Debt-for-development Exchanges: The Origins of a Financial Technique

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Abstract

Debt-for-development exchanges grew out of debt-equity exchanges and now include debt-for-nature, debt-for-education and debt2health exchanges, among other variants. The history of the evolution of this idea sheds considerable light upon the the technique and allows a more nuanced appreciation of it.

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I. INTRODUCTION

The beginning was in the early 1980s. And in the beginning were bad loans, and from the loins of these bad loans sprang debt-equity exchanges, which quickly begat debt-for-nature exchanges, and then debt-for-education exchanges, and most recently, debt-for-health exchanges. And today, when all the begatting has been done, the progeny are known mostly as debt-for-development exchanges, or

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sometimes as debt-for-investment projects (by those who wish to suggest for the technique a more commercial focus).[1]

This article is an analysis of the begatting – an examination of how a technique evolved to direct funds that would otherwise have serviced foreign indebtedness into financing development efforts in debtor nations.

Debt-for-development exchanges matter. In 2005 the United Nations urged developed nations to seek a 'durable solution to the debt problems of developing countries', and further noted that 'such mechanisms may include debt for sustainable development swaps,'[2] and in 2007 the European Network on Debt and Development noted that 'debt-swaps have a real and growing presence on the political agendas of donor countries.'[3]

So it is worth understanding where these techniques came from, and how they evolved. Indeed, it is the history of the evolution of the idea that explains the technique's quaint title. For, as my wife pointed out,

> Where is the exchange when a rich country offers to cancel some of its loans to a poor country, if the poor country spends money on a development project? That's like our saying to our daughter, 'You don't have to repay the advance we gave you last week, provided you spend half of it next week'.

The history explains all this. Not the shopping proclivities of young women, the author is insufficiently erudite to do that, but the title and evolution of a significant financial technique.

But first we must begin, and in the beginning bad loans were needed, loans that traded at a discount to their face value. For without a discount there is no reason to undertake debt-for-equity exchanges, and debt-for-development exchanges, while certainly still worthwhile without a source of discounted debt, certainly lose some of their attraction.

Sadly, bad loans are rarely in short supply; and oceans of bad loans became available in late 1982. In mid-August, 1982 Mexico announced the suspension of principal payments on its foreign debt and the debt crisis began.[4] Shortly afterwards, Brazil, Argentina and other Latin American nations announced they

[1] R.P. Buckley & A. Small, *Leveraging Australia's Debt Relief to the Philippines Using Debt-for-Investment Projects*, 7 Macquarie Law Journal (2007), 107.

[2] United Nations General Assembly, *Draft Resolution referred to the High-level Plenary Meeting of the General Assembly by the General Assembly at its fifty-ninth session: 2005 World Summit Outcome*, 15 September 2005.

[3] Marta Ruiz, *Debt Swaps for Development: Creative Solution or Smoke Screen?*, (European Network on Debt and Development, October 2007), p.4, available at <http://www.eurodad.org>, accessed at 12 December 2008.

[4] Darrel Delamaide, *Debt Shock* (London: Weidenfeld & Nicholson, 1984), p.6.

required substantial additional funding to avoid defaulting on their debts.[5] Commercial banks stopped virtually all lending to the region and, within 15 months, 27 countries had rescheduled their debt or were in the process of doing so.[6] More were to follow.

The traditional sources of foreign capital for Latin America before 1970 were bonds, direct investment, official loans and supplier's credits.[7] Thus each wave of defaults was not a crisis for the international financial system as the losses fell upon a broad range of individual investors and suppliers, not on a relatively small number of banks.[8] The development of the United States ('US') in the nineteenth century was mainly financed by issuing bonds, principally to European non-bank investors,[9] and the defaults, of which there were plenty,[10] therefore did not threaten the financial system.

In the early 1970s, aided by the development of syndicated loans, the major commercial banks began to lend to Latin America. The lenders were now banks, not investors in bonds or projects or exports to the region.[11] For the first time in history the major thrust of development finance was commercial bank lending.[12] The pace of lending accelerated throughout the decade. The total external debt of the seventeen highly indebted countries[13] in 1975 was US$76.6 billion.[14] This doubled by 1979, and doubled again by 1982, to a total of US$276.5 billion.[15]

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[5] Allegra C. Biggs, *Nibbling away at the debt crisis: debt-for-nature swaps,* 10 Annual Review of Banking Law (1991), 436; and E. Webb, *Debt for nature swaps: The past, the present and some possibilities for the future*, 11 Environmental and Planning Law Journal (1994), 222.

[6] Philip A, Wellons, *Passing the Buck – Banks, Government and Third World Debt* (Boston: Harvard Business School Press, 1987), p.255.

[7] Richard A. Debs, David L. Roberts & Eli M. Remolona, *Finance for Developing Countries – Alternative Sources of Finance – Debt Swaps* (New York & London: Group of Thirty, 1987) p.10; Marilyn E Skiles, *Latin American International Loan Defaults in the 1930s: Lessons for the 1980s?*, Federal Reserve Bank of New York, Research Paper No 8812, April 1988, 41-2. Stallings notes that suppliers credits only became significant after WWII; see Barbara Stallings, *Banker to the Third World: U.S. Portfolio Investment in Latin America, 1900-1986* (Berkeley and Los Angeles: University of California Press, 1987) pp.109-110.

[8] Frank Griffith Dawson, *The First Latin American Debt Crisis: The City of London and the 1822-1825 Loan Bubble* (New Haven, CT: Yale University Press, 1990) at 237; Delamaide (1984), *supra* note 4, p.49.

[9] Delamaide (1984), *supra* note 4, p.49; and Cleona Lewis, *America's Stake in International Investments* (Washington, DC: Brookings Institute, 1938) at pp.17-24, 30, 35, 36-39, 45-48.

[10] Delamaide (1984), *supra* note 4, p.49, and Lewis (1983), *supra* note 9, pp.25-6, 35 &45-6.

[11] Barry Eichengreen & Richard Portes, "After the Deluge: Default, Negotiation, and Readjustment during the Interwar Years", ch 2 in Eichengreen & Lindert (eds), *The International Debt Crisis in historical Perspective* (Cambridge, Mass: The MIT Press, 1989) pp.40-1.

[12] Debs, Roberts & Remolona (1987), *supra* note 7, p.10; and Delamaide (1984), *supra* note 4, p.49.

[13] Argentina, Bolivia, Brazil, Chile, Columbia, Costa Rica, Cote d'Ivoire, Ecuador, Jamaica, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela & Yugoslavia.

Certainly, when Mexico's inability to service its debt triggered the debt crisis, there was an abundance of bad loans to be used in debt exchanges. However, to facilitate the process there needed to be a market upon which entities interested in initiating debt-for-development exchanges could acquire the debt.

II. THE SECONDARY MARKET IN DISCOUNTED DEBT

A form of secondary market for the discounted debt of less developed countries and their corporations had 'existed on a relatively small scale since well before the onset of the crisis in 1982'.[16] But the secondary market really began to grow after 1982.[17] I have written at length elsewhere about the development of this secondary market.[18]

The market began as a swap market in which a US bank with one or two loans to Poland in its portfolio might swap them with a German bank for some Latin American loans that the German bank no longer wanted. Each bank was refocusing its portfolio on regions of the world it knew best, or, at least, to which it had sizable exposures. After some months, some brave and wise bankers began to actually sell loans, and absorb the losses. In the words of Lee Buchheit,

Fortunate indeed are those bankers who in 1983 sold off their Argentine exposure at a 15 or 20% discount although, at the time, this was accompanied by a good deal of hand-wringing, tooth-gnashing and piteous wailing about the cruelty of international lending.[19]

This secondary market provided the source of funds that were soon to be used in debt-equity exchanges and debt-for-nature exchanges.

III. DEBT-EQUITY EXCHANGES

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[14] The World Bank, *Developing Country Debt – Implementing a Consensus* (Washington, DC: The World Bank, 1987) p.26.

[15] Jeffrey D. Sachs, "Introduction" in Jeffrey D Sachs (ed), *Developing Country Debt and the World Economy* (Chicago: University of Chicago Press, 1989), p.9. For Instance, the net liabilities of Argentina, Brazil and Mexico to developed country international banks increased from $56.6 billion in December 1979 to $104.5 billion in December 1981; and almost as many net loans were made to the major debtors in 1981 and 1982 as the entire period from 1973 to 1979.

[16] United Nations Centre on Transnational Corporations, *Debt Equity Conversions – A Guide for Decision-makers*, (New York: United Nations, 1990) ("UNCTC").

[17] *Ibid*.

[18] R.P. Buckley, *Emerging Markets Debt – An Analysis of the Secondary Market* (Kluwer, London, 1999) pp.1-330; and R.P. Buckley, *A Force for Globalisation: Emerging Markets Debt Trading from 1994 to 1999*, 30 Fordham International Law Journal (2007), 185-259.

[19] Lee C. Buchheit, 'Return of the Living Debt', *IFLR*, (May 1990), 28.

Debt-equity agreements involve the sale of external debt by an investor to the debtor government in return for a discounted amount of local currency which must then be invested in shares in, or otherwise injected as capital into, a local company.[20] Their attraction for investors and debtor nations is that the secondary market discount is "recaptured" and divided between them. In effect a debt-equity exchange results in some debt relief for the debtor nation, and a preferential exchange rate for the foreign investor.[21] In exchange for this preference there are usually limitations. Often eligible investment is limited to certain industries and has to meet certain requirements and there are usually limitations on the repatriation of capital and the remittance of dividends. Furthermore, many countries nominate only a portion of their outstanding indebtedness as being eligible for conversion into equity.

In a typical scheme the central bank of the debtor nation announces that the debt can be swapped at a certain rate for equity in local businesses or used for capital investments in the debtor nation. The rate of exchange of debt-for-equity may be set by the central bank (for instance, the central bank may stipulate that it will retain 12 cents on the dollar so that, for every dollar tendered, the investor receives local currency to the value of 88 cents). Alternatively, the rate may be set by an auction so that investors bid for the right to convert debt into equity and those willing to accept the largest discounts receive the right to convert their debt.[22] For instance, in 1986 Nissan acquired some US$60 million of Mexican government debt on the secondary market at a price of US$40 million. It then resold the debt to the Mexican central bank for US$54 million in pesos for investment into its Mexican subsidiary. As a result some US$60 million in Mexican government debt was cancelled and Nissan was able to inject some US$54 million of equity into its Mexican operation for a cost of US$40 million.[23] In other words, as a result of this debt-equity exchange Nissan received a preferential exchange rate some 35% better than the market rate.

In summary, debt-equity schemes can increase investment and permit debtor nations to recapture part of the secondary market discount in the value of their loans at the cost of conferring a preferential exchange rate upon foreign investors.

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[20] Paris Club, *Debt Swap Reporting: Rules and Principles* (2006), available at <www.clubdeparis.org/en/public_debt.html>, accessed at 12 January 2009.

[21] Debs, Robertson & Remolona (1987), *supra* note 7, p.23. For an analysis of the preferential exchange rate involved in debt-equity swaps, see George Anayiotos & Jamie De Pinies, *The Secondary Market and the International Debt Problem*, 18 World Development 12 (1990), 1657.

[22] For two contemporaneous accounts of debt-equity schemes, see Martin W. Schubert, *Trading Debt for Equity*, The Banker, February 1987; and Martin W. Schubert, *Third World Debt as a Trading and Investment Tool*, Countertrade & Barter, April/May, 1987, 38.

[23] Eric N. Berg, "U.S. Banks Swap Latin Debt", The New York Times, 11 September 1986; Steven Freeland, *Turning to a Trusted Friend: Using Debt Exchanges for Environmental and Development Purposes*, Australian International Law Journal (2001), 105.

Chile was the first country to implement a formal debt-equity swap programme in 1985, which, in time, proved to be perhaps the most successful debt-equity scheme of all. Within the first three years, Chile reduced its external debt by some US$3.8 billion, or 19 per cent.[24] Chile's ability to operate the debt-swap program consistently over a prolonged period encouraged foreign investment in addition to that which otherwise would have been made. Strict limitations on the repatriation of principal and the remission of dividends abroad restricted the drain on Chile's foreign exchange reserves and, perhaps most importantly, Chile's economy had a remarkable capacity to absorb credit without leading to inflation. These factors allowed the program to be opened to local investors which promoted its acceptance by the Chilean people.[25] Despite its apparent success it had been suggested that the rapid decline in foreign direct investment (FDI) that occurred upon the scheme's termination resulted from market saturation and the inferior quality of remaining investment opportunities.[26]

Mexico's debt-equity scheme commenced in April 1986 and had retired US$3 billion of Mexico's US$107 billion foreign debt when it was suspended in November 1987.[27] It had to be suspended for the scheme was highly inflationary. Rather than issuing bonds, as Chile had done, Mexico printed pesos, which led to inflation. The exchange rate afforded to inbound investments by the scheme was highly preferential and the scheme, in the main, only supported investments that would have been made anyway (as will virtually always be the case in schemes of short duration due to the long lead times of international investment decisions).[28]

The popularity of debt-equity schemes was further enhanced in this period by the liberalization of US banking regulations. US banks had been limited to holding 20 per cent of the equity in any nonfinancial company. Regulation K was amended by the Federal Reserve Board in August 1987 to permit 100 per cent ownership of nonfinancial companies in the 33 most heavily indebted less developed countries provided the companies were state-owned and the

[24] R.P. Buckley, *Debt Exchanges Revisited: Lessons from Latin America for Eastern Europe*, Northwestern Journal of International Law and Business (1998), 666.
[25] *Ibid.*
[26] *Ibid.*
[27] Melanie Tammen, *Energizing Third World Economies: The Role of Debt-Equity Swaps* (The Heritage Foundation:1989), p.7.
[28] *Ibid.*

acquisitions were from the government[29] – a change enacted specifically to promote debt-equity privatizations.[30]
Debt-equity exchanges have also had their vociferous critics. In the words of Rudiger Dornbusch,

Washington has been obscene in advocating debt-equity swaps and in insisting that they be part of the debt strategy. The U.S. Treasury has made this dogma, and the IMF and the World Bank, against their staff's professional advice and judgment, have simply caved in.[31]

The principal objections of the critics have been the extent to which debt-equity schemes proved to be inflationary, and, because these inflationary consequences meant most schemes couldn't be maintained for more than about 18 consecutive months, the failure of the schemes to encourage additional investment. The short tenors of most schemes meant that a preferential exchange rate was, in effect, granted to inbound investment that was going to come into the country anyway. The potential for such an exchange rate to encourage genuinely additional investment was lost due to the relatively long lead times for foreign investment and the relatively short periods nations could afford to operate these schemes before inflationary pressures became so extreme the scheme had to be shut down. As we will consider below, debt-for-development exchanges do not suffer from these weaknesses: they don't tend to be inflationary, and as their goal is not to generate additional investment, if they are not run consistently this doesn't have any particular downside.

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[29] 12 CFR section 211.5(f). See also Eduardo C. G. de Faria, J. Andrew Scott & Nigel J. C. Buchanan, *PW/Euromoney Debt-Equity Swap Guide* (London: Euromoney Publications PLC, 1988) Ch 2, "U.S. Legal Considerations"; Lee C Buchheit, *The Capitalization of Sovereign Debt: An Introduction*, University of Illinois Law Review (1988), 410; and Lee C Buchheit, "Banking Regulation: Federal Reserve Liberalises Foreign Investment Rules for US Banks", [1987] 3 JIBL N-111 to N-113.
[30] With their potential for reducing both the debt burden on a country and the perceived inefficiencies of state-owned enterprises. See also David Spencer, *Regulation K Allows 100 Percent Ownership*, IFLR (October 1987), 13-14, citing the Federal Reserve Board's commentary on the amendment. For an example of a conversion which took advantage of this liberalised regulatory environment, see OCC Unpublished Interpretative Letter of Feb 27, 1989 from the Comptroller of the Currency to the President, Miami National Bank, NA, (Ref 12 USC 29a, 12 USC 24(7)) -- the Comptroller approved a transaction in which the named bank proposed to exchange its Argentine debt for Honduran debt and then swap the Honduran debt for local currency with which to acquire 100% of the common stock in a Honduran steel foundry.
[31] Rudiger Dornbusch, "Panel Discussion on Latin American Adjustment: The Record and Next Steps" in John Williamson (ed), *Latin American Adjustment: How Much Has Happened?* (Washington, DC: Institute for International Economics, 1990), p.324.

IV. DEBT-FOR-NATURE EXCHANGES

The idea of debt-for-nature exchanges was first proposed in 1984, and debt-equity schemes had shown the way. In the words of one market participant, 'the ideas for debt-for-nature didn't really get off the ground until debt-equity programs had been launched…Really these programs can be viewed as son-of-debt-equity'.[32]

The idea of utilising debt swaps for environmental purposes, in the model of a debt-for-equity exchange, is generally credited to Dr Thomas Lovejoy. In 1984, when Vice-President of the World Wildlife Fund, Dr Lovejoy suggested that creditors should give discounts to debtor nations who were investing in environmental protection.[33] He urged environmental NGOs to finance conservation through the use of the debt-swap model, by investing in discounted debt on the secondary market.[34] Two broad forms of debt-for-nature exchanges have developed. In the first form a nation's debts are purchased and offered to it for cancellation in exchange principally for its ongoing protection of a designated part of its land. In the second form of debt-for-nature exchanges, the debt is exchanged for local currency which is then used by local conservation groups (often in association with international conservation groups) for various environmental projects in the debtor country.

An example of a debt-for-nature exchange involving commercial debt purchased on the secondary market, is the first debt-for-nature exchange, in July 1987, in which Conservation International (a US conservation group) purchased about $650,000 face value of Bolivian debt for $100,000. Under an agreement previously reached with the Bolivian government, the external debt was cancelled in exchange for two commitments: (i) the protection by legislation of some 1.2 million acres of biosphere reserve and regional park and some 2.8 million acres of adjoining forest reserve as a buffer zone, and (ii) the establishment of an operational fund in local currency to the equivalent of $250,000 or the ongoing management and protection of the biosphere reserve.[35]

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32 Randall Curtis, Director of Costa Rica's debt-for-nature program for the Nature Conservancy, quoted in *The Debt-for-Nature Option*, 2 Swaps – The Newsletter of New Financial Institutions 11 (November 1988), 1.

33 See Thomas E. Lovejoy, "Aid Debtor Nations's Ecology", New York Times, October 4, 1984, at A31.

34 Freeland (2001), *supra* note 23. The World Wildlife Fund participated in its first commercial debt-for-nature swap with Ecuador in 1987, see Conservation Finance, "Debt-for-nature Swaps", available at: <www.worldwildlife.org/what/howwedoit/conservationfinance/debtfornatureswaps.html> accessed 15 December 2008.

35 M. Chamberlin, M. Gruson & P. Weltchek, *Sovereign Debt Exchanges* University of Illinois Law Review (1988), 443-445.

Early projects in which environmental NGOs engaged in swapping debt-for-nature encouraged the proliferation of debt exchange mechanisms using bilateral official debt and agreements negotiated directly between governments. The first government-to-government exchange was in 1989 between the Netherlands and Costa Rica.[36] The advent of government debt exchanges opened up a far wider pool of resources for use in debt exchanges.[37] It did however raise a plethora of additional concerns, including issues of compliance and enforceability, and brought to the fore the political dimension surrounding the implementation of such projects. The debt-for-nature exchange between the Netherlands and Costa Rica was the first debt exchange agreement to incorporate compliance provisions. Both nations had to approve the conservation agreement and were able to inspect the accounts of ongoing projects. Additionally, both nations were able to suspend funding on any project the progress of which they did not approve.[38]

The largest debt-for-nature exchange to date occurred in Poland, through the creation of the EcoFund in 1992. In 1991 the Paris Club agreed to forgive 50% of Poland's US$32 billion dollar debt, which had become unsustainable.[39] The Paris Club also authorised an additional debt reduction of 10% from other creditors.[40] Six countries restructured debt agreements with Poland, with the interest paid into the EcoFund for purposes of environmental preservation. In total US$473 million in local currency was invested in the fund. The US was the largest contributor, contributing US$367 million for EcoFund projects.[41]

The circumstances generating such large debt concessions were a desire to support reforms taking place in post-communist Poland, with Western governments taking strong interest in its transition.[42] The EcoFund provides grants to approved conservation projects. Projects approved have been in the areas of transboundary air pollution, climate change, biological diversity and the Baltic Sea.[43] Between 1992 and 2007 the EcoFund has financed 1,500 programs.

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[36] Jenifer A. Loughrey, *The Tropical Forest Conservation Act of 1998: Can the United States really protect the world's resources? The need for a binding international treaty convention on forests*, 14 Emory International Law Review (Spring 2000), 325.
[37] Freeland (2001), *supra* note 23, 123.
[38] Amanda Lewis, *The evolving process of swapping debt for nature*, 10 Colorado Journal of International Environmental Law and Policy 2 (1999), 442.
[39] The Paris Club is the name for the standing group of 19 governments with large claims on other governments.
[40] Organisation for Economic Co-operation and Development (OECD), *Swapping Debt for Environment: The Polish EcoFund*, (March 1998), 8, available at: <www.cbd.int/doc/external/oecd/oecd-poland-1998-en.pdf> accessed at 11 February 2009.
[41] Pervaze A. Sheikh, *CRS Report for Congress: Debt-for-nature Initiatives and the Tropical Forest Conservation Act*, (11 October 2006), CRS-5, available at: <www.au.af.mil/au/awc/awcgate/crs/rl31286.pdf> accessed 20 January 2009.
[42] Freeland (2001), *supra* note 23, 126.
[43] OECD (1998), *supra* note 40, 5.

All financing agreements were arranged for annual payments until the year 2010.[44]

Debt-for-nature exchanges of bilateral debt between governments have been supported in the US through legislative initiatives. The first legislation to enable bilateral debt to be swapped for conservation projects was the *Enterprise for the Americas Initiative Act* ('EAI') in 1990. The EAI allowed Latin American and Caribbean countries to reduce the level of bilateral debt owed to the US and then re-directed a proportion of debt repayments into a fund to support local environmental programs.[45] By 1993 the US had signed agreements with seven nations, with US$875 million of debt forgiven and the local currency equivalent of US$154 million used in funds for environmental purposes.[46]

Modelled on the EAI, the *Tropical Forest Conservation Act* (TFCA) of 1998 extended eligibility for debt-for-nature exchanges past Latin American and Caribbean nations in the field of tropical forest conservation. It empowered the President to authorise debt reductions, debt-buy-backs and debt-for-natures exchanges. For example, the Philippines and the US signed a debt-for-nature agreement in September 2002 in which the US agreed to cancel US$5.5 million of Filipino debt. In return the Philippine Government agreed to fund tropical conservation activities through local NGOs in the Philippines.[47] The Philippines agreed to apply in local currency the amount it would save in debt service repayments over the next 14 years to conservation activities over that period.[48] To date thirteen TFCA agreements have been conducted in twelve countries, which will generate more than US$163 million for tropical forest conservation.[49] A fourteenth pact with Peru was announced in late 2008 with an agreement to redirect US$25 million of Peru's debt into local funds to protect rainforests. With the execution of this agreement Peru will become the largest beneficiary of

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[44] Environmental Technologies Action Plan, *Polish EcoFund Offers Template for Eco-innovation funding*, available at: <http://ec/europa.eu/environment/etap/inaction/funcations/New/-Services/22_en.html>, accessed at 11 February 2009.

[45] United States Agency for International Development (USAID), *Innovative Financing for Forest Conservation and the Environment: Tropical Forest Conservation Act (TFCA), Enterprise for the America's Initiative (EAI)*, available at: <www.usaid.gov/our_work/environment/foresty/tfca.html>, accessed at 15 December 2008.

[46] Freeland (2001), *supra* note 23, 134.

[47] US Department of the Treasury Office of Public Affairs, Fact Sheet: US-Philippines debt-Reduction Agreement Under the Tropical Conservation Act (TFCA), (19 September 2002) available at < http://usinfo.org/wf-archive/2002/020920/epf509.htm> at 14 May 2009.

[48] *Ibid.*

[49] Bangladesh, El Salvador, Belize, Peru, the Philippines, Panama, Colombia, Jamaica, Paraguay, Guatemala, Botswana, and Costa Rica.

initiatives under this Act, with more than US$35 million generated for conservation projects.[50]

The US has not been alone in pursuing debt-for-nature agreements. In 2004 Germany and Indonesia entered into a debt-for-environment agreement under which some US$29.25 million of debt was cancelled.[51] Indonesia and Germany have hinted at the possibility of further debt-exchange agreements to curtail the effects of climate change and limit the level of deforestation.[52]

V. *DEBT-FOR-EDUCATION EXCHANGES*

Some three years after the early debt-for-nature exchanges, it was realised that the promotion of education could replace nature conservancy as the purpose of the exchange. Debt-for-education exchanges are another application of the basic principle that the acquisition of debt and its tender to the debtor nation for discharge can, by virtue of the debt's secondary market discount, magnify the purchasing power of hard currency for local currency.[53] Indeed, in the first debt-for-education exchange, Harvard University multiplied its purchasing power almost three times.[54]

In 1990 Harvard University and Ecuador entered into a debt-for-education agreement. Pursuant to the agreement, Harvard acquired $5 million of Ecuadorian debt in the secondary market and exchanged these loans with the Central Bank of Ecuador for 50 percent[55] of their face value in local currency bonds. As Harvard acquired the loans at a price of 15.5 percent of face value their total investment was $775,000.[56] The bonds were transferred to a local Ecuadorian educational foundation, formed for the purpose. This foundation sold the bonds in Ecuador and used the proceeds to purchase US dollars in the local market. The proceeds

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50 Daniel Gorellick, "United States, Peru Announce Debt-for-Nature Agreement", America.gov, 21 October 2008.

51 Embassy of the Republic of Indonesia, *Indonesian – Germany Bilateral Relations*, (3 June 2006), available at: <www.indonesia-embassy.de/en/about_indonesia/bilateral_relations.htm> accessed 8 December 2008.

52 Tony Hotland, "RI-Germany eye cooperation around renewable energy sources", The Jakarta Post, 28 February 2008, 3.

53 The discount in the secondary market is of the essence of all of these debt exchanges as noted, with respect to debt-for-nature swaps, by Facundo Gómes Minujín in *Debt-for-Nature Swaps – A financial mechanism to reduce debt and preserve the environment*, 21 Environment and Policy Law (1991), 147-148.

54 Jennifer F. Zaiser, *Swapping Debt for Education: Harvard and Ecuador Provide a Model for Relief*,12 Boston College Third World Law Journal (1992), 157.

55 The Ecuadorian government drove a hard bargain here, recapturing 50% of the loans value. The reason to insist upon such favorable terms was probably to minimise the inflationary impact of the local currency bonds which had to be issued to "repurchase" the debt.

56 Zaiser (1992), *supra* note 54, 180-181.

amounted to some $2 million, or almost three times Harvard's initial contribution. These funds, now owned by the local foundation, were invested in the US. The investments were designed to realise about $150,000 per annum of which about 85 percent was used to fund scholarships for Ecuadorian students to attend Harvard and the balance was to fund local costs for research and study in Ecuador by Harvard faculty and students.[57]

Since then Germany has undertaken three debt-for-education exchanges with Indonesia and one with Pakistan, and Spain has undertaknen debt-for-education exchanges with Ecuador (US$50 million), Nicaragua ($38.9 million), Honduras ($138.3 million), El Salvador (10 million), Bolivia (72 million) and Peru (US$11 million and 6 million euro). France has entered into exchanges to benefit education with Cameroon, Mauritania, Tanzania, Nicaragua and Uruguay. In most of these exchanges, the proceeds have been directed to funding local schools in the debtor nation. The Harvard model described above has proven to be highly unusual and not generally copied in later exchanges, although in one of the French exchanges a centre for scientific research and education was funded in the debtor nation.[58]

After the acceptance of debt-for-nature and debt-for-education exchanges, it was more than a decade before the application of the technique was extended again, this time to health.

VI. *DEBT-FOR-HEALTH EXCHANGES*

The adoption of the Millennium Development Goals in 2000 created a greater awareness of the need to foster development in impoverished nations, and of the importance of population health to this process.[59] Indeed, health epidemics threaten progress on all other development goals.[60] The Declaration of Commitment on AIDS/HIV was adopted in June 2001 by all UN member states. It holds that 'the HIV/AIDs challenge cannot be met without new, additional and sustained resources.' Importantly for our purposes, the Declaration supported

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[57] Ibid 182-183.

[58] UNESCO, Working Group on the Debt Swaps for Education, *Draft Report for the Director-General of UNESCO*, (August 21, 2007), available at: <www.unesco.org/education/EFAWGSDE/WGDSE_2nd_draftreportforDG_en.pdf> ,accessed 21 January 2009. See also UNESCO, *Education for All, Final Report of the First Meeting of the UNESCO Working Group on Debt swaps for education,* (2006) available at: <http://unesdoc.unesco.org/images/0015/00153714e.pdf>, accessed 21 January 2009.

[59] For more, see United Nation, *UN Millennium Development Goals* ('MDGs') <www.un.org/millenniumgoals>, accessed at 28 November 2006.

[60] Sydney Rosen, Jonathon Simon, Donald Thea & Paul Zeitz, *Exchanging Debt-for-Health in Africa: Lessons from Ten Years of Debt-for-Development Goals'*, (Harvard Institute of International Development, November 1999), p.5.

‘debt swaps for projects aimed at the prevention, care and treatment of HIV/AIDs.’[61] Debt exchange programs to generate funding to address HIV/AIDS and other serious epidemics have been vigorously promoted by the UN, in part for the potential to create publicity ‘of the need to join forces in the fight against the HIV/AIDS epidemic’ and in the hope that this publicity would lead to further private donations;[62] and, in part as simply another way to generate funds to tackle the HIV epidemic.

The Global Fund to fight AIDS, Tuberculosis and Malaria, is another UN initiative. It is a public-private partnership which seeks to finance public health initiatives in developing countries.[63] The Global Fund currently finances two-thirds of all international investments in fighting malaria and tuberculosis and provides more than 20% of world-wide funding for AIDS prevention.[64] In 2007 it launched its Debt2Heath initiative, a debt exchange program to fight HIV/AIDS, tuberculosis and malaria. The Global Fund proposed itself as a third party in debt exchange negotiations which seek to persuade creditor nations to forgo payment of sovereign debts if the debtor nation pays a portion of the amount owed in local currency to the Global Fund. Debt2Health is the first time debt-for-development exchanges have been organised through ‘triangular arrangements’ involving a multilateral organisation. The Global Fund has adopted debt exchange techniques to diversify its resource base and free up domestic resources. The Global Fund’s commitment is that all funds generated by debt exchanges will go towards financing grants, and none will be subsumed in administrative costs.[65]

A two-year pilot phase was announced in 2007, with Indonesia, Kenya, Pakistan and Peru eligible to participate.[66] Germany was the first donor participant in the program and committed to cancel EUR 50 million of its debt from Indonesia if Indonesia invested EUR 25 million in the Global Fund over a five- year period from 2008. Germany further agreed to make available a total of EUR 200 million for debt-for-health exchanges under the initiative by 2010. The first instalment was paid by Indonesia in June 2008.[67] The payments to the Global

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[61] UNAIDS, *Debt-for-AIDS: UNAIDS Policy Brief* (Geneva: UNAIDS, 2004), p.7.

[62] *Ibid*, p.19.

[63] The Global Fund has a Memorandum of Understanding with UNAIDS, which has been renewed annually since 2003. Memorandum of Understanding UNAIDS and The Global Fund, available at: <www.hivpolicy.org/Library/HPP000216.pdf>, accessed 29 January 2009.

[64] The Global Fund to fight Aids, Tuberculosis and Malaria, *Debt2Health: Innovative Financing of the Global Fund*, p.6, available at: <www.theglobalfund.org/documents/publications/other/D2H/Debt2Health.pdf>, accessed February 2, 2009.

[65] *Ibid,* pp.7-12

[66] The Global Fund to fight Aids, Tuberculosis and Malaria, *Q&A Debt2Health*, available at: <www.theglobalfund.org/documents/innovativefinancing/FAQ_d2h_en.pdf>, accessed February 2, 2009.

[67] Aditya Suharmoko, “RI pursuing debt-swap mechanism”, The Jakarta Post, 24 June 2008, 14.

Fund are equal to and in lieu of the periodic interest payments that would otherwise have been due to Germany, which avoids any adverse impact on the Indonesian budget.[68]

Thus far the only other agreement to be signed under the Debt2Health initiative has been between Germany and Pakistan in November 2008. Germany agreed to cancel EUR 40 million in debt under an agreement by which Pakistan agrees to invest EUR 20 million with the Global Fund. Annual payments of EUR 5 million will be made by Pakistan, commencing in 2009.[69]

In 2007 the then Labour Opposition made a policy commitment to, if elected, enter into a A$75 million debt exchange with Indonesia through the Debt2Health initiative stating it 'is time for Australia to join other progressive aid donors.'[70] The commitment to the debt exchange has been sustained by the Rudd government now it has assumed office, with assurances the exchange will be undertaken later in 2009.[71] If implemented, the debt exchange will see A$37.5 million invested by Indonesia in the Global Fund in return for A$75 million of debt being cancelled by Australia.[72]

This range of debt-for-development exchanges has a number of benefits.

VII. ADVANTAGES OF DEBT-FOR-DEVELOPMENT EXCHANGES

This financial technique has at least four benefits:

1. Debt-for-development exchanges promote debt reduction. Debt reduction is critically important for many developing countries. In 2005, the G-8 nations resolved that the IMF, the concessional lending arm of the World Bank and the African Development Fund should totally cancel all of their debts to poor countries that comply with the requirements of the World Bank's debt relief program, the Heavily Indebted Poor Countries initiative. This resolution became known as the MDRI, the Multilateral Debt Reduction Initiative. This total cancellation of debt will certainly assist those nations that receive it, but only 24

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68 The Global Fund, *supra* note 64, p.12.

69 The Global Fund to fight Aids, Tuberculosis and Malaria, *German Financial Co-operation with Pakistan*, (November 30, 2008), available at: <www.thegloablfund/documents/innovativefinancing/DE-PK.pdf>, accessed 2 February 2009.

70 Bob McMullan, Media Release, Labor Will Swap Indonesia's Debt for Health, 6 June 2007.

71 Commonwealth, *Parliamentary Debates*, House of Representatives, 26 August 2008, 6250 (Stephen Smith, Minister for Foreign Affairs).

72 Jubilee Australia states that this contribution 'could fund village and district level support for at least 106,128 HIV tests, the provision of AIDs treatments for over 3,000 people and the purchase of 23,000 TB treatments';Jubilee Australia, *Debt-for-Development Swap with Indonesia*, (Jubilee Australia Policy Paper, April 2007), p. 15.

nations currently qualify for such total debt cancellation, and only a further 17 can potentially become eligible in the future.[73]

Yet many nations not nearly poor enough to qualify for such relief labour under stultifying debt overhangs. For instance in 2007 Indonesia's total external debt stood at US$137.4 billion, which was 31.7% of GDP, and represented 104.5% of total exports.[74] In 2008 the Philippines total external debt was US$53.5 billion which represented 33.4% of GDP.[75] Debt-for-development exchanges offer debt relief to debt-constrained nations such as these which are not eligible for relief under HIPC initiatives.

2. Debt-for-development exchanges can be attractive to donor countries. Exchanges give donor countries considerable control over how the debtor country will spend the funds it, and the debtor country no longer has to commit to debt servicing. Well structured exchanges can also promote transparency and accountability in the ways that the savings generated by debt relief are applied.

3. Debt-for-development exchanges camouflage debt relief for donor countries. Debt relief is often a politically sensitive topic in donor countries. For instance, the announcement by the Australian government of the Debt2Health exchange with Indonesia was greeted with nary an adverse comment in the Australian media. Yet if the Australian government had announced the straight cancellation of A$75 million of debt owed by Indonesia one would anticipate considerable adverse comment in the media, and perhaps the radio 'shock-jocks' picking up on the development and arguing that here is another A$75 million that Indonesia can now use to buy arms to use, one day, against Australia (as utterly unlikely as such a development is in geo-strategic terms). The delivery of the debt relief as part of a debt-for-health exchange camouflaged it, and insured it against such a reception. Exchanges make debt relief more politically palatable for donor country governments.

4. Debt-for-development exchanges allow creditors to advance ends that serve the creditor as well as the debtor. For instance, Indonesia and the Philippines are both on the flight paths of migratory birds to Australia, and both have conditions ripe for the development of an Avian influenza transmissible to, and spreadable by, humans. Accordingly, if Australia were to enter into debt-for-development

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[73] International Monetary Fund, *A Factsheet: Multilateral Debt Relief Initiative*, (Jan 2009,) available at: <www.imf.org/external/np/exr/facts/mdri.htm>, accessed 10 December 2008.

[74] See International Monetary Fund, *Country Report No, 08/299*, (September 2008), available at: <www.imf.org/external/pubs/ft/scr/2008/cr08299.pdf>, accessed January 21 2009.

[75] *Philippines Quarterly Economic Update – January 2009*, Report for the World Bank, available at: <http://siteresources.worldbank.org/INTPHILIPPINES/Resources/PhilippinesQuarterlyEconomicUpdateWorldBankJanuary2009asofJan23.pdf>, accessed 15 December 2008.

exchanges with Indonesia and the Philippines to fund Avian influenza mitigation efforts in those nations, this would benefit both donor and recipient countries.[76]

VIII. DISADVANTAGES OF DEBT-FOR-DEVELOPMENT EXCHANGES

Debt-for-development exchanges have few downsides.

It is arguable that they entail a loss of sovereignty for the debtor nation if the debt relief was going to be granted anyway by a donor country, as the exchange simply gives to the donor country a degree of control over how the saved funds will be expended that it would not otherwise have had. However, this overlooks the fact that simple bilateral debt relief outside the HIPC or MDRI frameworks is not common, and debt-for-development exchanges surely encourage many more instances of debt relief than they provide control over the proceeds of cancellations that would have occurred anyway.

It is also arguable that exchanges may be used to get rid of illegitimate or odious debt.

Illegitimate debt is debt lent for irresponsible purposes, typically to promote industries in the creditor, not the debtor, nation. The best example of debt being treated as illegitimate is to be found in the decision in 2006 by Norway to cancel US$ 80 million of its loans to a number of developing countries, which loans had been extended to fund the purchase of vessels built in Norway. The debt was cancelled in recognition that the loans were made by Norway to promote employment in its ship-building industry, not responsibly to aid the debtor nation's development.[77]

Odious debt is much a narrower concept than illegitimacy. The idea is that sovereign debt is odious if (1) it is incurred for a purpose does not benefit the people of the debtor nation, and (2) it is incurred without the consent of the people. The reasoning is that "This debt is not an obligation for the nation; it is a regime's debt, a personal debt of the power that has incurred it, and consequently it falls with the fall of this power."[78] The concept is that it is appropriate for a people to have to repay loans incurred by a dictator without their consent if the

[76] Buckley & Small (2007), *supra* note 1, 107.

[77] Ruiz (2007), *supra* note 3, p.9. *Norway makes ground-breaking decision to cancel illegitimate debt*,(European Network on Debt & Development, October 3, 2006) available at:<www.eurodad.org/whatsnew/articles.aspx?id=302>, accessed 13 May 2009. (includes text of official Norwegian government press release, in English).

[78] M. Kremer & S. Jayachandran, *IMF Seminar: Odious Debt (*2002), 3-4, available at: **<www.imf.org/external/np/res/seminars/2002/poverty/mksj.pdf>,** accessed 17 February 2005.

loans were used to build hospitals or public infrastructure but not if the funds were used for purposes that don't benefit the people.[79]

If a donor government is choosing debt to offer up for use in an exchange it may be likely to offer first for exchange debt which may be illegitimate or odious. This is natural – most governments will take an opportunity to bury past actions which may have about them a certain odour. This causes NGOs such as the Jubilee Network to seek audits for all debt offered for use in exchanges to ensure illegitimate or odious debt is not used in exchanges.[80] Clearly it is preferable for illegitimate or odious debt to be cancelled outright because it is illegitimate or odious. However, if this is unlikely, and as Norway is the only nation to step up to the plate so far in this regard it does seem unlikely, the issue for international civil society is whether, given the crushing debt overhang in many poorer nations, it is better simply to support all exchanges that result in the reduction of debt and the application of funds to worthwhile developmental programs, without insisting on the somewhat idealistic requirement that debt used in these exchanges be audited to ensure it is free from any taints whatsoever.

Apart from these two issues, there seems to be few other grounds upon which objection to these exchanges is possible. Certainly the major criticism levelled at debt-equity schemes, that they are highly inflationary, doesn't apply to debt-for-development schemes as they have, perhaps sadly, never been operated at a scale sufficient to impact a nation's money supply.

IX. *SCALE OF DEBT-FOR-DEVELOPMENT EXCHANGES*

The scale of debt-for-development exchanges has far eclipsed the debt-for-nature exchanges out of which they grew. It was estimated that from 1987 to 1994 between US$ 750 million and US$ 1 billion face value of foreign debt was cancelled in debt-for-development exchanges[81] with UNICEF alone converting nearly US$ 193 million of debt-for-development.[82] In the same period, a total of

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[79] R. Rajam 'Odious or just Malodorous?'(2004) December *Finance and Development* 54, at 54-5; P. Adams, *Iraq's Odious Debts* Cato Institute Policy Analysis N0. 526 (2004), at 2; M. Kremer and S. Jayachandran, Id, at 3-4.

[80] See, for example, Jubilee USA, *Recent Developments on Odious and Illegitimate Debt*, (April 2008), available at: <www.jubileeusa.org/?id=111>.

[81] J. Kaiser & A. Lambert, *Debt Swaps for Sustainable Development A Practical Gude for NGO's* 14 (ICUN,1996). Much of the debt converted in debt-for-development swaps was official bilateral debt (i.e. loans made by developed nations to the LDCs) and was donated for the purpose by the developed nations. For instance, in 1994 Canada forgave 75% of the C$ 22.7 million of Peru's official bilateral debt and converted the balance for development purposes. Similar arrangements were entered into between Finland and Peru (1995), Germany and Peru (1994), Switzerland and Bulgaria (1995) and the United States and the Philippines (1995): *Id* at 8.

[82] *Ibid* 16.

about US$ 177 million of foreign debt was converted in debt-for-nature exchanges.[83] Since the mid-1990s the volume of debt exchanges has continued to grow. By 2003 the value of debt-for-nature exchanges was estimated to have reached over US$1 billion.[84] In 2007 Fundaciõn SES, Latindadd and the Organization of Iberoamerican States estimated that US$5.7 billion had been cancelled in debt-for-development exchanges, with some US$3.6 billion having, as a result, been invested to enhance development.[85]

X. CONCLUSION

This article has traced the birth and evolution of an idea. The precursor idea, of swapping debt-for-equity, is not new. In the 1880s, Peru crafted a resolution of its indebtedness in one, novel, massive debt-equity exchange: British bonds were exchanged for stock in Peruvian Corp., the owner of the state railways, lands and mining concessions.[86] Exchanging debt for equity is also often used by banks to resolve domestic corporate defaults.

However, it was the swapping of external debt for equity in national companies which gave commentators the idea of swapping external debt for nature conservancy efforts, and showed how the discount on the debt in the secondary market multiplied the buying power of the funds available for the task. A truly innovative idea was thereby born.

Debt-for-development exchanges have made only a tiny dent in the overall indebtedness of developing nations; sadly the debt burdens are too large for that. However to measure their effect on debt levels is to miss the important roles they have played. Some desperately poor nations, such as Bolivia, have been able to reduce their overall debt burden substantially and preserve some of their ravaged environment, through debt-for-nature exchanges using donated funds. Costa Rica received funding for conservation efforts where none would otherwise have been available. Villages in Peru, the Sudan and elsewhere have drinking water and villages in Indonesia, Pakistan, Nicaragua, and many other countries have schools because of debt-for-development exchanges. Most recently, these techniques have

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83 *Ibid* 12-13.

84 Romy Greiner & Allyson Lankeste, *Debt-for-conservation swaps: a possible financial incentive for on-farm biodiversity conservation,* Paper presented at the 50th Annual conference of the Australian Agricultural and Resource Economics Society, Sydney 7-10 February 2006, available at <http://www.riverconsulting.com.au/reports/Greiner_Lankester_AARES-2006.pdf>, accessed 21 February 2009.

85 Working Group on Debt Swaps for Education (2007), *supra* note 58, 5.

86 Carlos Marichal, *A Century of Debt Crises in Latin America* (Princeton, NJ: Princeton University Press, 1989); Werner Baer & Kent Hargis, *Forms of External Capital and Economic Development in Latin America: 1820-1997*, 25 World Development 11 (Nov 1997), 1805-1820.

begun to serve as a source of additional funds with which to fight the scourges of HIV/AIDS, malaria and tuberculosis.

Debt-for-development exchanges have made a significant contribution to date to development programs. The debt burden on developing countries has severely curtailed spending on health, education and other social programs and the need to raise exports to service the debt has often damaged the environment in those countries. Debt-for-development exchanges have been important because they have gone some small way to redressing these damaging social and environmental impacts of external debt.

As the current Global Financial Crisis will impact poorer nations more harshly than richer ones, and as the consequences will be felt for longer in poorer, and thus less resilient, economies, debt-for-development exchanges have an even more important role to play now in seeking to offset some of the impacts of the Global Financial Crisis. The export revenues of poorer nations are falling, in some cases precipitately, as commodity prices weaken and global trade flows contract. Most developing countries do not have freely convertible currencies and raise external capital in foreign currency, so debt service needs to be funded from export revenues. Contracting export revenues will thus intensify the burden on these nations of servicing their existing external debt. In addition, debt-for-development exchanges offer funding for development projects that will be more needed than ever, in this context of decreasing export income. Creditor governments would be well advised to make greater use of debt-for-development exchanges in the coming years as measures to reduce the impact of the global financial crisis upon poorer and more vulnerable nations.

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12 CFR section 211.5(f).