

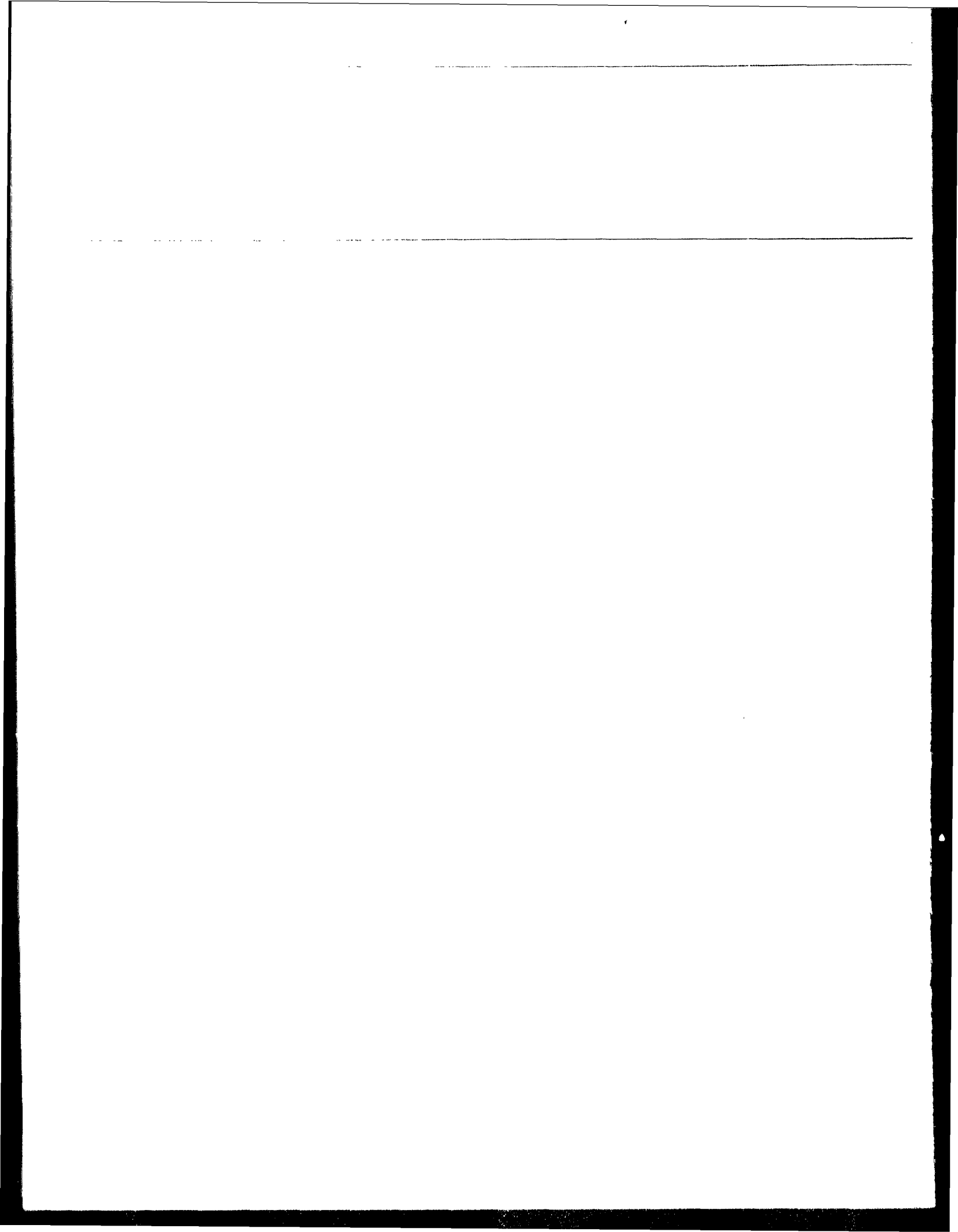
GAO

December 1991

DEVELOPING COUNTRY DEBT

Debt Swaps for Development and Nature Provide Little Debt Relief







United States
General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

B-242690

December 9, 1991

The Honorable Gus Yatron
Chairman
The Honorable Doug Bereuter
Ranking Republican Member
Subcommittee on Human Rights
and International Organizations
Committee on Foreign Affairs
House of Representatives

In response to your request, we examined issues concerning debt swaps for development and nature. A debt swap is a form of debt conversion in which external hard currency debt is traded for local currency or debt denominated in local currency. Debt-for-nature swaps support specific environmental projects, such as the designation and management of protected areas, the development of conservation management plans, the training of park personnel, and environmental education activities. Development swaps support projects such as microenterprise, education, training, health, agriculture, and other selected development activities. In this report, we will refer to debt-for-development and debt-for-nature swaps collectively, as "debt swaps."

Our objectives were to

- ascertain the number of developing countries that have participated in debt swaps, the extent to which these swaps have reduced total external debt, and the number of programs that have been undertaken;
- assess the advantages and disadvantages of debt swaps and the efforts of the U.S. Agency for International Development (AID) to support private voluntary organizations (PVOs) that participate in such swaps; and
- develop information on whether the International Bank for Reconstruction and Development (World Bank) had implemented the Department of the Treasury's April 1988 recommendations on debt-for-nature swaps.

Results in Brief

From 1987 through 1990, 13 countries completed 26 debt swaps. These swaps retired debts totaling about \$126 million (less than one-twentieth of 1 percent of the countries' external debt and less than one-fifth of 1 percent of their commercial debt.) Of the \$126 million, \$86.4 million was exchanged by Costa Rica. Fifteen swaps for nature accounted for nearly

90 percent of the \$126 million, while 11 swaps for development accounted for about 10 percent.

The advantages and disadvantages of debt swaps vary by participant. PVO participation in debt swaps enhances their ability to raise funds and offers PVOs the prospect of providing additional funding for the PVO's programs. However, many PVOs have not participated in swaps because of their complexity and the high resource commitment required.

Debt swaps allow commercial banks to dispose of high-risk loans. Moreover, some leading economists believe that if swaps involve a significant proportion of a country's debt, the swaps could cause a large increase in the price of the developing country's debt on the secondary market.¹ This higher price increases the benefit to bank creditors. According to AID and Department of the Treasury officials, such price increases have not occurred with respect to the debt swaps finalized to date. However, these swaps have represented a very small proportion of a country's outstanding debt: even in the case of Costa Rica, the debt swapped accounted for less than 2 percent of the country's outstanding external debt. Commercial banking officials with whom we spoke stated that the tax and accounting treatment of these debt swap transactions provided no incentive for banks to donate debt.

Weighing debt swaps' relative advantages and disadvantages to debtor countries is complex. The main attractions for debtor countries are the potential prospects of conserving foreign exchange resources through reduced debt service costs and the benefits of the environmental and development improvements in the country. On the other hand, the list of disadvantages is lengthy: the potential inflationary impact of debt swaps, the relatively high price that could be paid for the debt, the implicit subsidy provided to PVO's through a debt swap, the cost of servicing domestic bonds issued in exchange for the external debt, the perceived loss of sovereignty incurred if land ownership were transferred to an international PVO, and the potential for debt swaps to restrict remunerative development activities. Some economists believe that even if these disadvantages can be overcome, a debt swap makes sense only if a straight donation would not otherwise occur. AID has had limited involvement in debt swaps, viewing its role as more catalytic than direct.

¹The "secondary market" in the context of developing country debt is an over-the-counter market in which dollar and other hard-currency debt is traded. Foreign governments owe this debt to private sector creditors (usually commercial banks).

The World Bank has acted on four of the five recommendations made by the Department of the Treasury in its April 1988 report on debt swaps. The Bank has not swapped any of its debt instruments, nor has it initiated pilot swap projects in developing countries. However, it coordinated one of its loans with a debt swap financed by AID and the World Wildlife Foundation in Madagascar. Appendix I provides more details on debt swaps.

Scope and Methodology

We conducted our review in Washington, D.C., New York City, and Costa Rica. In Washington, D.C., we interviewed and obtained records and documents from officials from AID, the Departments of State and Treasury, the World Bank, and several nongovernment organizations. In New York City, we interviewed and obtained data from officials of commercial banks and various nongovernment organizations. During our visit to Costa Rica, the country that has participated in the most debt swaps, we interviewed AID officials and host country officials from the Ministry of Natural Resources, Energy, and Minerals. We also met with officials from central and commercial banks, the Inter-American Development Bank, and private voluntary organizations.

We did not evaluate specific debt swap development and nature programs, commercial debt equity swaps, or proposed swaps involving official debt, such as those financed under the Enterprise for the Americas Initiative. Further, accurate and complete information is not available on all debt swaps because some debt swap participants have not publicized their involvement.

We conducted our review from July 1990 to August 1991 in accordance with generally accepted government auditing standards. AID and the Department of Treasury program officials reviewed a draft of this report, and we have included their comments where appropriate.

We are sending copies of this report to the Administrator of the Agency for International Development, the Secretaries of State and Treasury, and other interested congressional committees. We will also make copies available to others upon request.

I can be reached on (202) 275-5790 if you or your staff have any questions. Major contributors to this report were Ronald A. Kushner, Assistant Director; Wyley Neal, Evaluator-in-Charge; James Lee, Evaluator; and Berel Spivack, Senior Economic Advisor.



Harold J. Johnson
Director, Foreign Economic
Assistance Issues

Contents

Letter		1
Appendix I		
Debt Swaps for	Background	8
Development and	Limited Developing Country Participation in Debt Swaps	9
Nature	Advantages and Disadvantages of Debt Swaps	10
	AID's Role in Debt Swaps	15
	World Bank Implementation of Treasury Department	16
	Recommendations	
Table	Table I.1: Impact of Debt Swaps on the Level of	9
	Outstanding Debt	

Abbreviations

AID	U.S. Agency for International Development
PVO	private voluntary organization

Debt Swaps for Development and Nature

Background

Since August 1982, when Mexico stopped making debt service payments, many of the 76 developing countries with recent debt-servicing difficulties had per capita output that grew slowly and even declined. In the previous decade, these countries had experienced substantial growth in their per capita output. Their slower growth was due, in part, to their large external debt, which lessened their credit worthiness, caused lenders to be reluctant to extend them new credit, and restricted their growth and development.

By 1990, the external debt of developing countries with recent debt-servicing difficulties had grown to \$770.7 billion. This figure equaled about 250 percent of their annual export earnings, while their debt service payments equaled about 27 percent of their export earnings. Both percentages were substantially higher than those for the 54 developing countries without recent debt-servicing difficulties.

Following the international debt crisis, commercial banks' portfolio of developing country debt deteriorated, and the banks sold increasing quantities of developing country debt for less than its face value. Volume on the secondary market grew quickly: from approximately \$2 billion (face value) in 1985, to \$9 billion in 1987, and \$70 billion in 1990. As secondary markets grew in size, a former vice president of the World Wildlife Foundation advocated that conservation groups use the debt swap mechanism to raise local currency. The idea was to provide some debt relief to developing countries with debt-servicing problems in exchange for local currency resources that would be used to carry out environmental and development projects in these countries. This concept became known as debt-for-nature and debt-for-development swaps.

In these swaps, a PVO uses its funds to purchase a debtor country's external commercial debt on the secondary market at a significant discount from the debt's face value. Then, the PVO and the debtor country usually exchange the external debt instrument for domestic currency or a domestic currency bond that the local PVO uses to fund agreed-upon projects. Generally, all terms of the swap are agreed to before its execution. The five major steps of a debt swap are as follows:

- U.S. and debtor country PVOs develop a project proposal or identify a program to promote. The PVOs negotiate with the country's central bank on transaction issues including the discount rate for converting the debt into the local currency instrument.
- PVOs solicit funds from private foundations, AID, and other sources to purchase the debt instrument.

- PVOs purchase the debt instrument at the secondary market price or receive the debt instrument as a donation.
- PVOs transfer the debt instrument to the country's central bank, which converts the external debt into local currency or debt.
- The central bank, or its agent, disburses local currency funds to the local PVO for approved debt swap projects.

Limited Developing Country Participation in Debt Swaps

The first debt swap took place in Bolivia in 1987 when \$100,000 was used to purchase Bolivian debt with a face value of \$650,000. Since that time 25 other debt swaps, involving 12 additional countries, have been completed. These swaps retired about \$126 million in outstanding commercial debt in exchange for internal obligations payable in local currency or local currency instruments. Table I.1 shows the number of countries that have completed debt swaps and the impact of these swaps on the countries' level of outstanding debt.

Table I.1: Impact of Debt Swaps on the Level of Outstanding Debt^a

Dollars in millions				
Country	Total external debt	Total commercial debt	Amount of debt swapped	Percent of debt swapped to total debt
Bolivia	\$4,359	\$395	\$0.7	0.0160
Brazil	111,290	49,949	7.2	0.0064
Costa Rica	4,468	1,415	86.4	1.9357
Dominican Rep.	4,066	739	0.6	0.0148
Ecuador	11,311	4,847	18.5	0.1636
Guinea	2,176	34	1.0	0.0460
Madagascar	3,607	150	3.0	0.0832
Niger	1,578	101	1.1	0.0700
Nigeria	32,832	6,144	3.5	0.0110
Philippines	28,902	8,790	1.3	0.0045
Poland	43,324	9,268	0.1	0.0002
Sudan	12,965	1,388	0.8	0.0062
Zambia	6,874	70	2.3	0.0335
Total	\$267,752	\$83,290	\$126.4^b	0.0472

^aTotal external and commercial debt is as of 1989, and the amount of debt swaps is as of 1990. According to Department of Treasury officials, the level of outstanding commercial debt changed little between 1989 and 1990.

^bDoes not add because of rounding.

Source: Statistical data compiled by GAO on the basis of information provided by AID, the World Bank, the Debt-for-Development Coalition, and major PVO's.

Debt swaps have not significantly reduced any country's external debt. Costa Rica, the most active participant, reduced its outstanding external debt by only 1.9 percent. The Costa Rican government believed that tropical forests were one of Costa Rica's most valuable natural resources. In addition to their environmental benefits, the forests constitute an important tourist attraction and are thus potentially a significant generator of foreign exchange. Costa Rica was therefore favorably disposed to participate in debt-for-development swaps—specifically, in programs that would contribute to the protection and development of this resource. The Costa Rican government has developed guidelines to facilitate the swap process and implemented policies that have lessened some of its adverse effects, such as inflation.

During our work in Costa Rica, we visited the Guanacasta Regional National Park, which is primarily supported by funds generated through debt swaps and channeled through an indigenous PVO. The park appeared to be well maintained and protected, and conservation and research activities and small development projects were conducted there.

Several factors are impediments to greater swap activity by debtor countries. Debtor governments have not directly undertaken debt swaps because their loan agreements with commercial banks normally prohibit them from buying back their own debt in the secondary market. Thus, PVOs working in debtor countries have been critical elements in the implementation of swaps since these PVOs do not face the same restrictions as their government. However, U.S. PVO officials told us that in many cases developing countries lacked experienced PVOs to implement a swap project. Since debtor countries have limited resources, expenditures for debt swaps compete with expenditures for other priority areas, and with other programs, such as debt-for-equity swaps.¹

Advantages and Disadvantages of Debt Swaps

Although advocates often describe debt swaps as “win-win-win” situations in which all participants (the private voluntary organizations, commercial banks, and the developing countries) benefit, there are advantages and disadvantages for each party that participates.

¹ A debt equity swap is similar to a debt-for-development or debt-for-nature swap, but without the latter's philanthropic characteristics. In a debt-for-equity swap, a private individual or profit-making enterprise typically replaces the PVO. This individual or enterprise is motivated by a desire to lower the cost of local equity investments, such as land or companies.

**Private Voluntary
Organizations**

Programs sponsored by PVOs clearly benefit from debt swaps. Normally a PVO receives more in local currency from debt swaps than it could have received from purchasing local currency directly with dollars. A PVO's participation in debt swaps can also increase its profile and ability to raise funds; this is especially true for PVOs involved in environmental conservation activities. Additionally, because these swaps involve intense negotiations with the debtor country and commercial banks, a PVO can develop networks of contacts that may prove valuable for future programming activities. A disadvantage to a PVO is the amount of time and staff resources it takes to finalize a swap agreement; some swaps have taken up to 18 months to complete. The negotiation process between a PVO, the debtor country, and commercial banks has almost always been complex and labor intensive.

The costs of this complex process can limit PVO participation in debt swaps, especially smaller, inexperienced PVOs. All PVOs are faced with making a cost benefit decision: would a straight donation or a swap be more beneficial, considering the level of resources and time involved in finalizing a swap agreement?

Commercial Banks

Commercial bank creditors benefit from these swaps because they allow the banks to dispose of high-risk loans and could cause the price of a developing country's debt to increase on the secondary market. Commercial banks' involvement in debt swaps has primarily been to sell debt to PVOs on the secondary market and act as the PVO's financial intermediary. One bank, Fleet Norstar Financial Group of Rhode Island, has donated a debt instrument (\$250,000) to a PVO for a debt swap. Although the banks are willing to sell some of their high-risk debt holdings to the PVOs on the secondary market, the banks have little incentive to donate debt holdings for debt swap purposes.

Banking officials told us that the economic advantages to be gained from donations of debt holdings were insignificant, and that if they donated debt instruments for one country, pressures could build for expanding such treatment to other countries. Furthermore, they said that the banks' shareholders generally did not support donating bank assets for charitable causes. However, the BankAmerica Corporation announced in July 1991 that it would donate up to \$6 million of its Latin American debt holdings for environmental programs in Mexico and Central and South America.

According to banking officials, changes in U.S. tax and accounting treatment could stimulate more donations for swaps. These changes would allow contributions to PVOs for programs in developing countries to be deducted from domestic-source income (rather than partially deducted from foreign income as is now required).

Some leading academic economists believe that creditors, not debtors, receive most of the added benefits from programs like debt swaps, particularly if the swaps retire significant amounts of debt. The reason is that the announcement of the intended purchases under the swap program creates expectations on the secondary market that debt will be retired and the developing country will be more creditworthy. Thus, the price of this debt increases, and the commercial bank could receive a significantly higher post-announcement price for the external debt than the previous prevailing price. In addition, the more developing country external debt the PVO tries to purchase for this program, the greater the price it is charged. This situation is more advantageous to banks. However, AID and Department of Treasury officials told us that, while they agreed with this theory, in practice this situation has not occurred because of the small amount of debt involved in debt swaps.

Developing Countries

The most obvious advantages for a debtor country that participates in debt swaps are the environmental and development programs it receives and the reductions to its external debt. Many economists argue that reducing the external debt of a heavily indebted country may result in the country's becoming more creditworthy and thus being able to obtain foreign investments that would otherwise not be possible. To the extent that this theory is realized, the swap is beneficial. There are, however, potential disadvantages to debt swaps, such as (1) the relatively high price that could be paid for the debt (as previously discussed), (2) the implicit subsidization of the swap, (3) its potential inflationary impact, (4) the financial cost of servicing the domestic debt issued in exchange for the external debt, (5) the perceived sovereignty issue, and (6) the potential for restricting resource development, which could dissuade developing countries from participating in a debt swap.

Implicit Subsidization

The developing country's central bank pays the PVO a subsidy. This subsidy is the difference between the amount of local currency the central bank pays the PVO for the external debt and the amount the PVO paid the commercial bank for the debt (when the amount is expressed in local currency at the time of the swap). For example, the Nature Conservancy purchased a \$5.6 million Costa Rican debt instrument for \$784,000 on

the secondary market and exchanged it with the Central Bank of Costa Rica for about \$1.7 million in local currency, resulting in a subsidy of about \$1 million. Some economists argue that the subsidization inherent in debt swaps makes sense only if the donation would not otherwise have occurred. They also believe that the benefits to the debtor country are reduced because of the subsidy it pays for the external debt.

The environment, health, education, or other sector engaged in the debt swap normally receives a form of additionality because of the swap. Thus, when the debtor country first negotiates the swap with U.S. and host country PVOS, it is faced with choosing which sector will receive the implicit subsidy. To the extent that debt swap expenditures simply replace normal budget expenditures for the same purpose as the swap, there is no additional benefit or government allocation for the subsidized sector. This is not normally the case, however, since most swaps increase government expenditures over previous levels because of the subsidy. To finance this increase, the government can reduce expenditures for other sectors, increase taxation or domestic borrowing, or resort to monetary expansion. Since any of these options may involve a cost, it is important that when debtor countries consider the pros and cons of a debt swap arrangement, they consider, among other things, the importance of the debt reduction and the relative priority of the particular investment activity to benefit from the swap.

Potential for Inflation

Although the inflationary implications of debt swaps have been negligible to date because of their limited number and relatively small size, the potential for inflation could pose a problem for all forms of debt swaps. A debtor government may print money to finance the debt conversion and thereby increase its money supply. When the country's money supply increases, the relative value of the local currency falls and prices for goods and services increase. Repeated debt swaps of significant size could increase inflation. Over the years, some developing countries have suspended debt swap programs, giving inflationary concerns as the reason.

A participating developing country can offset the potential high prices caused by debt swaps by neutralizing the effects on their money supply. One way is for its central bank to sell local currency bonds to PVOS or another member of the private sector and avoid immediately increasing the outstanding local money supply. Most of the debt swaps to date have involved the issuance of bonds, which will need to be serviced, instead of a lump sum disbursement of local currency. Costa Rica has used this method to deal with the potential inflationary consequences of its swap

activities. The interest payment on the bond is used to support the local PVO's development and conservation efforts in the host country.

Another way for the developing country's government to negate the inflationary effect of a debt swap is to sell something other than bonds to absorb the additional currency or agree to undertake development or environmental actions in lieu of making cash payments—debt-for-policy reform. The Bolivian government used the latter method when it agreed to undertake land use reforms, rather than pay the PVO local currency.

Evidence indicates that debt swaps completed to date have had negligible inflationary effects. Nevertheless, it is possible that a number of large swaps by a developing country could result in substantial injections of new money into an economy and bring about more serious inflationary consequences. The amount of swap activity that any economy can tolerate may vary markedly between countries. Each country has to determine its own level of activity to ensure that it conforms to the absorptive capacity of the local economy.

Perceived Sovereignty and Land Use Concerns

One of the more controversial aspects of debt swap arrangements, particularly when this mechanism was first used, was the perception among some people in developing countries that their country might lose some of its sovereignty as a result of the transaction. For example, some people were concerned that if land ownership were transferred to an international PVO, the country would no longer have control over this resource. While such transfers have not occurred to date, the perception persists and is a serious concern in some debtor countries.

Also, some developing country government agencies and sectors of society favor developing their country's natural resources without the constraints imposed by restrictions in debt swap agreements. They portray debt swaps, especially swaps related to environmental conservation, as attempts by foreigners to control the country's land use and natural resource development. They believe that while the country may gain benefits from an improved environment, the debt swaps could adversely effect economic development and growth by prohibiting remunerative activities such as timber cutting, farming, or mining certain lands. This happened in Bolivia in 1987 when it set aside land in a nature swap that could have been used for timber cutting.

The perception that development of natural resources could be restricted because of conservation efforts supported by foreigners has inhibited some developing countries from participating in debt swaps.

For example, Brazil, until recently, had refrained from participating in debt swaps, in part, because such swaps were perceived by some people in Brazil as allowing external interference with the development of the Amazon Basin. Despite this perception, the President of Brazil announced in June 1991 that Brazil would swap up to \$100 million of its debt to finance environmental projects. Additionally, in Costa Rica most of the swap proceeds were used to support existing protected areas. As previously mentioned, Costa Rica believes its tropical forests are one of its most valuable assets. Its development strategy includes the continued protection of these areas and the promotion of eco-tourism to bring in foreign exchange.

AID's Role in Debt Swaps

Since AID first became involved in debt swaps in 1987, it has provided about \$11 million in grants to PVOs for swaps. These funds have helped support purchases (on the secondary market) of the debt of eight developing countries—one Caribbean, one Latin American, five African, and one Asian. AID also directly supports the Debt-for-Development Coalition,² which was established in 1988 to coordinate efforts of PVOs and facilitate their turning developing country debt into development opportunities. Through 1990, AID made grants totaling approximately \$1 million to finance the Coalition's operations and plans to continue making grants to the Coalition through 1993.

While AID announced a Debt-for-Development Initiative in February 1989,³ it has not directly encouraged PVOs or developing countries to participate in debt swaps. AID officials have indicated that they view their role in debt swaps as catalytic; they look to such groups as the Coalition to provide direct assistance to PVOs interested in initiating debt swap transactions.

Our review of selected AID project files indicated that before AID approves funding for a PVO debt swap, the PVO submits documentation for AID's review showing that (1) the project(s) are appropriate for AID funding; (2) agreement has been reached with the host country's central bank over exchange terms; (3) the debt swap will earn a better rate of exchange per grant dollar than would be yielded by directly purchasing

²Coalition members are U.S. colleges and universities, cooperatives, private voluntary organizations, and research institutes engaged in economic development programs overseas.

³This initiative is intended to support certain programs of nongovernmental organizations in developing countries. This help is carried out through debt exchange transactions that will reduce the host countries' debt and obtain a favorable rate of exchange for foreign assistance funds provided to nongovernmental organizations.

local assets with dollars; and (4) the debt will be purchased at the lowest market price from a reputable financial institution.

World Bank Implementation of Treasury Department Recommendations

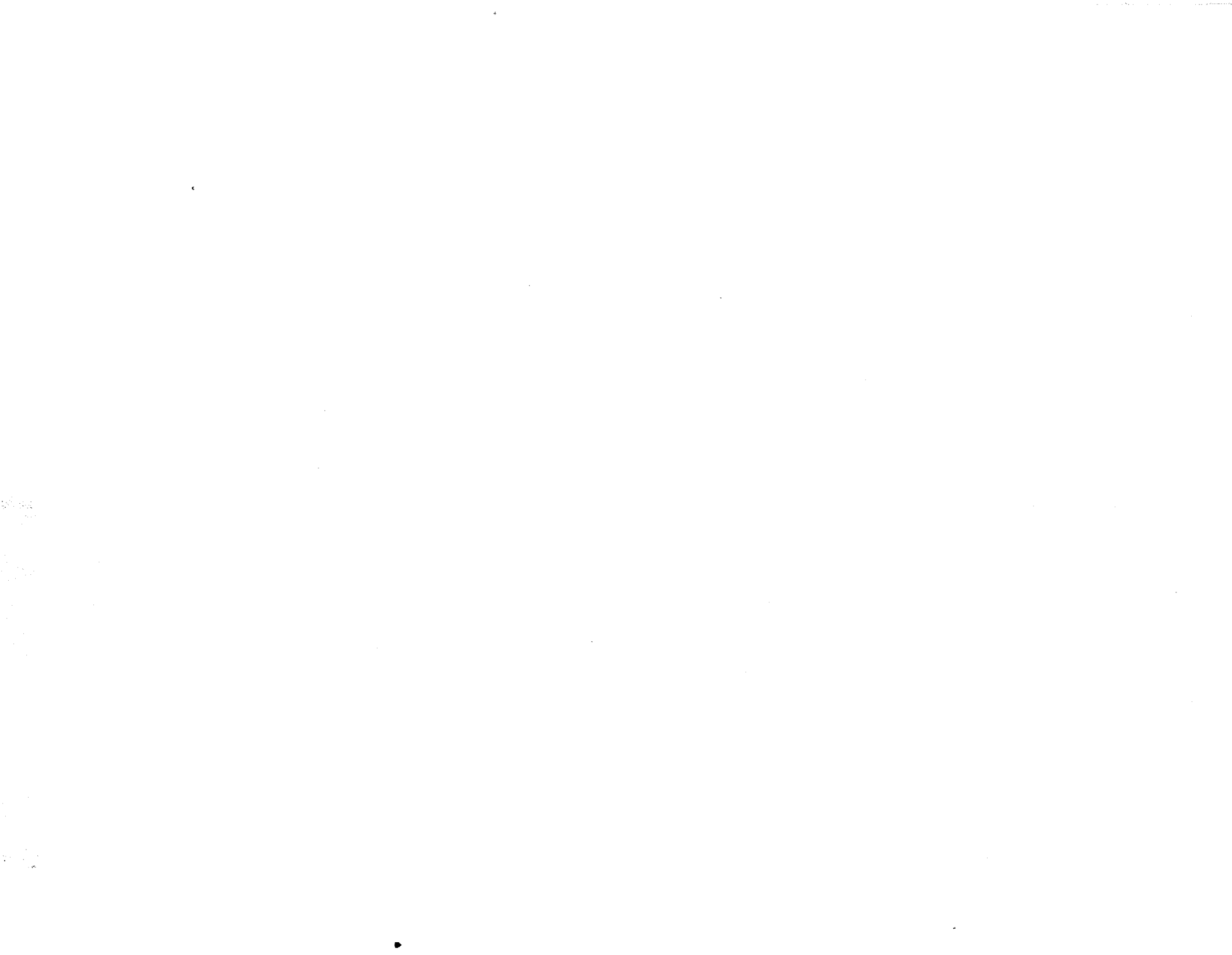
The Foreign Operations, Export Financing and Related Programs Appropriations Act of 1987 (P.L. 100-202) required the Department of the Treasury to undertake an analysis of potential initiatives that multilateral development banks could undertake to enable developing countries to repay portions of their outstanding debt through investments in tropical forests, wetlands, and other conservation-related activities. While the Treasury's report was directed toward all multilateral development banks, it made specific recommendations to the World Bank designed to encourage participation in environmental debt swaps. The report recommended that the bank (1) help developing countries establish priorities for conservation and environmental projects; (2) piggyback debt-for-nature swaps on new bank loans; (3) serve as a clearing house to facilitate PVO and commercial bank debt swap activities; (4) help borrowers develop incentives for sustainable resource management through structural adjustment and sector loans; and (5) establish a debt-for-nature pilot program in countries interested in implementing a debt swap.

According to a Treasury report, the World Bank reacted positively to the Treasury's recommendations and had acted on four of Treasury's five recommendations. The Treasury report points out, for example, that the World Bank has been helping its borrowers prioritize conservation and environmental projects by developing coherent environmental strategy plans, issue papers, and action plans. The Bank has also piggybacked one of its loans with a debt swap financed by AID and the World Wildlife Foundation in Madagascar. It has also attempted to link more of its structural adjustment loans to environmental objectives. However, since borrowers have not demonstrated much interest in debt-for-nature swaps, the Bank has rarely been an agent for debts swaps.

The Bank has not established pilot debt swap programs with borrowing countries because it does not believe the financial benefits are sufficient to merit involvement and it does not believe there is great interest in swaps among its borrowers. However, countries such as Brazil, Mexico, and Poland have shown interest in participating in debt swaps over the last several months.

**Other Multilateral
Development Bank
Involvement in Debt
Swaps**

Other multilateral development banks have shown interest in debt swaps. For example, the Inter-American Development Bank plans to open a facility supporting such swaps and has announced plans to help Mexico purchase up to \$100 million of its debt in a swap to fund tree planting in Mexico City. African Development Bank officials are interested in becoming active participants in debt swaps but do not currently have the resources to do so. The Asian Development Bank has expressed interest in swaps but has not participated in any to date.



Ordering Information

The first copy of each GAO report is free. Additional copies are \$2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

**U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20877**

Orders may also be placed by calling (202) 275-6241.

United States
General Accounting Office
Washington, D.C. 20548
Official Business
Penalty for Private Use \$300

First-Class Mail
Postage & Fees Paid
GAO
Permit No. G100