (such as a fund). A possible

disadvantage, of course, is that this transfer of title relinquishes direct control over the monies and leaves its direction largely to the discretion of the second party.

While the benefits of establishing an endowment can be great, it should also be emphasized that it involves risks and is not an appropriate mechanism for every development project or every development organization. Establishing an endowment requires careful planning and execution, clear communication between donor and recipient, a strong understanding of host country laws and regulations on investing funds, and consistent follow-up in maintaining the fund. Two factors help this process significantly: experience in managing investments and strong advisory expertise in both countries.

Endowments in U.S.A.I.D.

Endowments, that is *dollar-funded* endowments, have not typically played a great role in U.S.A.I.D. It can be speculated that the reasons behind this included the complexity of establishing fully-operational endowments, a general lack of expertise in the area, and certain legislative restraints to using U.S. currency. Until recently, prevailing legal interpretations prohibited the establishment of dollar-funded endowments by A.I.D. due to the fact that U.S. dollars appropriated for development assistance by Congress could not generate sufficient interest unless there was specific Congressional approval. The earliest endowments, therefore, established in the late 1970s and early 1980s, were funded in local currency generated through Economic Support Funds and from the sale of Title I and II food aid programs (Public Law 480).³

Interest in dollar-funded endowments began to grow when, in 1990, Congress granted approval for their establishment in some specific cases. Congress allowed for endowments funded by the proceeds from debt-equity and debt-for-nature swaps. This resulted in instances where dollars generated by these transactions have been channeled to developing country organizations through U.S. non profit NGOs and PVOs, or where bilateral assistance programs were replaced in certain countries.

In 1993, the Foreign Aid Appropriations Act⁴ specifically allowed placement of development assistance funds in interest-bearing accounts that could be used, among other things, as endowments. This provision has also been incorporated in the 1994 Foreign Aid Appropriations Act.

Thus, the bulk of A.I.D.'s experience in endowments to date has been in establishing and managing *local currency* endowments: endowments established using non U.S. currency and maintained in local (non-U.S.) banks. This involved a lesser risk for

U.S. dollars and yet was still able to contribute to U.S. goals toward international development. Some of these early A.I.D. endowments took the form of trust agreements, whereby local currency endowments were established in the country and A.I.D. personnel managed the funds and directed it toward achieving development purposes. These entities supported foundations that replaced direct A.I.D. programs in countries such as India, Israel, Portugal, and the former Yugoslavia.⁵

In the middle and late 1980s, A.I.D. established a series of local currency endowments for eight indigenous NGOs in Costa Rica, the Dominican Republic, Honduras, and Ecuador. These endowments did not require Congressional authorization, and were established to support specific institutional strengthening objectives. In most instances, the organizations were involved in agricultural-related research or education. This was due in large part to the fact that, typically, A.I.D. local currencies were managed by the U.S.A.I.D. missions' agricultural offices.⁶

These endowments ranged in size from \$400,000 (IDEA in Ecuador) to \$60 million (EARTH in Costa Rica). In most cases the endowment funds were invested, at least initially, in government securities. In some instances, such as EARTH and FUNDAGRO in Ecuador, significant portions of the original endowment funding were converted into dollar-dominated securities. This has been critical to the maintenance of the endowments' principal and earnings. When conversion has been impossible, such as for the Honduran Agricultural Research Foundation (FHIA) and the Agricultural School at Zamorano, currency devaluation and inflation eroded the value of the endowment assets.⁷

Establishing the Endowment

The establishment of an endowment involves a lengthy and careful multilateral negotiation process. The purpose of the endowment must be clearly established, and include indicators for evaluating the success of the investment and a clear time-frame in which the goals are expected to be achieved. The negotiation typically involves an organ of A.I.D., such as a country mission or bureau, representatives of the recipient institution or NGO, and representatives of the host government. Representatives from each party should be carefully selected: they should have the appropriate authority to initiate endowment agreements, and should preferably have experience in this area. In addition, it is recommended that there be strong advisory counsels⁸ involved at every stage of the negotiations. The agreement itself should focus on the amount of the endowment and the terms of its payment and repayment, requirements for investment, including an acceptable rate of interest and payment schedule, and sufficient assurances that the economic standing of the host country will allow the agreement to endure.

Although the conditions for each endowment will differ, it is suggested that the following points be thoroughly addressed in coming to an agreement:

- Is there satisfactory evidence that the endowment mechanism is the most effective and efficient means of achieving the particular outcomes sought? Would it be simpler to obtain grant monies for the same purposes?
- Does the proposed project duplicate or displace any development project already in place, or is it complimentary? Do elements of it duplicate or displace other projects or parts of other projects? What is already being done in this area?
- Are the legal, financial and regulatory environments of the host country compatible with the purposes of the endowment? Will the environment of the host country enable the endowment to flourish and for its earnings to effectively work toward the proposed development goal? Are there factors which may hamper this process (inflation, government corruption, lack of interest in the proposed project, logistic and technical difficulties in achieving the goal of the project)?
- What time frame is reasonable for achieving the proposed goal (and what extensions of this time-frame are possible if unforeseen difficulties arise)? What is the estimated cost for achieving this goal in this time frame? Is this a reasonable estimate? What other sources of funding may be found or leveraged in the event that the monies prove insufficient to achieve the goal?
- Is the endowment investment plan well thought-out and carefully considered? How will the corpus of the investment be protected against inflation and political instability in the area? What interest rate will it be earning over what period of time, and will the real value (purchasing power) of these earnings be sufficient even several years in the future?
- How much of the endowment can be drawn upon over what period of time? Is there a restriction that only the interest be spent for the purposes of the development project? What mechanisms are in place for expanding the endowment base?
- How stable is the recipient institution or NGO? Has the organization successfully dealt with large sums of money under their care in the past? How sound is the organization's reputation for development work in this area, and for how long have they been in it? Have there been any recent changes in leadership

or basic organizational policy?

- What kind of oversight will there be over the funds in terms of a representative board of directors or governors, experienced in the management of development funds and familiar with the ways of the particular country? Is there provision for annual audits or other oversight mechanism, conducted by an external, impartial firm, as a means to monitor the activities of the institution entrusted with the endowment fund?
- What other forms of funding are in place to support the development activity or institution? (Endowment income typically provides only a portion of an institution's earnings. Thus, successful endowment funding presupposes a well-developed capacity for fiscal planning, the leveraging of resources, and management on the part of the institution to be endowed.)
- What measurements are in place for evaluating the successful application of the funds and successful management of the endowment? What courses of action are available if the endowment is deemed to have been mismanaged or the program unsuccessful due to poor performance?
- How will the endowment fund be dissolved and to whom will the remaining funds (if any) revert? What mechanisms are there for early dissolution and who controls this?

Although the conditions for establishing an endowment will differ from case to case, it is very important to ensure that all parties involved understand and agree to (in writing) as many of the terms of the endowment as it is possible to foresee.

In most instances, the agreement is drawn up in a Memorandum of Understanding (MOU) between the negotiating parties. The MOU is a legal document to which the signatories are legally bound. An MOU is chosen as the legal instrument instead of a project grant agreement as it applies to the life of the endowment, whereas the latter expires at the end of the project.⁹ As the primary legal document in the establishment of an endowment, the MOU should be rigorous in its consideration of the conditions under which the agreement should be made. The MOU should faithfully record the agreement between all parties to the terms of the endowment investment, including an understanding of each of the provisions listed above. A copy of an MOU is included as an appendix at the end of this paper.

Issues of Concern

Although A.I.D.s experience with endowments is scanty, certain issues suggest pitfalls to be aware of. These concerns center on issues of institutional displacement, performance, financial management and accountability, and the suggestion that those entrusted with the endowment management be representative in some form.

A primary area of concern is that of "institutional displacement," whereby the establishment of an endowed NGO provides a mechanism for the host government to either avoid undertaking the development initiative itself, or to avoid focusing on its own internal governmental problems that hinder its ability to undertake such projects. Establishing an endowed entity charged with a specific project may "displace" work that should be undertaken and overseen by the host government itself. Furthermore, endowed institutions may be ineffective in the long-run if their establishment alienates bureaucratic structures in the host government (perhaps formerly charged with overseeing the particular area targeted by the NGO) which then dismantle the NGO after the donor project is terminated, or otherwise allow conditions to return to the same state they were in before the project was initiated. The risk exists, too, that a government will invite and support the establishment of an endowed organization simply as a means of gaining foreign aid, and may, moreover, attempt to gain control of the monies in the endowment for purposes other than those of development.¹⁰

The strongest mechanism for avoiding this trap is the MOU. It should be well-established, primarily, that the development assistance is merited in this particular area and that its advancement will be more-or-less unfettered by governmental interference. A thorough understanding of the country's governmental, judicial, and legislative functions is important in designing the MOU, recognizing bureaucratic weaknesses that may affect the functioning of the endowment, the endowed organization, or the development activity. However, an imperfect governmental structure should not prevent an endowment being established: only a governmental or other structure that appears to seriously jeopardize the interests or the functioning of the endowment. The MOU should reflect these considerations and include mechanisms for avoiding them. Specifically, the MOU should be clear as to who controls the endowment monies at all times and to where the funds revert if and when the endowment or the activity dissolves.

Organizational performance is a second area of concern.¹¹ Mechanisms need to be in place whereby A.I.D. can monitor the performance of the endowed organization and can take action in the event that this performance is unsatisfactory. Again, preliminary research (knowledge about the NGO or institution to be endowed including its past history managing funds, its size and the nature of its activities, its experience in

achieving development projects successfully) is important to establishing the endowment, and again, the MOU may be an effective tool to monitoring the organization's activities. The MOU can, for example, stipulate conditions under which the endowment monies must be returned to A.I.D. and the project itself dissolved.

But there are other suggestions, too, for controlling organizational performance. Responding to the question, "does a secure financial base undermine organizational efficiency and effectiveness?," one author suggests that it is "better to have an organization that always remains a little hungry, forcing it to secure some of its resources the old-fashioned way, by earning it in the marketplace," than to set it up with a rich endowment that provides for its every wish and whim. It is rare to find an endowment that entirely funds a development project, anyway, and not unusual to find stipulations that the organization come up with "matching grants" or other fund-raising means to round-out the corners of the development project. This stipulation can not only help to avoid the above predicament, but can be an asset to the organization, requiring that it hone its marketing skills, that it develop its interactive skills and contacts with other funding sources, and, of course, that it trim bureaucratic excesses and focus on the development project in hand.¹²

Perhaps one of the greatest dangers to an endowment is that of devaluation or other financial troubles. The vast majority of developing nations, which is typically where development projects are targeted, pose a serious risk of endowment devaluation due to rapid inflation, currency devaluations, or sweeping and unexpected changes in government policies. The stewardship of an endowment in such troubled waters can be particularly challenging, and thus it is advisable that the endowed organization be familiar with the management of large (and international) funds. Then of course, it is also advisable to be aware of the possibility that economic instability in developing nations may be used as a screen to disguise the mismanagement or misappropriation of funds.

A.I.D. has traditionally sought to cope with these possibilities by insisting on a range of protective measures, including annual audits by a reputable and independent accounting firm, selected competitively with A.I.D. as a voting member in the selection process, and the selection of custodian bank and investment firm, again selected competitively with A.I.D. input. As dollar endowments become more widely used in A.I.D. assistance projects, guidelines are likely to be more restrictive; for example, the investment of dollar endowments will most likely have to be in reputable U.S. banks located in the United States. The MOU is again the appropriate vehicle for establishing these measures and ensuring that they are understood and agreed upon by all parties.

Lastly, it is hopefully a long-term goal of any development initiative is that the

changes initiated by it will be lasting and, in some way, self-regenerating. In other terms, it is not the purpose of A.I.D. to mould itself into becoming a perpetual crutch for particular countries or areas, which implies that an important part of the development assistance is the aspect of *teaching* the means to self-sufficiency.

Perhaps the best way of achieving this goal is to build the community right into the development project from the beginning. Although this can be done simply by providing lessons or writings that enumerate how to achieve the same process, it is probably more effective, and builds greater trust between community (be that host government or local community) and NGO, if the community is directly involved in the decision-making and allocation of resources toward achieving the goal. Of course, this presupposes that the community agrees on the goal and the methods to achieving it. The argument to counter this is that, if the community *fundamentally* does not agree with the goal or its methods, it is unlikely to be successful in the long-run anyway. Agreeing on the project goals and the methods for implementing it are therefore intrinsically important to its ultimate success.

In establishing an endowment or an endowed NGO, the possibility may exist for setting up a board of directors or trustees with powers of oversight over the funds. This board may be strengthened by having a representative and diversified nature; by lessening the number of "outsiders" to the board, this quality may also make it more impervious to "outside" (for example, governmental) attack. For example, if the board of directors has only non-governmental persons, then the government of the country may legitimately ask for a thorough case-by-case account of endowment operations. On the other hand, if the government is guaranteed a permanent voting presence on the endowment's board, the requirement for detailed audits may be seen as unnecessary. The caution, of course, is that such a marriage requires careful diplomacy in the securing of each parties' interests. The NGO, for example, must be careful that their development work is able to continue without interference; the government must ensure (and with a board seat is better able to) that the NGO carries out only development work approved by the government. The guiding factor in selecting the board is that it should be balanced in such a way as to prevent either great disagreement (and therefore gridlock) or great uniformity (in which case all options may not be explored for the advancement of either the fund or the development project).

The Puerto Rico Community Foundation is one example of the strengths that may be found in a carefully put-together representative board. The aim in the establishment of this board was that it represent the *society* (not the institutions) of Puerto Rico. To achieve this, board members were sought and solicited in an extensive and thorough process of asking at all levels of society for the names of two or three people highly

regarded for their intelligence and integrity; those whose names appeared numerous times were contacted while those whose names appeared only once or twice in the process were eliminated. Eventually, after several months of interviewing, a board was established and charged with providing leadership in Puerto Rican social development.

The Board's greatest success occurred in the early 1980s when the AIDS epidemic broke out in Puerto Rico. The Board, representative of many different parts of the society, was able to quickly respond to the crisis with public education programs (the first in a Latin American country), and social programs, going to gay bars and other places to provide counseling, medications, shelter, and support. The Board's success stood in marked contrast to the efforts of either the Government (who, for political reasons did not recognize certain groups in its society) or the Catholic Church (who did not condone various behaviors involved in the outbreak of the epidemic). Because the membership of the Board spanned many sectors of society, including the Government and the Church, but was not limited to its own interests as these groups were, it was able to intervene quickly and ameliorate the situation in Puerto Rico.¹³

Some suggestions exist regarding board selection, including that it be "representative," "self-perpetuating," and "restricted."¹⁴ Endowment charters (or the MOU) should specify boards whose members: (a) represent different interest groups or organizations (that they be "representative"); (b) select their own replacements (that they be "self-perpetuating"); and (c) occupy seats with different and restricted qualifications (that they be "restricted"). The board can benefit greatly from multiple perspectives in terms of experience, for example by involving a variety of NGOs, private sector representatives, and, of course, governmental representatives. Once again, the key to establishing such mechanisms lies in the careful drafting of the MOU, clearly stipulating requirements for the governance of the endowment monies, and retaining sufficient control over the outcome that changes can be made in time if it appears necessary.

Trusts

Trust funds are essentially an asset (be that in terms of funds, property, or other value) that are held "in trust" by another party. A Trustee (or Board of Trustees) is given legal title to administer property for another party. A trust may be set up in conjunction with an endowment (or, as later discussed, a debt swap) whereby the endowment may be invested and disbursed by the trustees in accordance with the wishes and directions of the owner, who retains title to the asset and, therefore, ultimate responsibility over its application. At his/her own discretion, the owner appoints and may revoke appointments related to the governance of the trust.

In A.I.D. a trust fund has typically referred to host country owned local currency that is deposited by the host country in a trust account and is used for developmental activities jointly agreed upon by the host country and A.I.D. This action is often considered to be one possibility for dollar assistance provided by A.I.D. to the host country. The bulk of A.I.D.'s involvement with trusts for international development appears to have been in this form. However, some "trust funds" have been used for the operating expenses of the A.I.D. mission; a purpose perhaps only indirectly linked with international development initiatives.

While retaining greater control over development funds may make trusts attractive to some, they have their own difficulties and may, in many cases, *not* be a legally possible alternative. This is primarily because of the laws of appropriated funding. Appropriated funding is granted by Congress on the proviso that it be *obligated* within a specified period of time (usually one year) to a specific project or activity. As legal title is generally retained in trust funds, in many cases the establishment of a trust does not constitute "obligating" funds. Congress is not authorized to continue granting monies for a project or activity until the previous allotments are properly obligated or until other arrangements are made to provide for its return or obligation. Nonetheless, although this is true in many cases, there have been examples where trust funds have been established by the Agency with appropriated dollars by obligating the funds under an agreement with the trustee.

A second possible concern with trusts is that they can involve greater administrative costs than (for example) an endowment or a grant agreement. In addition to possible legal fees involved in drawing up the trust agreement, the trustees are often entitled to a fee or an honorarium for their services in managing the fund. For example, in the case of the Agricultural Venture Trust established by A.I.D. in 1986 in the Barbados, the trust schedule made provisions for:

I. Honorarium to Trustees

The Trust may provide honoraria to Trustees as follows: The Chairman of the Trustees US\$3,000 per calendar year; the Executive Representative of the Trustees US\$3,000 per calendar year; other Trustees US\$2,000 per calendar year. In the event that any Trustee attends more than four meetings of the Trustees in any calendar year, then he or she may be provided with an honoraria of US\$250 for each such meeting attended in excess of four in any calendar year. Finally, the Trustees may be reimbursed for the direct travel cost and per diem expenses incurred to attend meetings of Trustees, provided that such reimbursement shall not exceed that allowed for U.S. direct-hire USAID personnel.¹⁵

However, these expenses and allowances should be negotiated in the course of the establishment of the Trust and clearly agreed to in writing. Fees and allowances need not be excessive.

Establishing a board of Trustees should follow similar guidelines to establishing a trust, with consideration to the reputation and experience (and representative qualities) of the board or trustee selected; the purpose, time-table, and investment policies should be clearly established in writing in the agreement and there should be a clear path for dissolving the trust arrangement if this is later deemed necessary; provisions should be made for the possible re-couping of funds in the event that they are mismanaged, and in an effort to prevent their mismanagement, regular audits or other checks should be maintained; minutes should be kept of all board meetings and accurate records of all investments and their terms of investment. In this way it is possible to ensure that the trust monies are used for the correct purposes in the best possible way.

Thus, in some situations a trust arrangement may be preferable to an endowment or other structure in that it enables a tighter control over the funds by virtue of the retention of legal title. This may be preferable in committing U.S. funds to an area or an organization where the risks are significant and this retention is merited. Furthermore, based on the argument in this paper that endowments may better support the intentions of the Foreign Assistance Act (which declares development to be the responsibility of each country for itself), trusts may also support this intent. The establishment of a trust (using U.S. currency and held in trust by an organization in the host country) can provide a similar level of "training" and "experience" in managing international funds, but there is potentially a lesser risk in a trust as greater legal control is retained. Overall the benefits are probably proportional: an endowment, fully managed and operated by the recipient organization may be a stronger tool for increasing an understanding of its uses and investment possibilities, but a trust may provide more security for the Agency because of the retention of title and therefore control.

Conclusion

A brief conclusion would suggest that endowments and trusts can be powerful mechanisms for achieving development aims, but that they are by no means simple to manage or unequivocally beneficial in all areas. In many cases, neither one may be an appropriate tool for the goals envisioned. This can be due to any number of factors, including economic or political instability in the host country, weaknesses or inexperience in the NGO, or lack of foresight in funding a development goal that is achievable and is desired by the community or government. However, in areas where these aspects are not problematic, where the host government is supportive and committed to the

establishment of an endowment and in favor of the development work proposed, where inflation and other economic problems can be controlled, and where a perpetual fund such as an endowment promises to support the initiatives as direct grants cannot, endowments may even support the provisions of the Foreign Assistance Act better than other methods as they enable developing countries manage their own development assistance initiatives.

Debt Swaps

A debt swap is a mechanism by which a third party, usually an NGO, enters the secondary financial market to purchase a developing country's hard currency debt and, subsequently, exchanges 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. A diagram of the debt-swapping process is included as Appendix III.¹⁶

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 address development issues as well as financial aspects of the debt conversion.¹⁷

From the precedent set by Conservacion Internacional, NGOs have worked out variations on a negotiation process that basically comprises five steps:

First, 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.

Second, 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 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).

Third, the creditor bank transfers the debt title to the NGO.

Fourth, 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.

Finally, the NGO establishes a local currency fund to implement the conservation or other development project.¹⁸

It should be noted that the debt swapping process can involve the establishment of an endowment, in either local or hard currency monies, for the ongoing support of the development project. Moreover, it should be stressed that, as with endowments and trusts, the successful establishment of debt swaps requires considerable foresight and management. Strong legal and financial counsel is recommended at all stages of the negotiation.

The Benefits of Debt-Swaps

"Well-structured debt-swap programs involving nonprofit organizations should provide financial benefits for all parties to the transactions," asserts one author.¹⁷ "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. [...] 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."¹⁹

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 negligible.

Debt swaps are also favorable to the other parties, including the commercial bank and the NGO. For the bank, the debt conversion process allows it to recover a portion of what is calculated to have been an uncollectible debt-- a bad loan. U.S. banks can also claim a tax benefit for their donations or losses.²⁰ For the NGO a debt swap may yield a 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 up front to pay for a project with high 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 importantly, through the debt-swapping process, NGOs can negotiate directly with the debtor government on project-specific issues. In some cases this may lead to additional concessions and funding.

There are also important non-monetary benefits to 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."²¹

The U.S. Government encourages debt-for-development transactions as a means for reducing the debt burden of developing countries and for increasing the resources available for development," states the Debt-for-Development Coalition.²² The Treasury Department supports the inclusion of debt-for-development swaps under the Brady plan

debt restructurings. Legislation under the Enterprise for the Americas Initiative would authorize government agencies to sell to participants in debt-for-development swaps the loans the agencies have made to developing countries. NGO-initiated debt swaps are encouraged in the Fiscal Year 1990 amendment to the Foreign Assistance Act and the 1989 International Development and Finance Act. These Congressional mandates: (1) allow PVOs and other NGOs to establish, and retain interest from endowments with local currency generated from A.I.D.-financed debt-for-nature and other debt-for-development swaps; and (2) provide specific authority for A.I.D. to finance debt-for-nature swaps through grants to NGOs to purchase discounted commercial debt. Subsequently, A.I.D. has developed a Debt-for-Development Initiative and has issued guidelines and encouragement to the missions to support debt swaps.

Furthermore, Section 567 of Public Law supports debt-for-development swaps by stating:

"Debt-for-Development. Sec. 567 In order to enhance the continued participation of nongovernmental organizations in economic assistance activities under the Foreign Assistance Act of 1961, including endowments, debt-for-development and debt-for-nature exchanges, a nongovernmental organization which is a grantee or contractor of the Agency for International Development may place in interest bearing accounts funds made available under this Act or prior Acts or local currencies which accrue to that organization as a result of economic assistance provided under the heading "Agency for International Development" and any interest earned on such investment may be for the purpose for which the assistance was provided to that organization."²³

The Foreign Assistance Act is explicit in its authorization of debt swaps; a result of the growing interest in A.I.D. and conservation-oriented NGOs in debt-for-nature swaps particularly. These NGOs have developed this financing technique as a kind of banker's "appropriate technology." After several years of debt-for-nature swaps, experience has shown some of their limitations. NGOs active in programming these swaps have sought ways to overcome these limitations which include, for example, the swap's leverage, which can multiply the exchange rate several fold. Leveraging funds can, however, create a problem of how to match the sudden availability of a large amount of money with well designed, ready to implement, projects. As a result NGOs are sometimes forced to keep the local currency proceeds of a swap in a local bank until they have effective ways to spend the money.²⁴

Limitations to Debt Swaps

It would be remiss, however, to discuss debt swaps without mentioning some of their limitations. First, not all countries with external debt are suitable for debt swap programs. 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.²⁵

Second, 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, few countries have formal debt conversion programs, and these are so new (introduced during the past five years or so) that there is much trial and error in implementing debt conversion programs. Additionally, there are sufficient differences among the programs that can be confusing.

Third, the debt conversion process will not be successful if a good rate of exchange cannot be agreed upon or if the government and the NGO cannot agree on the development projects to be undertaken. Debt swaps are a sophisticated multi-party agreement that require skill and knowledge to successfully complete.

It must be stressed, too, that the above-mentioned benefits arise from *well designed* and *well coordinated* debt swaps. The process of working out a transaction acceptable to all 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. Many NGOs are neither able to afford such up front expenses, and, it must be stated, many NGOs lack adequate resources to function

effectively as intermediaries in debt swaps.²⁶

Lastly, although proponents of the debt conversion process assert that it stimulates increased investments in productive activities, thereby generating more employment, income, goods, and services, the extent to which debt swaps actually generate additional investment is often negligible.

Other Macroeconomic Issues

Although debt conversions help reduce the external debt of debtor countries, they are not cost free to the debtor countries and can engender unintended macroeconomic effects. There is a divergence of views concerning these processes, centering around four issues: subsidies, additionality, increasing domestic debt and inflation.

The first question in the debate is whether or not the debtor government is efficiently allocating its resources by buying back its external debt at a price significantly higher than the secondary market rate, thereby subsidizing those who redeem its debt for cash payments, bonds, or other local assets. 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. In particular, the subsidies might help in highly indebted countries where little or not new foreign investments have been made. Proponents further 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).²⁷

Conversely, skeptics argue 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 up front 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. Disagreement 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 and justify the subsidy borne by the government. However, if the investments are not additional (i.e. they would have occurred anyway), then the government provided a subsidy that was clearly unnecessary. This has two immediate repercussions for the government. 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.²⁸

The other main issue for economists centers around 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 up front 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."²⁹

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 large amounts of debt made through up front 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.³⁰

Chew summarizes that "[t]hese 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."³¹ Furthermore, 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).

**Appendix I:
An Example of a Memorandum of Understanding**

The following is the text of a MOU established between the Government of the Republic of Honduras, U.S.A.I.D., and the Escuela Agricola Pan-Americana, Incorporated ("Zamorano"), established 17 November, 1988³² in Tegucigalpa, Honduras. The Spanish text, included in the original MOU, is not included.

This Memorandum of Understanding is entered into this 17th day of November, 1988, by the Government of the Republic of Honduras (the "Government"), the United States Agency for International Development ("A.I.D."), and the Escuela Agricola Pan-Americana, Inc. ("EAP"), a U.S. non-profit corporation organized under the laws of the State of Delaware and authorized to operate an agricultural training school and related facilities in Honduras by virtue of Legislative Decree No. 47 (1949), as subsequently amended from time to time.

The purpose of this Memorandum of Understanding is to describe and establish an educational endowment (referred to as the "EAP Honduran Endowment") to be administered by the Board of Trustees of EAP. References in this Memorandum of Understanding to "EAP" are meant to include the Board of Trustees of EAP unless the context clearly indicates otherwise. The objectives, terms, and conditions set forth in this document are derived from information contained in the document, "A Proposal for Endowment Assistance" submitted by EAP to the Government and A.I.D. ("Proposal"). The contents of

this Memorandum will control in the event that conflicts arise between it and the Proposal for Endowment Assistance.

ARTICLE I

Objectives

The objectives of this Memorandum of Understanding are:

- (a) To provide a permanent source of funding to enable worthy low income Hondurans to take advantage of the educational opportunities available at EAP;
- (b) To provide an assured source of funding for programs by EAP which can have direct positive impact on water availability and the management of forests and other natural resources and agricultural potential of Honduras;
- (c) To assist and encourage EAP in its program of long-term capitalization.

The foregoing objectives shall be accomplished through financial means which are consistent with the Government's Economic Stabilization and Recovery Program.

ARTICLE II

Establishment of the EAP Honduran Endowment

Section 2.1 Establishment and Management of the EAP Honduran Endowment in accordance with Honduran Law.

The EAP Honduran Endowment is hereby established for the purposes set forth in this Memorandum of Understanding. This Memorandum and the management of the EAP Honduran Endowment shall be governed by the Agriculture Decree No. 47 of 1949 cited above. At the same time, it is recognized that EAP is qualified as a tax-exempt organization under Section 501 (c) (3) and related provisions of the Internal Revenue Code of the United States. Accordingly, EAP also shall manage the EAP Honduran Endowment consistently with the tax-exempt status of the EAP under the laws of the United States.

Section 2.2 Capitalization of the EAP Honduran Endowment

(a) The EAP Honduran Endowment will be capitalized by a conditional grant by the Government of Honduras to EAP. The first installment of funds for the EAP Honduran Endowment will be taken from a Special Account in the Central Bank of Honduras which is used for deposits of Lempiras in conjunction with the Economic Stabilization and

Recovery Program of the Government.

(b) The Government will make a total contribution of Thirty Million Lempiras (L30,000,000) in three equal installments to the EAP Honduran Endowment. The first installment of Ten Million Lempiras (L10,000,000) shall be made to EAP following its fulfillment of Conditions contained in Section 3.1. of this Agreement. Future installments shall be subject to the availability of funds to the Government and the agreement of the Parities, at the time of subsequent installments, to proceed. If the Government does not have funds available for the second and third installments after EAP has complied with the Conditions Precedent to such installments, the Government shall make such funds available as soon as possible thereafter.

(c) The grant to EAP of funds for the EAP Honduran Endowment will be irrevocable and non-reimbursable, subject only to the conditions contained in this Memorandum.

Section 2.3 Appointment of Trustee and Management of EAP Honduran Endowment.

The EAP Honduran Endowment will be managed by the Board of Trustees of EAP which shall have a fiduciary responsibility for the management of the EAP Honduran Endowment. The Board of Trustees shall ensure that the capital of the EAP Honduran Endowment is

maintained intact and invested in accordance with the following norms:

(a) The EAP Honduran Endowment capital provided through conditional grants from the Government shall be invested only in bonds of the Government of Honduras and its agencies issued by the Central Bank of Honduras, or in such other investments as the Government and EAP may agree in writing.

(b) EAP will be entitled to use the income from the investment of the EAP Honduran Endowment capital for the purposes set forth herein, but EAP may not use the capital, except for purposes of further reinvestment.

ARTICLE III

Conditions Precedent to Disbursements by the Government

Section 3.1. Conditions Precedent to First Installment

Prior to the disbursement of the first installment of Ten Million Lempiras (L10,000,000) to the EAP Honduran Endowment, EAP shall, except as the Government may otherwise agree in writing, furnish the following in form and substance satisfactory to the Government:

(a) A formal resolution by the Board of Trustees to EAP which accepts their responsibilities as trustees for the EAP

Honduran Endowment.

(b) Evidence that agreement has been reached between EAP and a private bank or other depository institution to hold the EAP Honduran Endowment's portfolio of investments and to receive Endowment income and disburse such income to EAP in accordance with this Memorandum of Understanding.

(c) Evidence that EAP has delivered investment instructions to the depository institution for the investment of the first installment of funds and for the investment of subsequent disbursements installments as may be effected by the Memorandum of Understanding. Such instructions shall have been previously approved by the Government.

(d) Evidence that the EAP has developed and placed in operation an accounting system adequate to track the receipt and disbursement of resources including capital contribution and interest income, savings and disbursements granted under this Memorandum.

Section 3.2. Conditions Precedent to Second Installment and Use of Income on First Installment

Prior to the disbursement of the second installment of Ten Million Lempiras (L10,000,000) or the use by EAP of the income earned on the first installment, EAP shall, except as the Government may otherwise agree in writing, furnish

the following, in form and substance satisfactory to the Government:

(a) Evidence that since September 17, 1987, EAP has obtained financial support totaling Two Million Five Hundred Thousand Lempiras (L2,500,000) from sources other than the U.S. Government. At least One Million Lempiras (L1,000,000) (or the U.S. Dollar Equivalent) of such support shall be in the form of additional capitalization (i.e. interest income accrued to the U.S. Endowment, and/or additional contributions to either Endowment) of the EAP United States Endowment or the EAP Honduran Endowment. The remainder of such support may be in the form of contributions for capital assets for EAP, including buildings, land, equipment, vehicles, and scholarships funds. Contributions made directly and exclusively for operating expenses and which do not increase the capital of the EAP in one of the forms discussed in this section shall not be included in determining compliance with this condition.

(b) Evidence that EAP has delivered investment instructions to the depository institution for the investment of the second installment of funds and for reinvestment of subsequent disbursement installments as may be effected by the Memorandum of Understanding. Such instructions shall be satisfactory to the Government.

Section 3.3. Conditions Precedent to Third Installment and Use of Income from Second Installment

Prior to the disbursement of the third installment of Ten Million Lempiras (L10,000,000) or to the use of EAP of the income earned on the second installment, EAP shall, except as the Government may otherwise agree in writing, furnish the following to the Government, in form and substance satisfactory to the Government:

(a) Evidence that since September 17, 1987, EAP has obtained financial support totalling Five Million Lempiras (L5,000,000) from sources other than the U.S. Government. At least Two Million Lempiras (L2,000,000) (or the U.S. Dollar Equivalent) of such support shall be in the form of an additional capitalization (i.e., interest income accrued to the U.S. Endowment, and/or additional contributions to either Endowment) of the EAP United States Endowment or the EAP Honduran Endowment. The remainder of such support may be in the form of capital assets for EAP, including buildings, land, equipment, vehicles and scholarship funds. Contributions made directly and exclusively for operating expenses and which do not the capital of the EAP in one of the forms discussed in this section shall not be included in determining compliance with this condition.

(b) Evidence that EAP has delivered Investment Instructions to the depository

institution for the investment of the third installment of funds. Such instructions shall be satisfactory to the Government.

Section 3.4. Condition Precedent to Use of Income from Third Installment.

Prior to the use by EAP of the income earned of the third installment, EAP shall, except as the Government may otherwise agree in writing, furnish to the Government, in form and substance satisfactory to the Government, evidence that, since September 17, 1987, EAP has obtained financial support totalling Seven Million Five Hundred Thousand Lempiras (L7,500,000) from sources other than the U.S. Government. At least Three Million Lempiras (L3,000,000) (or the U.S. Dollar Equivalent) of such support shall be in the form of additional capitalization (i.e., interest income accrued to the U.S. Endowment, and/or additional contributions to either Endowment) of the EAP United States Endowment or the EAP Honduran Endowment, and the remainder of such support may be in the form of capital assets for EAP, including buildings, land equipment and vehicles. Contributions made directly and exclusively for operating expenses and which do not increase the capital of the EAP in one of the forms discussed in this section shall not be included in determining compliance with this condition.

Section 3.5. Terminal Dates for Compliance with Conditions Precedent.

(a) EAP shall comply with the conditions specified in Section 3.1. within six (6) months of the date of this Memorandum, or such later date as the Government may agree in writing. If EAP does not comply with such conditions within the required time period, the Government may terminate this Memorandum by written notice to EAP.

(b) The Government shall send written notice to EAP when funds for the second and third installments become available. EAP shall comply with the conditions specified in Section 3.2 and Section 3.3 within twenty-four (24) months of EAP's receipt of notice of the availability of funds for the second and third installments, respectively, or such later date as the Government may agree to in writing. If EAP does not comply with such conditions within the required time periods, the Government may cancel the undisbursed balance of the Endowment.

(c) EAP shall comply with the conditions of Section 3.4 within twenty-four (24) months of the date of disbursement of the third installment or such later date of the parties may agree to in writing. If EAP does not comply with such conditions within the required time period, the Government may order the EAP to repay the third installment to the Special Account.

Article IV

Section 4.1 Permissible Investments

The principal of the EAP Honduran Endowment shall be invested only in bonds of the Government of Honduras and its Agencies issued by the Central Bank of Honduras, or in such other investments EAP and the Government may agree to in writing.

Section 4.2. Uses of EAP Honduran Endowment Income

EAP shall use the investment income received from the EAP Honduran Endowment for the following purposes:

(a) Priority use of Endowment income will be given for scholarship support for low income families in accordance with criteria set forth in the Proposal. Sufficient funds will be allocated in any year to support as many Honduran students as have met the entrance requirements and policies of the EAP and attend the EAP during the year.

(b) To the extent that Endowment Income in any given year exceeds the needs outlined in Section (a), above, a portion of the excess income may be expended or reserved for programs having a direct positive impact on water availability or the management of forests or other natural resources of Honduras.

(c) A portion of the income may be maintained in the endowment and

invested as set forth in Section 2.3 (a) in this Agreement.

(d) Such other uses as the parties may agree in writing.

Article V

Miscellaneous

Section 5.1. Communications

Any notice, request or other documentation submitted by any party to any other party will be in writing and will be deemed duly given or sent when delivered to such party at the following address:

To EAP:

Pan American Agriculture School
Post Office Box 93
Tegucigalpa, D.C.
Honduras, Central America

To the Government:

Ministry of Finance and Public
Credit
Tegucigalpa, D.C.
Honduras, Central America

To A.I.D.:

Agency for International
Development (A.I.D.)
c/o American Embassy
Tegucigalpa, D.C.
Honduras, C.A.

Other addresses may be substituted for the above upon the giving of notice.

Section 5.2. Reports, Records, Inspections, Audit

Unless otherwise agreed to in writing, EAP agrees:

(a) As pertains to the EAP Honduran Endowment Fund, to establish and maintain, in accordance with generally accepted accounting principles and practices, internal control systems and procedures adequate to ensure proper control and management of the receipt and use of all funds, property and other assets acquired; to keep minutes of the proceedings of the Board of Trustees; and to maintain accurate records and detailed accounts of all investments, receipts, disbursements and other transactions hereunder.

(b) To render a written report of the EAP Honduran Endowment to the Government, with a copy to A.I.D., upon its request, at least semi-annually setting forth a description of all securities and other property purchased and sold, all receipts, disbursements, and other transactions effected by it during the preceding period and listing the securities and other property held by it at the end of such period.

(c) To have a certified public accounting firm, acceptable to the Government, carry out a financial and compliance audit of the books and records of the EAP Honduran Endowment annually. Audit reports shall be submitted to the Government with a copy to A.I.D., upon

its request.

(d) To afford authorized representatives of the Government the opportunity at all reasonable times to inspect the EAP Endowment, the utilization of all funds, property and other assets acquired by the EAP Honduran Endowment, and books, records and other documents relating to the Endowment. The foregoing reporting requirements in this section pertain indefinitely unless otherwise agreed in writing.

Section 5.3. Termination of Endowment

The grant from the Government to the EAP Honduran Endowment is conditioned on the satisfaction of the Government that the affairs of the EAP Honduran Endowment shall be managed in accordance with this Memorandum. If the Government determines that EAP has failed to comply with the terms of this Agreement, it shall advise A.I.D. in advance of its determination and, shall notify EAP in writing. If such non-compliance is not corrected within ninety (90) days to the satisfaction of the Government, the Government may order the depository institution to return the funds held in the EAP Honduran Endowment to such account as the Government may specify.

Section 5.4. Refunds

In the case of any disbursement from the EAP Honduran Endowment which is not supported by valid documentation in

accordance with this Memorandum, the Government may require EAP to refund the amount of such disbursement to the EAP Honduran Endowment within ninety (90) days after the receipt of the request therefore. Prior to exercising its right to require a refund hereunder, the Government shall advise A.I.D. of its intent to do so. Failure of the Government to exercise its refund rights under this section shall not affect any other rights that it may have under this Memorandum.

Section 5.5. Representation

For all purposes relevant to this Agreement, EAP will be represented by the Director of the EAP; the Government will be represented by the Minister of Finance and Public Credit; and A.I.D. will be represented by the person holding or acting in the Office of the Director, USAID/Honduras, or by such other additional representatives as they may designate.

Section 5.6. Amendments

This Memorandum may be amended by the unanimous consent of the parties hereto.

IN WITNESS WHEREOF, the Government of Honduras, the Agency for International Development and the Escuela Agricola Pan-Americana, Inc., each acting through its duly authorized representative, have caused this Memorandum of Understanding to be

signed in their names and delivered as of the day and year first above written.

(Signed by Jose Simon Azcona Hoyo, Presidente, and Etrain El Giron, Ministro de Hacienda y Credito Publico, Republica de Honduras; John Smith, Presidente, Junta de Fideicomisos and Simon E. Malo, Director, Escuela Agricola PanAmericana; and Everett E. Briggs, Ambassador and John A. Sanbrailo, Mission Director, United States of America.)

Appendix II: Endowments and Educational Development

The following section is an excerpt from Gary Hansen's article, *Terms of Endowment: A New A.I.D. Approach to Institutional Development*³³ (December 1990) and highlights a couple of endowments established by A.I.D. and their application toward education-based institutions as the primary means of supporting international development initiatives. The institutions included are: the Honduran Agricultural Research Foundation (FHIA), the Institute for Agricultural Strategies (IDEA), and the Pan-American Agricultural School (EAP) in Latin America.

Honduran Agricultural Research Foundation (FHIA), Honduras

In 1984, the Honduran Agricultural Research Foundation (FHIA) was established as a private, nonprofit foundation. The land, buildings, and other facilities for FHIA were inherited as a gift from the former agricultural research facilities of the United Brands Company. In order to provide an initial base of funding, A.I.D. awarded a 10-year grant to FHIA to help cover the Foundation's operating and program expenses.

The FHIA mandate is to engage in research and extension on agricultural crops. FHIA soon demonstrated a capacity to effectively conduct short- and medium-term applied research and to rapidly disseminate research results to farmers. These achievements were notable because they addressed the problem of the declining rate of growth in the agricultural sector.

FHIA's accomplishments prompted the Government of Honduras and A.I.D. to examine the prospect for further strengthening the Foundation's research and extension role. Thus, in 1989, A.I.D., the Government, and FHIA initiated negotiations, soon to be completed, to establish an endowment sufficient to meet FHIA's core operational and program expenses.

The Memorandum of Understanding (MOU) vests fiduciary responsibility for the endowment with the FHIA Administrative Council, a nine-member group operating under the guidance of the FHIA General Assembly, which consists of private citizens and government officials concerned with agricultural research and extension. The funding source for the endowment is ESF locally generated currency. The MOU requires that the endowment be invested in general government revenue bonds. Reinvestment of earnings on the endowment capital from ESF funds in other than government bonds can be done only in consultation with the Government to ensure that these reinvestments are

consistent with the Government's economic stabilization policies.

The endowment will be provided in installments. A matching formula requires FHIA to match a percentage of the total A.I.D./Government of Honduras contribution to the endowment. This formula is designed to encourage FHIA to expand the endowment and to build a long-term support constituency for its research.

FHIA can meet its matching requirement through either cash or in-kind contributions. However, the MOU limits in-kind contributions (e.g., capital assets like buildings, land, equipment) to no more than half of the total contributions. The other half must be in the form of cash contributions to the FHIA endowment. Furthermore, FHIA will receive double credit on the match for contributions made in foreign currencies, such as U.S. dollars.

FHIA will be given a specified time to meet the matching requirements for each installment. During this period, interest earned for each installment must be reinvested in the endowment until the match contribution is fulfilled, at which time subsequent earnings can be used to meet core program and operating expenses. The Government has the right to reclaim the interest on those installments if FHIA does not provide matching funds in the specified time period.

Earnings from Government/A.I.D. contributions to the FHIA endowment must be spent on a range of core operational and program expenses, as specified in the MOU. FHIA must consult with the Government of Honduras and A.I.D. if it wishes to alter the agenda of core expenses. However, earnings from contributions generated by FHIA's matching contributions can be spent at FHIA's discretion. Similarly, matching contributions designated as an endowment donation can be invested by FHIA in government or nongovernment investments.

The roles of A.I.D. and the Government of Honduras in governing and managing FHIA are spelled out in the MOU. A.I.D. has official membership on the FHIA General Assembly and Administrative Council, whereas the Government of Honduras has ex officio membership on these bodies. FHIA must provide semiannual financial reports to the Government of Honduras, employ a certified public accounting firm acceptable to the Government, and submit annual audit reports to the Government.

Institute for Agricultural Strategies (IDEA), Ecuador

In 1985, the U.S. Agency for International Development (U.S.A.I.D.) Mission and the Government of Ecuador signed a grant agreement to fund an agricultural policy

institute within the Science Foundation, a private nonprofit organization. The purpose of the institute was to conduct economic studies and sponsor public seminars and workshops on important agricultural policy issues. In 1988, the institute was established as an independent foundation and renamed the Institute for Agricultural Strategies (IDEA).

IDEA emerged as a result of a growing interest by leaders in the Government of Ecuador and A.I.D. to elicit private sector support for a more market-oriented approach to agricultural growth. To mobilize the private sector, some kind of institutional mechanism was needed to build linkages where few existed between agriculture, producer and peasant associations, and input and product supplier organizations. IDEA was established to serve as such a mechanism.

IDEA's principal role is to stimulate agricultural policy analysis, discussion, and debate within the private sector, thereby building the private sector's capacity to demand sound policy decisions. IDEA has a board of directors and a small professional staff that manage and fund the contracting of important policy studies and seminars to the private sector. The focus of these efforts is primarily in macroeconomics, prices and marketing, and natural resource policy. IDEA carries out pilot or demonstration projects following the completion of some of these studies. It is also providing overseas scholarships to train a small cadre of policy analysts.

Current IDEA expenses are funded from an A.I.D. grant. Once this grant expires IDEA funding will be drawn from several sources, including income from a \$400,000 endowment established in 1989 by A.I.D. from PL-480 local currency. The endowment interest is to be reinvested and allowed to accumulate and compound until the expiration in 1993 of the A.I.D. project grant.

The major portion of the endowment (\$300,000) has been deposited in a Citibank account, where it is provided a bank guaranteed rate of interest of 43.5 percent for a 3-year period. The remaining \$100,000 has been converted to dollars to purchase U.S. Government Treasury notes. The finance committee of the IDEA Board of Directors manages the endowment.

Pan-American Agricultural School (EAP), Honduras
See also Appendix I

The Pan-American Agricultural School (Escuela Agrícola Pan-Americana [EAP]) located in Zamorano, Honduras, was established in 1942 as a private, post-secondary school to train agriculturalists throughout the Latin American region. From 1942 to 1957 the school was able to cover its finances from a trust fund established by the United Fruit

Company, and thereafter from additional funds generated from student fees, private and public donations, and sales of products grown at the school.

Over the years the school has grown in prominence and has been asked to assume an increasing range of education and research responsibilities. To expand its financial base to meet these challenges, in 1987, EAP initiated discussions with the USAID Mission and the Government of Honduras on the possibility of securing income from the endowment. Negotiations were concluded that same year; the project agreement provided EAP with a local-currency equivalent of \$15 million.

The funds for the endowment were drawn from ESF-generated local currency. Because the ESF account is the product of a stabilization and recovery program supported by an A.I.D. project already approved by the Honduran legislature, additional legislative action to ratify the endowment was unnecessary.

The conditions stipulated in a formal memorandum of understanding (MOU--see Appendix I) among EAP, the Government of Honduras, and A.I.D. require that the grant funds be invested only in short-term (3-5 years) general revenue Government bonds of the Central Bank of Honduras. EAP is further obliged to keep the endowment capital intact, meaning that the capital can only be touched for reinvestment purposes. The MOU also contains a clause making the endowment irrevocable and nonreimbursable, with any proposal for its dissolution subject to proceedings and laws of the Honduran judicial system.

Finally, it is stipulated that during the term of the MOU, which is due to expire in 8 years, reinvestment of the Government grant into securities other than government bonds can be done only after consultation with the Government in order to ensure that such reinvestments are consistent with the Government's economic stabilization and recovery program. After the 8-year period, EAP is free to convert the bonds to other local and/or foreign investments.

The MOU authorizes EAP to use up to 70 percent of the income to cover the cost of education for Honduran students and the remainder to fund natural resource management programs carried out by the school nearby. This condition holds beyond the 8-year MOU.

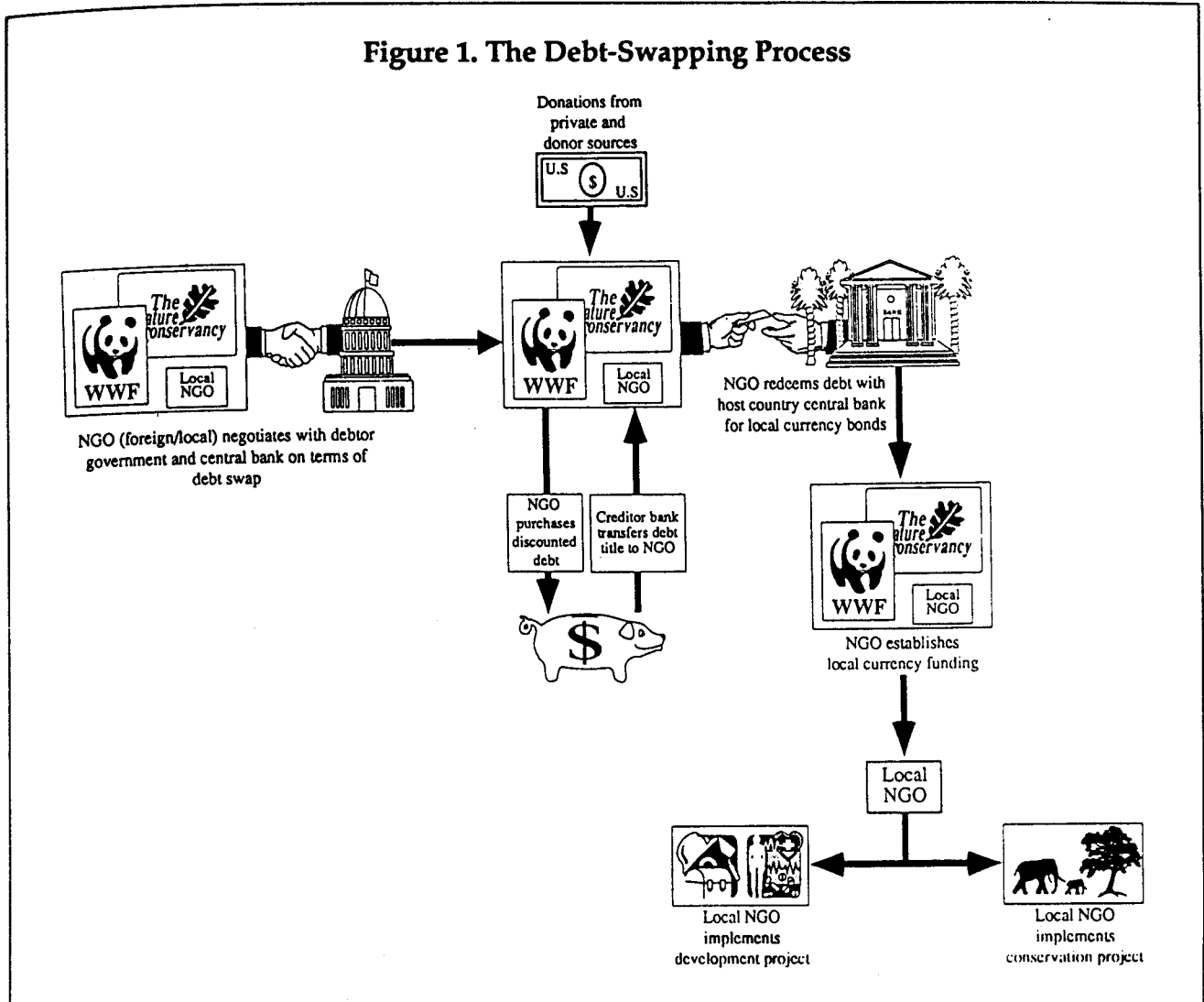
The MOU also includes a 25-percent matching requirement intended to encourage the school to mobilize funds from other sources. As part of the matching formula the Government of Honduras/A.I.D. local-currency endowment is provided in three equal installments. The second and third installments are released only after EAP

demonstrates that it has met the 25-percent matching requirement in each case. Furthermore, the income generated from the first installment cannot be used by the school until it has met the matching formula for the second installment. This rule also applies to the second and third installment.

The matching formula also requires that at least half of the 25-percent match be in cash (local currency or U.S. dollars), with the rest allowed in kind, including buildings, land, equipment, and vehicles (but not for operating costs). Finally, the restrictions on the nature of portfolio investments (the purchase of government bonds) and the use of income generated (for Honduran students and natural resource management programs) from the Government grant do not apply to funds or assets generated by the matching contributions.

The MOU stipulates that EAP's Board of Trustees also serve as trustees for the endowment; they in turn are required to select, after careful review, and after consultation with the Government, a depository institution to assume custody of the funds and to disperse the income generated from the endowment. The Board meets twice a year and has 22 active members, 7 of whom are from Honduras and 15 from the United States.

**Appendix III:
The Debt-Swap Process**
Reprinted from an article by Siew Tuan Chew³⁴



Appendix IV:
Is the Debt Crisis Over?

An excerpt from World Debt Tables 1992-93 by the World Bank, Washington DC³⁵

For the commercial banks and some of their middle-income developing-country borrowers, the debt crisis that began ten years ago is largely over. Developing-country debt no longer poses a systemic threat to the international banking system and, for some of the previously debt-distressed middle-income countries, renewed portfolio flows are part of a wider (albeit still fragile) return to market access. The crisis is certainly far from over, however, for many other developing countries. External viability remains elusive for many low- and lower-middle-income countries (especially in Sub-Saharan Africa), who are indebted largely to official bilateral creditors and whose debt burdens are, in some cases, unsustainably high. Furthermore, for some smaller middle-income countries, resolution of commercial debt problems has still to be achieved through Brady-type agreements.

Emerging countries. Several middle-income countries now have a track record of sound domestic policies and commercial debt and debt service reduction. Six countries have completed officially supported DDSR agreements--Costa Rica, Mexico, Nigeria (using its own reserves), Philippines, Venezuela, and Uruguay. They have reduced the commercial debt stock by more than a third. A few other middle-income countries, notably Chile, have re-established market access without comprehensive DDSR agreements and are, generally, meeting debt servicing obligations. For these countries, debt indicators have fallen to pre-1982 levels. They have paid a heavy price in foregone development and falling per capita incomes but, for them, the debt crisis is finally over (although in countries with sizable official debt, such as Nigeria, difficulties remain). Their task now is to follow prudent economic policies to obtain sustained access to international private capital on favorable terms. Assuming that commercial bank reduction packages for Argentina and Brazil are successfully concluded, less than a fourth of the commercial debt of all developing countries remains to be restructured.

Preserving market access is also a continued priority for several countries which have maintained full debt servicing throughout the 1980s--for example, Algeria, Botswana, China, Colombia, Hungary, India, Indonesia, Republic of Korea, Malaysia, Pakistan, Thailand, Tunisia, Turkey, and Zimbabwe. Some of these countries maintained access to new flows from private capital markets. Other countries, however, faced serious difficulties and needed to make an effort to avoid rescheduling. The experience of other debtors in restoring broken relationships with creditors reaffirms the value of avoiding debt service interruptions and sustained adjustment efforts. However, many of these countries believe that their efforts were not always rewarded by access to markets,

or adequately recognized in the BIS capital adequacy guidelines, where claims on all developing countries outside of the OECD are treated uniformly. The official sector, especially multilateral institutions, has played an important role in securing adequate external finance in support of the adjustment programs in a number of these countries.

The remaining middle-income countries. Among the group of severely and moderately indebted middle-income countries which are still under debt restructuring arrangements, there are considerable variations in the structure of external debt. Some, such as Bulgaria, Cote d'Ivoire, Dominican Republic, Ecuador, Peru, and Poland have a high share of commercial debt in their total debt obligations. Some of these countries have been attempting to negotiate a DDSR agreement with their commercial bank creditors but have been unable to agree upon a package. In some cases negotiations have been protracted.

Commercial banks have little incentive, it seems, to incur the administrative costs of regularizing debt in some countries that account for only a small fraction of their balance sheets. In other cases, conditions in the debtor country have not been conducive to pursuing serious negotiations.

There is no simple solution to the commercial bank debt overhang of these countries. Some have advocated "leaving it to the market to sort out." Others have revived the idea of an officially created debt reduction facility, which would buy out debt at a discount. On balance, it seems that the basic tenets of the debt strategy to date-- adoption of a menu-based, case-by-case approach that recognizes widely differing country circumstances, and official coordination of the debt reduction process--offer the best hope.

For other middle-income countries, the share of official bilateral debt in their overall debt obligations is much higher. The response to their difficulties has come mainly through improved rescheduling terms offered by official bilateral creditors and the Paris Club. New terms introduced in September 1990 offered long maturities and grace periods (15 and 8 years respectively for nonconcessional debt) and also permitted limited debt conversions. In early 1991, two lower-middle-income countries (Egypt and Poland) were granted exceptional debt relief of up to 50 percent in present value terms on a phrased basis, contingent on maintaining an appropriate IMF program. Since then, successive G7 Summits (in July 1991 and July 1992) have encouraged the Paris Club "to recognize the special situation of some highly indebted lower-middle-income countries on a case-by-case basis." More recently, the French government has established a fund to convert the official debt repayments of some countries into financing for development projects.

Enhanced Toronto terms and beyond. The external financing needs of severely indebted low-income countries (SILICs) have been met during the 1980s through strong official support with highly concessional finance, extensive debt rescheduling, and ODA forgiveness. However, because net flows on debt have remained positive for these countries throughout the 1980s, their outstanding debt has continued to grow. Many of them now have debt service obligations that are well in excess of sustainable levels. The average ratio of actual to scheduled debt service is estimated at about 50 percent in 1992 (although it varies greatly from country to country), indicating debt distress.

The debt problem of SILICs is exacerbated by structural weaknesses in their economies, including poor infrastructure, low levels of skilled manpower, and undiversified exports. Adverse terms-of-trade shocks in the mid-1980s led to a declining noninterest current-account balance (excluding official transfers) and repeated recourse to rescheduling, and to the run up of arrears.

In 1988, the Paris Club recognized that the debt buildup had become unsustainable in a number of low-income developing countries, and agreed to offer debt and debt service reductions among other debt restructuring options (Toronto terms). A further step was taken in December 1991 when the Paris Club agreed to implement a new menu of concessions for low-income countries, the "enhanced Toronto terms"--essentially two options providing for deeper debt reduction, plus the nonconcessional option from the old Toronto terms. The concessional options amount to 50 percent forgiveness in present value terms on debt service payments falling due during the consolidation period. Additionally, the agreements provided for a deferred consideration of potential debt reduction. Creditors indicated that they would be willing to consider restructuring of the remaining stock of pre-cutoff-date debt after three to four years. The enhanced Toronto terms represent a substantial advance over the previous Toronto terms and their application has already benefited twelve countries with a consolidated amount of US\$2.5 billion. They differ in three respects, however, from the proposal of the so-called "Trinidad terms" set out by the (then) U.K. Chancellor of the Exchequer in 1990: by deferring consideration of the stock of debt until three or four years later, by retaining a nonconcessional option; and in the benchmark adopted for the extent of debt reduction given.

The effect of rescheduling terms varies considerably from country to country, reinforcing the merits of the case-by-case approach of the Paris Club tailored to meet individual financing needs of the rescheduling countries. However, in several SILICs, debt burdens remain at unsustainably high levels even after the application of either the enhanced Toronto or the Trinidad terms. This raises the issue of whether more comprehensive measures are needed for countries that are attempting to pursue

sustained domestic policy reform.

Lessons of the Crisis

The principal policy lesson of the debt crisis is that domestic resources and policy, not external finance per se, are the key to economic development. First, the volume of external finance that developing countries can attract is severely limited by the perception of country risk. Second, heavy reliance on external finance is a risky strategy because it increases vulnerability to adverse external developments and their attendant long-term development impact. External finance can play an important beneficial role, but only when it supplements and supports sound development policy.

Other lessons of the debt crisis can be grouped into two sets: first, on how to prevent a crisis, and, second, on how to deal with a crisis if it occurs.

Preventing a Crisis

● **Prudent lending and borrowing policies should take into account the vulnerability to adverse external shocks.** Current interest rates and terms of trade conditions are a poor guide for external finance decisions. Seemingly cheap variable-rate loans may turn out to be expensive if interest rates increase. Negative terms of trade shocks may be permanent rather than transitory and merit adjustment rather than external finance; positive terms of trade developments could be transitory rather than permanent, and apparent increases to wealth backing external finance could vanish. Prudent external finance decisions should take into account the vulnerability of the country, both in terms of its level of external liabilities and its capacity to adjust quickly to adverse external developments. Prudent decisions of foreign investors in developing countries should recognize the global, systemic nature of the risk (such as world trade conditions), which limits developing country risk diversification and calls for prudent portfolio allocations.

● **Building risk-sharing contingencies into financial contracts makes crises less likely and less costly if they occur.** Because there was a predominance of syndicated lending to sovereign borrowers at variable rates in the 1970s, rising interest rates led to large debt service obligations, inability to pay, and permanent recontracting. Fixed rates, as implemented in par bond conversions under the Brady Plan, provide protection against increases in market interest rates. Other ways to build risk sharing into contracts include commodity-linked finance (such as in recapture provisions under the Brady Plan) and various forms of equity. In this

respect, recent increases in FDI and the boom in portfolio equity flows to some developing countries are welcome developments.

● **External finance for investment in low-income countries must come largely from official concessional sources.** As the debt crisis showed, commercial banks are inappropriate means of channeling long-term finance to the weakest developing countries. Many low-income countries are structurally weak and cannot count on attracting private capital for their longer-term needs. Furthermore, the commercial bank reorientation toward short-term and transaction-oriented business will likely continue. Therefore, the external finance for priority investment needs of these countries should come mainly from official sources on terms linked to their repayment capacity.

Dealing with a Crisis

● **In a solvency crisis, early recognition of insolvency as the root cause and the need for a final settlement are important for minimizing the damage.** Early efforts to solve the cash flow problems of debt-distressed countries only by encouraging commercial creditors to lend new money were frustrated because they were uncertain about the countries' ability to pay. As a result, protracted renegotiations and uncertainty damaged economic activity in debtor countries for several years while the lack of cooperation between creditors and debtors remained with no end in sight. It took too long to recognize that liquidity was the visible tip of the problem, but not its root.

● **A final settlement of a solvency crisis requires debt and debt service reduction.** A debt overhang beyond what a country can be expected to be able to pay under normal circumstances creates a burden of uncertainty on how the fruits of economic growth will be shared with old creditors. As a result, new investors are reluctant to invest their resources and growth suffers while the debt overhang keeps mounting. The reduction of debt obligations in line with ability to pay removes the debt overhang distortion affecting both the country and foreign investors and makes possible faster economic growth on a sustainable basis.

● **Good domestic policy is the basis for capital market access.** A track record of sound economic management is the key to preserving and restoring access to international capital markets. East Asian countries with strong policy frameworks have been able to maintain market access even in the face of the global private capital retrenchment of the mid 1980s. Debt and debt-service reduction has produced strongly positive results when combined with conducive policy

frameworks (such as in Chile and Mexico). Debt and debt service reduction alone cannot be expected to pave the way for an enduring solution when policy frameworks are weak.

● **The official sector has an important role to play in implementing a final settlement and solving the crisis.** Official intervention was the key for avoiding a systemic collapse by coordinating concerted lending and overcoming the free-rider problems that complicate debt negotiations. The official sector has been key in designing and supporting the Brady Plan, which successfully addressed the commercial debt problem of middle-income countries. Official support for commercial debt reduction for low-income countries, as well as official bilateral debt reduction involving debt forgiveness as part of recent Paris Club plans, are further examples of the role of the official sector in implementing DDSR operations. Most importantly, the official sector has paid close attention to the macroeconomic policy framework of debtor countries as a way of ensuring that debt relief under various forms is put to productive uses.

Footnotes

1. Public Law 87-195, Section 102 (b) (1) (The Foreign Assistance Act of 1961 as amended).
2. *A.I.D. and Endowments: from Grants to Investment*, The PROFIT Advantage, Fall/Winter 1993, page 2
3. Profit, page 2
4. Public Law 102-391, Section 567, October 1992
5. Profit, page 2
6. Profit, page 2
7. Profit, page 2
8. While we suggest that expert counsel be sought in establishing endowments, this may take numerous forms. It may be helpful in some countries to consult lawyers knowledgeable about the laws of the country, but in other countries this may be inapplicable and financial experts, including accountants, may be better able to guide the establishment of an endowment. (Weatherly, W. Paul, December 1993)
9. Hansen, Gary, *Terms of Endowment: A New A.I.D. Approach to Institutional Development*, Innovative Development Approaches, No. 3, December 1990, page 4
10. Hansen, page 8
11. Hansen, page 8
12. Hansen, page 8
13. Weatherly, W. Paul, December 1993
14. Weatherly, W. Paul, *Guidelines for the Africa Bureau of the Agency for International Development for Programming Local Currency Endowments: A Report to AID/AFR/TR (Draft)*, 28 October 1991, page 2
15. Trust Agreement between U.S.A.I.D. and the Caribbean Financial Services

Corporation, Bridgetown, Barbados, September 29, 1986, Attachment I, page 2, Section I.

16. The Debt-for-Development Coalition, Inc. *The Debt-for-Development Coalition: How the International Debt Problem Can Work for Development*, 1993
17. Chew, Siew Tuan, "Recycling Old Debt for New Ventures: Debt-for-Nature and Debt-for-Development Swaps," *Innovative Development Approaches*, January 1991, pages 9-10
18. Chew, pages 10-11
19. Chew, pages 11-12
20. Chew, page 12
21. Chew, page 12
22. The Debt for Development Coalition, Inc. (cited above)
23. Public Law 102-391, Section 567, October 6, 1992
24. Weatherly, page 3*
25. Chew, page 14
26. Chew, pages 11-12
27. Chew, pages 16-17
28. Chew, page 17
29. Chew, page 17
30. Chew, page 17
31. Chew, page 17
32. Memorandum of Understanding between U.S.A.I.D., the Government of the Republic of Honduras, and the Escuela Agricola Pan-Americana, 17 November

1988 (full text).

33. Hansen, Gary, *Terms of Endowment: A New A.I.D. Approach to Institutional Development* Innovative Development Approaches series, No. 3 (December 1990), pages 14 - 15 and 17.
34. The Debt Swap Process, diagram reprinted from Chew, Siew Tuan, *Recycling Old Debt for New Ventures: Debt-for-Nature and Debt-for-Development Swaps*, Innovative Development Approaches series, No. 4 (January 1991), page 11.
35. *World Debt Tables 1992-93: External Finance for Developing Countries (excerpt)*, The World Bank, Washington DC, pages 7 - 11.