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Linking Debt Relief and Sustainable Development: Lessons from Experience

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Linking Debt Relief and Sustainable Development: Lessons from Experience

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Abbreviations

APG	All Party Parliamentary Group on Overseas Development
CIDSE	Coopération Internationale pour le Développement et la Solidarité
CRF	Caribbean Resilience Fund
CSO	civil society organisation
DCI	debt-for-climate initiative
DFI	Development Finance International
DSSI	Debt Service Suspension Initiative
ECLAC	Economic Commission for Latin America and the Caribbean
G20	Group of 20
G-24	Group of 24 on International Monetary Affairs and Development
GCE	Global Campaign for Education in Spain
HIPC	heavily indebted poor countries
IDA	International Development Association
IEG	World Bank Independent Evaluation Group
IEO	IMF Independent Evaluation Office
IIF	Institute of International Finance
IMF	International Monetary Fund
MDRI	Multilateral Debt Relief Initiative
NGO	non-governmental organisation
NPV	net present value

ODA	overseas development assistance
ODG	Observatorio de la Deuda en la Globalizacion
OECD	Organisation for Economic Co-operation and Development
OED	World Bank Operations Evaluation Department
PRSP	Poverty Reduction Strategy Paper
SeyCCAT	Seychelles Conservation and Climate Adaptation Trust
TFCA	Tropical Forests Conservation Act
UN	United Nations
UNDP	United Nations Development Programme
UNESCO	United Nations Educational, Scientific and Cultural Organization

Abstract

The Covid-19 crisis has dealt a blow to developing-country economies, which were already facing rapidly rising debt burdens, calling into question their ability to scale-up climate investments. As the international community considers a menu of options to address the rising prospect of widespread debt distress and defaults in the developing world, it will be crucial that it weighs how such options can best contribute towards addressing the equally urgent climate crisis. Having that need in mind, the current paper examines the experience with debt-for-development swaps and major debt relief processes in order to draw some lessons that could help shape a debt-for-climate initiative (DCI). It concludes that, in order to significantly expand the fiscal space and create the incentives for investing in climate change adaptation and mitigation, a DCI would have to be a transaction capable of combining debt cancellation and swaps in creative ways. It also makes some recommendations to ensure the scheme reaps the benefits that swaps and debt relief have proven they can bring, while avoiding some of their identified shortcomings.

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Executive Summary

The imperative of responding to the global challenge of climate change calls for scaling-up investments in climate change adaptation and mitigation. At a time when the ability of developing countries to make such investments was already in doubt due to rapidly rising debt burdens, the Covid-19 crisis has dealt a blow to their economies.

As the international community considers a menu of options to address the rising prospect of widespread debt distress and defaults in the developing world, it will be crucial that it weighs how such options can best contribute towards addressing the equally urgent climate crisis. Having that need in mind, the current paper examines the experience with debt-for-development swaps and major debt relief processes in order to draw some lessons that could help shape a debt-for-climate initiative (DCI).

In order to significantly expand the fiscal space and create the incentives for investing in climate change adaptation and mitigation, a DCI would have to be a transaction capable of combining debt cancellation and swaps in creative ways. Since the experience with swaps shows that their contribution to debt sustainability has been marginal at best, the transaction will need to include a meaningful debt cancellation component. The swap component could add to the foreign exchange savings inherent to plain debt relief those derived from the conversion to domestic debt, which some recipients may be in a position to also frontload.

In order to make scale and relevance feasible in the current landscape of creditors, the DCI would need to adopt a comprehensive approach involving bilateral, multilateral, and private creditors under principles of broad and fair burden-sharing. The DCI should take a programmatic approach to establish the climate link, requiring beneficiary countries to implement a comprehensive climate plan. This plan should be developed in participatory, transparent, and accountable processes, draw upon existing national climate and development strategies where these exist, and seek to address the interlinkages with poverty, inequality, and job creation. The plan could include policy actions as well. Monitoring and evaluation should rely on homegrown processes and institutions, complemented by a commitment to have periodic reviews in a multilateral forum involving creditors and debtors. Though most likely the Bretton Woods Institutions will be central to the management of such an initiative, it would be desirable to also involve an international organisation with a climate mandate in a deciding role. Economic policy conditionalities should be kept to a minimum, have broad social acceptance in the debtor country, and exclude any form of tied aid.

To improve chances of long-term debt sustainability, the initiative should rely on debt limits and improved fiscal and debt management, but it could also add active components on promoting state-contingent loans and a requirement that comprehensive climate plans address economic diversification.

Bolivian farmer in her quinoa field



Linking Debt Relief and Sustainable Development: Lessons from Experience

The imperative of responding to the global challenge of climate change calls for scaling-up investments in climate change adaptation and mitigation. Seventy per cent of the projected investment needs on sustainable infrastructure will be required in emerging market and developing countries, with countries other than China accounting for most of the increase (Bhattacharya et al., 2016).

At a time when the ability of developing countries to make such investments was already in doubt due to rapidly rising debt burdens (World Bank, 2019), the Covid-19 crisis has triggered a global economic crisis and dealt a blow to their economies. Developing countries – whose health, economic, and social protection systems are the least prepared to cope with such a crisis – are being disproportionately affected. Some economists project that nearly 40% of sovereign debt in emerging and developing economies could be at risk of default in the next year.

Amidst emerging recognition that a growing number of developing countries will be unable to meet debt payments, debt relief and restructuring proposals have been gaining new momentum, including some steps taken by the Group of 20 (G20) and the International Monetary Fund (IMF). Debt swaps and debt cancellation are among the proposals that different actors have put on the table to respond to the current crisis (UN, 2020a, 2020b; UN Secretary-General, 2020).

As the international community considers options to address the rising prospect of debt distress and defaults in the developing world, it will be crucial that it weighs how such options can best contribute towards addressing the equally urgent climate crisis.

The current paper examines the experience with debt-for-development swaps, the Heavily Indebted Poor Countries (HIPC) Initiative and its expansion, the Multilateral Debt Relief Initiative (MDRI), in order to draw some lessons that could help shape a debt-for-climate initiative (DCI). The first section provides a general background and history on debt swaps and refers to some recent proposals. Section 2, which is based on a review of the literature, assesses the benefits and limitations of debt swaps and extracts some lessons for improving any future initiative. Section 3 discusses and extracts lessons from relevant aspects of the HIPC Initiative and the MDRI. The last section offers conclusions and recommendations to take into account in a DCI.

1 Introduction to Debt Swaps, History, and Recent Proposals

A debt swap is a financing modality or mechanism for development purposes. A debt swap (or conversion) is defined as the cancellation of (part of the) external debt of a country in exchange for the debtor government's commitment to mobilise domestic resources (local currency or bonds, also known as «counterpart funds») for an agreed purpose on agreed terms (OECD, 2007). The terms «debt swap», «conversion», and «exchange» are often used interchangeably. The amount of funding mobilised will depend on three factors (Ingelmo, 2005):

- 1) The nominal value of the debt to be forgiven;
- 2) The conversion rate (also called «discount» rate), that is, what percentage of the nominal value of the cancelled debt claim is to be mobilised by the donor as counterpart funds; and
- 3) The disbursement modalities, that is, what is the schedule for the debtor to mobilise the counterpart local currency funds.

Debt swaps can be bilateral or triangular. In a bilateral debt swap, the creditor cancels debt owed by the debtor government in exchange for the debtor government setting aside an agreed amount of counterpart funds in local currency for an agreed purpose. This model is used mostly in official (government-to-government) debt swaps (OECD, 2007). In a third-party (trilateral/multilateral) swap, on the other hand, a third party (e.g. a non-governmental organisation, NGO) solicits debt donations or purchases debt from a creditor in a secondary market – at a discount from face value – and negotiates separately with the debtor government the cancellation of the debt in exchange for project funding (OECD, 2007).

Debt swaps can also be for a specific project or for a counterpart fund that is created to receive and disburse the funds in projects according to agreed-upon guidelines that the creditor and debtor negotiate (Ugarteche, 2004).

The swap of debt in exchange for various debtor commitments has been actively practiced since the late 1980s (UNESCO, 2011). The initial debt swaps were debt-for-equity conversions and strongly linked to privatisation programmes. In these transactions, debt was swapped for public assets in countries such as Chile – swapping 70% of its commercial debt in 1985 – as well as Argentina, Mexico, and the Philippines during the 1980s and 1990s (Griffith-Jones, 1992; Moye, 2001).

The debt-for-development swaps are inspired by the experience with debt-for-equity swaps. The first debt-for-development swap was a debt-for-nature swap that took place in 1987, when US-based Conservation International exchanged debt with the Bolivian government for its commitments to protect a biosphere reserve and establish a supporting fund in local currency (Buckley, 2011). Since then, debt swaps have been structured to support, in addition to nature, a variety of other purposes, such as health, education, child development, among others (Cassimon et al., 2009a).

In a development that helped to propel debt swaps, they were integrated as an option in Paris Club provisions, initially under the Houston terms (1990). These terms suffered some modifications in the Naples terms (1995) and Cologne terms (1999).

According to Paris Club rules, all overseas development assistance (ODA) debts (see Annex 1) are eligible for debt swaps, whereas non-ODA debt, for example claims stemming from trade credits, is subject to certain restrictions. Debtor countries are permitted to convert up to 20% of their non-ODA debt within the debt-swap framework. Such countries also have the alternative to opt for a sum of approximately US\$20–40 million. There are nominal ceilings in effect for creditors holding small amounts of debt. One alternative for them is to opt for that US\$20–40 million ceiling (Paris Club, 2020a, 2020b, 2020c, 2020d).

These upper limits are designed to ensure that creditors are able to maintain their claims and that all creditors accord equal treatment to their debtors. They also serve to minimise moral-hazard behaviours on the part of debtors and to safeguard solidarity among creditors (Berensmann, 2007).

As a means of ensuring a high level of inter-creditor transparency, both creditors and debtors are required to report regularly to the Paris Club on transactions conducted in the framework of debt-swap operations (Paris Club 2020a, 2020b, 2020c, 2020d).

The most comprehensive survey of debt-for-development swaps found during this review was carried out by Serrani and Filmus (2009), who identify 128 such swaps for a nominal amount of US\$6.1 billion that have been converted into US\$3.3 billion since the beginning of the practice in the 1980s. Of those, 51 cases were debt-for-nature swaps, for a total nominal amount of US\$2.6 billion, which was converted into US\$1.3 billion.

After a first wave of debt swaps, at the end of the 1990s their relevance declined in the context of adoption of the much more comprehensive Heavily Indebted Poor Countries initiative, which would later be expanded in the MDRI (see Section 3). Other reasons given for this decline were the appreciation of debt titles of developing countries in secondary markets, making commercial debt swaps less attractive as an option for NGOs (Cassimon et al., 2011; UNDP, 2017), and the end of the Brady plan (Sheikh, 2018).

In the 2000s, traditional debt-for-development swap proposals re-emerged both in the analytical agenda and in practice, although the form undeniably had far greater ambition than the latter ultimately yielded. This second wave of initiatives was especially relevant in the context of countries and/or debt titles that fell outside of those more comprehensive international debt efforts. Thus, they tended to target lower middle-income countries (such as Indonesia and El Salvador), or non-HIPC, low-income countries (such as Pakistan), non-eligible debt (such as the debt remaining after the HIPC Initiative and the MDRI), or recalcitrant creditors within existing debt relief initiatives (Cassimon et al. 2008, 2011).

Debt swaps: Activity and proposals in the last decade

Recent reports concur that swap activity significantly declined after 2010 (Ito et al., 2018; Sheikh, 2018). One possible reason for this that the literature identifies is that creditor countries, such as the United States, the EU, and Japan, suffered from the global financial crisis and could no longer afford debt relief practices, including debt swaps for development (Ito et al., 2018; Sheikh, 2018).

Among the very few recent experiences, The Nature Conservancy, in 2016, conducted a debt-for-nature restructuring with the government of Seychelles and its Paris Club creditors that was designed to help the government redirect a portion of its debt payments towards marine conservation and climate adaptation (Weary, 2016). For this swap, the NGO bought debt owed mostly to the United Kingdom, France, Belgium, and Italy at a discount, mobilised about US\$15 million in impact investment, and then raised a further US\$5 million from philanthropic donors to lower the interest rate on the government's outstanding loan. The government repays The Nature Conservancy loans into a specially created independent trust – the Seychelles Conservation and Climate Adaptation Trust (SeyCCAT) – which will use the proceeds to fund marine conservation and climate adaptation programmes over the next 20 years (Gerretsen, 2020). The Nature Conservancy believes this strategy can be replicated in other countries, and at the moment it is discussing possible similar deals with eight countries and hoping to have closed another two (one in the Caribbean and one in Africa) by the end of the year (World Ocean Initiative, 2020). The Seychelles deal represents an innovation in more than one respect: It is the first debt-for-nature swap to mobilise impact investing and finance climate adaptation (Gilbert, 2016; the first to address marine conservation; and the first to contain a government policy commitment in that regard – the government commits to protecting 30% of its seas (World Ocean Initiative, 2020).

The US conducted two debt-for-nature swaps (2011 and 2014) with Indonesia under the Tropical Forests Conservation Act (TFCA) programme (Sheikh, 2018). One of these was a more than US\$20 million transaction reported as part of its contribution to the Fast Start Finance pledges under REDD+ (Watson et al., 2014). The swap directed resources to forest conservation programmes in Indonesia (Watson et al., 2014). In 2013, the United

States also carried out the biggest swap ever under the TFCA, with the Philippines, in the amount of near US\$32 million (Sheikh, 2018).

Although actual activity has declined, there have been a number of proposals that are more ambitious than previous swaps. Since 2010, the Commonwealth Secretariat has been advocating a debt swap for a climate change adaptation and mitigation proposal (Mitchell, 2016). The proposal calls for donors to use pledged climate funds to finance a gradual write-down of 100% of the small states' multilateral debt stock held by various multilateral institutions. This would be contingent on debtors agreeing to make an annual payment to a trust fund in an amount equal to their existing multilateral concessional debt service payments, and in local currency. The payments would be made over a period of 10–15 years (or a period prior to the maturity of the existing debt) and used to finance climate change adaptation and mitigation projects (Mitchell, 2015). Based on data from 2012 – and depending on the preferred eligibility criteria to apply – the initiative would have an estimated total cost ranging between US\$4.5 million and US\$4.5 billion (Mitchell, 2015).

The Economic Commission for Latin America and the Caribbean (ECLAC) has been advocating a Debt for Climate Adaptation Swap Initiative for small island Caribbean states. This proposal envisions the creation of a Caribbean Resilience Fund (CRF) to attract large-scale funding to build Caribbean resilience through adaptation- and mitigation-related sustainable infrastructure and other projects (McLean et al., 2020). The CRF would be housed within a credible subregional financial institution (McLean et al., 2020). One of its sources of funds would be debt swaps, with the beneficiaries making their debt repayments (preferably in local currency) with the CRF. ECLAC also suggests that, for countries with high levels of debt from official creditors, the Green Climate Fund would be requested to purchase multilateral and bilateral debt owed at a negotiated discount; for countries with high levels of debt from private creditors, a debt buyback scheme would be utilised, as well as debt-for-equity swaps (ECLAC, 2019). Three pilot countries in the Caribbean have expressed their readiness to participate: Antigua and Barbuda, Saint Lucia, and Saint Vincent and the Grenadines (McLean et al., 2020).

Stiglitz and Rashid (2020) recently proposed a multilateral initiative to buy back sovereign bonds of developing countries and facilitate their restructuring in more lenient terms, thus avoiding costly holdout and coordination problems. In exchange, debtors could agree to use the savings from bond buy-backs to finance not only public health expenditures but also contribute towards minimising climate risks, with money invested in climate change mitigation and adaptation.^[1]

1 For a critique of this proposal, see Sundaram and Chowdhury (2020).

2 Debt Swaps Experience and Lessons Learnt

This section reviews the literature commenting on the experience with debt-for-nature swaps – and other debt-for-development swaps – in order to draw upon some lessons learnt. Unless otherwise noted, «swaps» in this section refers to «debt-for-development» swaps.

2.1 Financial considerations

Volume of debt exchanged

There is general agreement that swaps carried out so far have been for amounts too small to provide any meaningful relief to the respective debtors (Cassimon et al., 2009a, 2009b; Ruiz, 2007). According to Cassimon et al. (2009a), «[D]ebt swaps are deemed too small, in comparison with the overall debt burden of countries suffering from debt overhang, to make a real dent.» Assessing the 11 swaps Indonesia carried out, he finds that, altogether, they had relieved Indonesia of just a tiny fraction of its total external public debt (Cassimon et al., 2013).

The fact that the addition of all swaps carried out since the beginning of the practice barely surpasses US\$6 billion (Serrani and Filmus, 2009) is illustrative of its limitations, especially when compared with the amounts of debt involved in the HIPC Initiative. One possible exception is the Polish EcoFund, which involved 10% of the debt of Poland at that moment – a conversion of more than half a billion US dollars (see Annex 2). While considering that a German swap in Peru had no significant impact on its debt situation, Berensmann (2007) also finds that debt swaps in Jordan contributed significantly towards reducing the debt burden, representing roughly 10% of the country's external debt.

A related debate is whether a debt swap is only worth pursuing if it meaningfully alleviates the debt burden, or if its other advantages may justify it nonetheless. Serrani and Filmus (2009) recognise that debt swaps cannot be a valid and structural response to the debt problem in developing countries, but they see them as a mechanism to transfer resources to sensitive budget areas that have been traditionally underfinanced. Along similar lines, the Global Campaign for Education in Spain (GCE, 2006) believes that the agreed amounts in the swaps it reviewed can lead to meaningful improvements in social services in developing countries. Sheikh (2018) mentions the example of Ecuador, which reduced its external debt of US\$8.3 billion by only US\$1 million through a debt-for-nature swap, yet it doubled its budget for parks and reserves with money received from the resulting conservation fund. UNESCO (2011) states: «The fact that the swaps [in addition to helping fund education] provide financial relief to over-indebted countries can be viewed as a positive result of – but

not a necessary condition for – using swaps.»^[2] Buckley (2011) believes it is «fatuous» to assert that debt swaps are too small to make a difference in a country's indebtedness position, concluding that «the need to make big steps does not invalidate the contribution of small ones». For instance, in reference to an Australia–Indonesia debt swap, he argues that Indonesia is better off directing the swap amount of A\$37.5 million to the fight against tuberculosis rather than servicing and repaying A\$75million in loans to Australia (Buckley, 2011).

Fiscal space

Regardless of the amount of debt involved, there is an expectation that debt swaps free up fiscal resources that can be allocated to development priorities such as conservation. This expectation is subject to two important qualifications.

First, to assess how much savings a swap will free up, it is important to look beyond the nominal values of the debt being cancelled and the counterpart funds to be mobilised. Usually, the timing of the repayment of the debt to be forgiven would have materialised over a period of years – perhaps decades – whereas the counterpart resources to be mobilised have to be mobilised on a different schedule that may be shorter-term. Therefore, a more accurate picture of the actual fiscal space obtained by the debt swap can be obtained by calculating and comparing the net present value (NPV) of the debt and of the counterpart funds. Especially for concessional debt with long repayment rates, the NPV will be significantly lower than the nominal value (Cassimon et al., 2009a, 2009b).

Thus, a poorly structured debt-for-nature swap, in which annual domestic counterpart payments occur prior to the realisation of savings from debt relief, may worsen the government's fiscal position instead of improving it (Cassimon et al., 2011). For instance, with this analysis, a Spain–El Salvador debt swap for education reduced, rather than enlarged, the fiscal space of the latter. This was because the swap combined a no conversion rate – meaning the full amount of debt had to be mobilised in counterpart funds – and, yet, counterpart fund payments were to be made up front (Cassimon et al., 2009a). Similarly, a German swap with Indonesia dealt with ODA debt claims with a long-term original repayment schedule, so the budgetary gains were much more modest than portrayed by the German donor institutions (Cassimon et al., 2009b). Along similar lines, Berensmann (2007) comments that no calculation of the NPV of the debt had been carried out in the German swaps with Indonesia and Jordan. She concludes that the «partner country would benefit financially from the debt swap only if the burden on its budget due to the local currency requirement were lower than the net present value of the debt set to be cancelled».

2 UNESCO still cautions that the impact of swaps on education will be limited if one sticks to the piecemeal and strictly bilateral approach that had characterised such schemes (UNESCO, 2011), but this appears to be a call to keep in mind the impact on education, rather than the impact on indebtedness.

Moreover, the debtor might need to raise funds in local currency at a higher interest rate, resulting in a higher cost than with foreign currency-denominated debt (Berensmann, 2007). In an environment of limited access to foreign currency, however, local currency funding might still be a sensible option, even in the face of higher interest rates.

Second, it needs to be taken into account whether the expectations that the cancelled debt was going to be repaid were realistic. As put by Cassimon et al. (2009b),

only the share of debt service that would have been actually paid up to the creditor in the absence of debt relief generates real fiscal space, so that debt relief operations that seem very generous at first sight may in effect only bring about minor budgetary gains.

Of course, the analysis of whether debt would have been paid absent the exchange requires relying on a counterfactual, which Cassimon et al. recognise is not easy (Cassimon et al., 2009b).

Impacts on balance of payments

Since the debtor country is usually required to mobilise counterpart funds in domestic currency, debt swaps can have a positive impact on a country's balance of payments by reducing debt service payments in foreign currency (GCE, 2006; UNESCO, 2006). It is worth noting this positive effect may take place even without any gains in the fiscal space:

Even if fiscal space effects are zero or negative, the balance of payment (BOP) situation of the debtor country can be positively impacted by [a switch from foreign to local currency debt], to the extent that the country suffers from severe foreign exchange shortages.

(Cassimon et al., 2009a)

However, these benefits will depend on the extent to which the debtor has a high domestic debt burden, which is a difficulty that can be managed if the payments are scheduled to take place in tranches (Moye, 2001; UNESCO, 2006). Obviously, a debtor that has adopted a hard currency as its own would not get any such benefit, as GCE (2006) mentions in connection to the Ecuador–Spain debt swap. Debtors whose currency is strongly pegged to a hard currency are in a similar position, as is the case for the countries in the CFA franc zone (Moye, 2001).

A potential side-effect that merits consideration is the impact that additional injections of local currency financing could have on inflation (OECD, 2007). Moye's (2001) caution on such an impact, however, is made in light of the experience with debt-for-equity swaps in Latin America. As put by Buckley (2011), debt-for-development swaps «have, perhaps

sadly, never been operated at a scale sufficient to have an impact on a nation's money supply». Kaiser and Lambert (1996) are even more sceptical about the overall argument connecting debt swap-related injections to rises in inflation. Where inflationary impacts are a risk, monetary authorities can take steps to sterilise, reduce, or neutralise monetary expansion (DFI, 2009; Griffith-Jones, 1992).

A proposal by UNESCO's Advisory Panel of Experts on Debt Swaps and Innovative Approaches to Education Financing (Bond, 2012) adds a twist to the local currency financing effects of a swap. The mechanism under this proposal would still start with the creditor cancelling a specific amount of debt, but the debtor country's government – instead of allocating funds from its own tax-financed budget to fund certain social projects – would use the fiscal space generated by the cancellation to issue government bonds (Debt Conversion Development Bonds, as named in the proposal). The revenue raised through these bonds would then be used to fund the agreed-upon priorities (Bond, 2012). A key attraction of the Debt Conversion Development Bonds for the beneficiary country is that they allow the government to frontload funding today by issuing bonds that will be repaid with no added fiscal burden in the future (Bond, 2012). It offers additional benefits in terms of deepening local currency bond markets. But the condition of not adding to the fiscal burden can only be met if the servicing of the bonds is aligned with the fiscal space created by the debt relief. The Advisory Panel acknowledges that one of the conditions for the scheme to work is that the government should already have established its ability to issue long-term debt at reasonable real fixed interest rates³ (Bond, 2012). Since domestic bonds typically will be subject to higher interest rates than foreign currency lending, it is unclear how often this condition can be met in practice – an issue the Advisory Panel does not explore in depth.

Transaction costs

The experience to date shows that debt swaps tend to have high transaction costs (Cassimon et al., 2009b; Ruiz, 2007; UNDP, 2017; Warland and Michaelowa, 2018). Some of the reasons are the relatively small amounts involved (Berensmann, 2007), the multiplication of transaction and management costs inherent to the fragmentation of projects being dealt with separately (Cassimon et al., 2011; Ruiz, 2007), and the time-consuming nature of the negotiations, often taking several years (OECD, 2007).

To some extent, the choice of governance and administration arrangements can help manage transaction costs (see subsection 2.2 on Governance and Administration). Furthermore, scaling-up operations through multi-creditor funds can minimise transaction and negotiation costs and create efficiencies (Cassimon et al., 2009a; Ruiz, 2007; UNESCO,

3 Other conditions also need to be present: sustainable debt and fiscal performance, absorption capacity for the funding, absorption capacity for the new issuance in the bond market, etc. (Bond, 2012).

2011). The ECLAC and Commonwealth proposals previously described offer some ideas on how to do this. Cassimon et al. (2009a) mention the EcoFund and the Debt2Health Conversion Scheme of the Global Fund to Fight AIDS, Tuberculosis and Malaria as inspirations, though noting other drawbacks in the design of these funds.

Regardless of how much can be done to manage transaction costs downward, a sober assessment of transaction costs needs to be part of estimating the benefits of debt swaps in terms of lower debt burdens, the amount of released fiscal space, and impacts on balance of payments.

Additionality

Additionality in debt swaps has been addressed by the literature, both in regards to the creditor and the debtor (Cassimon et al., 2009a, 2011; GCE, 2006; ODG, 2005; UNESCO, 2006). In regards to the creditor, additionality means that, in line with the agreement at the Monterrey Consensus, debt relief should be fully financed by additional resources (para. 46). According to Cassimon et al. (2011), swaps may merely substitute planned government expenditures on conservation, leaving open the possibility of using the savings elsewhere (and not necessarily to the benefit of the environment). There is some empirical evidence to suggest that debt relief, in general, has not been additional to ODA (Panizza, 2008). Cassimon et al. (2013) argue that, since the OECD Development Assistance Committee allows the whole nominal value of debt relief to be counted as ODA – and such value typically overestimates the cost to the creditor – debt swaps are an attractive option for donors to boost ODA figures. In fact, UNESCO (2006) mentions the increase it can provide to its reported ODA as one of the reasons why a creditor may engage in a debt swap.

In regards to the debtor, additionality is present when the development measures financed with the counterpart funds would not have been undertaken if the debt swap were absent (Berensmann, 2007; GCE, 2006).

Admittedly, determining additionality both for the creditor and the debtor requires settling the difficult counterfactual of what would have happened if the debt swap had not taken place. In the case of the debtor, some have suggested measuring education spending against a historical spending baseline (Berensmann, 2007; UNESCO, 2006). In relation to the creditor, Cassimon et al. (2009a) state that persuading donors to undertake debt-for-education swaps above and beyond other aid commitments seems politically difficult under prevailing ODA rules, but it may not be impossible. Furthermore, one advantage of swaps from a political perspective is that they make debt relief more marketable to creditor country constituencies (Buckley, 2011; UNESCO, 2006). The argument that swaps can help additionality in this way may offer a certain potential when it comes to climate.

Aerial view of Belayan River in Indonesia



2.2 Governance and administration

Good governance and an enabling environment in the debtor country are necessary conditions for the success of a debt swap (Fuller et al., 2018). First, there needs to be strong political leadership and support for the swap at the highest levels (Fuller et al., 2018; OECD, 2007). Second, since creditors need to be convinced that the debtor commitments under the swap will last over the time of the swap implementation, the debtor will need to be able to provide certainty and stability in the institutional and policy framework (OECD, 2007). Third, swap negotiations can be complex and time-consuming, so specialised human resources with capacity to engage in such negotiations is extremely important. According to the OECD (2007), development of a credible expenditure programme is of paramount importance to engage the creditor. However, there are multiple cases of swaps in which the expenditure programme was left to be defined by an implementing agency under the oversight of the governance body.

At the same time, the literature notes the potential of swaps to act as the trigger or catalyst for institutional developments. Resor (2005) mentions how in the cases of Ecuador and the Philippines, they helped catalyse new institutions and provided lessons for institutional reforms that can foster participation from diverse sets of stakeholders, ranging from national monetary officials to grassroots community organisations. Fuller et al. (2018) highlight the case of Jamaica in the 1990s. Sheikh (2018) argues that the establishment of laws, programmes, and funds dedicated to conservation that follows debt-for-nature initiatives in debtor countries is generally significant, relative to what the country originally would have spent on conservation. The EcoFund in Poland, which would not have been created without the swap but, once created, became a catalyst for a number of additional multimillion donor grants, is a case in point (OECD, 2007). Moreover, in the case of debt-for-nature swaps, it can help mainstream the environment in the growth agenda of the debtor and raise the status of environmental departments within the government (OECD, 2007). The creation of SeyCCAT as a result of the recent debt swap in Seychelles (Adam, 2020) could be hailed as another example of a swap having institutional impacts and raising the profile of environmental priorities. Kilbane Gockel and Gray (2011) refer to the effect of swaps on strengthening the institutions of civil society in order to implement long-term conservation programmes.

The governance models adopted in debt swaps have been highly idiosyncratic, but a common practice in the case of bilateral debt swaps has been the establishment of a governing body with creditor–debtor representation (sometimes called «Binational», «Dual», or «Oversight» committees). In many cases, there is also some sort of advisory organ with creditor–debtor representation that can make recommendations, sometimes called a «Technical Committee».

Regarding the administration of the counterpart funds, the OECD (2007) believes that accountability to all stakeholders – and shielding from ad hoc political interference – is

crucial for the institution in charge to gain credibility, domestically and internationally. This can be achieved, among other ways, through objective, accountable, transparent, and highly professional operations (OECD, 2007). Showing credibility to stakeholders as well as a demonstrated ability to achieve stated objectives efficiently are also decisive factors in its ability to leverage additional local and foreign financial resources. Experience shows that the best results are achieved when the structure is set up in such a way as to enable all the main parties to be involved in the key decision-making processes – with balanced representation and voting rights, and with effective powers to oversee the implementation of decisions (OECD, 2007). Other studies call for the administration to be located in the head of an independent body that guarantees transparency of the allocation of resources and, generally, with the participation of the parties and civil society organisations (CSOs) that have an active role in the priority sectors that the agreement covers (Ingelmo, 2005; Ugarteche, 2004). The rules of procedure of the managing institution(s) should be defined in order to achieve greater transparency, including investment and financing policies, criteria for eligibility, and the selection of projects (Ingelmo, 2005; Ugarteche, 2004).

For the OECD (2007), there must also be a clear division of responsibilities between the governing body and the executive body, whereby the governing body is held accountable for establishing strategic objectives, the eligibility and appraisal criteria, the «rules of the game», and supervision. The executive body, on the other hand, would be responsible for the implementation of these established rules in the day-to-day operations (OECD, 2007). In particular, this body should be staffed by non-political professionals, carry out the appraisal and selection of projects, and be held strongly accountable for its performance, according to the rules established by the charter and governing body (OECD, 2007).

The literature discusses the pros and cons of embedding the swap administration in the existing systems and structures of recipient countries. According to Cassimon et al. (2009a), system alignment along the whole debt swap process – working with the recipient country’s systems and procedures to the maximum extent possible – is indispensable for long-term capacity-building and the strengthening of the public sector. But studies they reviewed «cast doubt» on how well-aligned recent debt swap initiatives for the education sector have been (Cassimon et al., 2009a). For Cassimon et al. (2008), debt swaps are

an instance of micro-earmarking, [...] [in which] funds are placed in jointly-managed counterpart funds, often outside the government budget, using donor-imposed implementation and monitoring mechanisms that bypass the government’s system of public finance management, procurement rules, implementation procedures, and finally monitoring and evaluation.

GCE (2006) finds potential drawbacks in the practice of appointing an international financial institution to administer the funds, as they could add needless levels of

bureaucracy to the process and allow for some undesirable intrusion on the part of an international lender.

With a more nuanced approach, Vera (2007) considers the two alternatives: placing an international organisation in the role of trustee and manager of the funds, or running the programme through the existing ministerial structures of the country. Though theoretically the second is preferable, in practice the choice will need to depend on country circumstances (Vera, 2007). He recognises that the option of the external manager lacks the benefits mentioned by Cassimon et al. (2009a), can add financial costs (the commission to be charged by the manager), and introduces greater complexity. However, it can have benefits, namely: counting on the capacity of the international organisation in question, and introducing more agility during the project bidding phase (Vera, 2007). Ultimately, Vera does agree that strengthening national management systems so that they can be fit for purpose should be an objective in international cooperation (Vera, 2007). UNESCO (2011), in turn, finds positive outcomes in two swaps, France–Cameroon and Spain–El Salvador, which were run through the respective Ministries of Education. In the former, «the fact that the project was operated by the existing education system which provided much ‘in kind’ support allowed for cost savings» (UNESCO, 2011).

Participation and transparency

The literature on debt swaps highlights the increased participation of civil society as one of their benefits, both for the creditor and the debtor (OECD, 2007; UNESCO, 2006). In practice, there is a wide variety of experiences illustrating whether and how civil society was incorporated into the process. Serrani and Filmus (2009) survey the instances of civil society participation in the 128 debt-for-development swaps covered by their study. They find that in 29 debt swaps – including 7 debt-for-nature swaps – there was some form of representation in the Binational Committees, and 92 for which there was no such representation.^[4] In 77 debt swaps – including 38 debt-for-nature swaps – civil society was represented in the Technical Committees, and in 43 it was not^[5] (Serrani and Filmus, 2009).

An evaluation of swaps in which Spain was the creditor found that the participation of a Spanish CSO was usually envisioned for the Technical Committee but not for the Oversight (Binational) Committee. This modality excluded participation from civil society in negotiations of the agreements and the design of regulations, and from the decision-making (GCE, 2006). Moreover, it only guaranteed participation from Spain’s civil society – it would have to be an organisation with a presence in the debtor country – whereas civil society participation from the debtor was contingent on the decision of that country (GCE, 2006).

4 For the remaining cases, they could not find data.

5 For the remaining cases, they could not find data.

Another study documents different roles that civil society plays in Spanish debt swaps: in Ecuador, monitoring and guaranteeing transparency; in Nicaragua, influencing the general orientation of the swap programme; in Honduras and El Salvador, technical advice (Vera, 2007). Reflecting on these experiences, Vera's study posits that technical advice functions could be left to other agents such as experts and international organisations, and that civil society should focus on monitoring and influencing the decisions on the swap implementation (Vera, 2007). It also contrasts the difference between the process of selecting the Spanish CSO – which relies on the collective of organisations proposing a representative, or a triad of choices from which the government picks one – and the selection of the debtor country civil society representative, which can be a conflictive decision. The regulations of the debt swaps should better spell out the role of CSO representatives, and this should be communicated to them. The study also recommends the organisation of ample collectives including more sectors (e.g. teacher unions and other stakeholders) to allow broader representation (Vera, 2007).

Berensmann (2007) discusses a Germany–Peru debt swap that included civil society in the founding committee that designed the working procedures and goals of the counterpart fund. Two CSOs were also represented in the decision-making body, proposed by the Peruvian government with agreement from the German side. However, instead of accepting the two civil society representatives offered by civil society through their own processes, the Peruvian government nominated a representative from a conference of university rectors for the second slot. She states that more analysis would be needed to ascertain what influence civil society actually had, and whether the university rectors can be said to actually represent civil society in the process (Berensmann, 2007), with another commentator purporting that that was at least questionable (Vera, 2007).

A more expansive view is held by the OECD (2007), which says that the most successful institutions managing counterpart funds usually allow «internal and external stakeholders, such as NGOs, academic institutions, contributing donors, etc.,» to effectively incorporate their interests into the expenditure programme while having all appropriate checks and balances in place. However, examining the Indonesia–US swap experience, Cassimon et al. (2011) caution that too many seats for CSOs could raise questions about national ownership. The structure in question had one representative from the United States and one from Indonesia, respectively, as well as representatives designated by Conservation International and four local Indonesian NGOs (Cassimon et al., 2011).

Vera (2007) criticises that, in the case of Bolivia, the association of municipalities – clearly not a CSO – joined the Technical Committee. Furthermore, the municipal association represented capital cities and, thus, did not really represent involvement of the municipalities that would ultimately implement the projects – which might have made more sense (Miranda, 2020). UNESCO (2011), discussing a Spain–El Salvador debt swap for rural school constructions, offers the suggestion that several stakeholders where schools were built or refurbished should have been involved in discussions at an earlier point in the

process so that they could have taken more responsibility for making the programme a success, while recognising that the dual committee eventually acknowledged this issue and modified the process.

Researchers also address transparency in debt swaps as a condition to ensure effective social participation (GCE, 2006). Progress in the representation of CSOs as well as the posting of information on the internet – including about the conditions to apply for financing from a counterpart fund – were found to help advance such transparency (GCE, 2006; Vera, 2007). Though it would be desirable to have more homogeneity and complete information provided on websites – especially when it comes to the conditions to apply for financing and the projects that have been approved (Vera, 2007).

Another dimension of transparency that the literature addresses has to do with the origin of the debt being swapped. Indeed, as reported by authors, some CSOs have stated the criticism that debt swaps may give a guise of legitimacy to debts that should have been cancelled because they are illegitimate and odious (see Buckley (2011), Kaiser and Lambert (1996), and Ingelmo (2005) for reference to this debate in the context of Argentina). In the words of Kaiser and Lambert (1996):

the legitimacy discussion has undergone considerable refinement. Today research enables organizations which formerly were leaders in the general legitimacy debate to determine very precisely which parts of the overall foreign debt they think are illegitimate. These debts, it is still argued, should be exempted from any conversion – because they should have been cancelled from the outset.

GCE (2006), along similar lines and analysing the policies of the Spanish government, believe that transparency in the origins of the debt should be assessed before determining its eligibility.

Accountability, monitoring, and evaluation

Most debt swaps provide for a periodic (e.g. annual or bi-annual) review of the swap progress, which is centred on financial aspects and usually entrusted to an international financial institution and submitted to the Oversight Committee. The institution should also carry out an ex post evaluation of the projects (GCE, 2006; Vera, 2007).

However, monitoring and evaluation of swaps' intended development outcomes remain blind spots (UNESCO, 2007). For instance, Vera (2007) believes that the evaluations normally provided for in most swap agreements are a necessary but insufficient requirement to assess whether the intended outcomes were achieved, and that an evaluation of the impact of the full debt swap should be carried out, too, which would require a clear definition of baselines and objectives at the beginning. The GCE (2006) believes that financial

performance is too narrow a scope for an audit, which should also include aspects such as transparency, participation, and additionality, and that the audit itself should allow civil society involvement, which was not the case for the swaps it reviewed. Berensmann (2007) sees positive value in the German framework calling for an internationally recognised auditor to audit debt swap projects, and she underscores that the auditor should be independent and not based in the country in question.

Another aspect that an evaluation arguably should cover is the sustainability of the priorities funded with swap resources after it ends. UNESCO (2011) assesses the experience with a France–Cameroon swap, in which additional resources for the education sector were devoted towards expanding the hiring of contract teachers. By the timed end of the swap in 2011, the sustainability of the programme remained an open question:

By increasing the number of contract teachers, the government has created an annual liability for salaries that will be difficult to cut. It does not help that in 2011, education's share of the budget was reduced from over 17% to less than 15%.

(UNESCO, 2011)

A similar situation can be found in a Bolivia–Spain debt-for-education swap. In that case, resources were allocated to capacity-building activities in technological centres that were created in a number of municipalities (Miranda, 2020). Municipalities were engaged from the beginning and, in applying for support, needed to commit to financing some of the additional activities from their own resources. Yet, at the end of the programme, it was unclear whether municipalities would be in a position to sustain the continuation of the additional capacity-building with their own budgets (Miranda, 2020). One way to deal with the uncertainty as to the sustainability of the support after the swap ends is to direct the funding to plug infrastructure or knowledge gaps – that is, beneficial one-off investment – rather than attempt to compensate a government's lack of current spending (Ugarteche, 2004). This lesson has limited applicability in the field of debt-for-nature swaps, in which, almost by definition, sustaining the outcomes over time are a central component of success, but one can envision climate-related investments of this nature, for example a one-off upgrade of an infrastructure asset.

In the case of debt-for-nature swaps, to the limitations of swap evaluations in general, one should add those inherent to conservation work:

The lack of appropriate indicators of conservation success is a problem that extends far beyond [...] debt-for-nature swaps, to the international conservation community. Conservation organizations spend billions of dollars and countless staff hours each year to protect biodiversity, often with unproven results.

(Kilbane Gockel and Gray, 2011)

Sheikh (2018) states that the success of initiatives designed to ensure the long-term funding of the conservation of forests is difficult to measure in a short time-frame. He suggests that a 10-year period at minimum might be needed after the end of the swap.

The concerns surrounding the enforceability of agreements in debt-for-nature swaps was already present in the earliest analyses (Hrynik, 1990; Model, 1991). Sheikh (2018) agrees that three-party debt transactions have historically had weak enforcement mechanisms. In his view, however, bilateral debt transactions, such as those conducted under the Enterprise of the Americas Initiative, generally include safeguards and default provisions to protect the US government from losing funds.

2.3 Ownership and policy coherence

Coherence with existing policies of the debtor

An important discussion in the literature concerns the alignment of debt swaps support with national development and sectoral strategies (Berensmann, 2007; Cassimon et al., 2009a; GCE, 2006), a guideline that the UNESCO Working Group on Debt Swaps for Education has endorsed. According to Fuller et al. (2018), if commitments to mitigation or adaptation activity are anchored in the country's pledges outlined in National Adaptation Plans or Nationally Determined Contributions, there is much greater buy-in and a higher chance of follow-through on pledges.

Cassimon et al. (2009b) and Berensmann (2007) find that two Germany–Indonesia swaps were very well integrated within Indonesia's national development strategies, displaying a considerable degree of policy alignment and country ownership. Examining a Spain–El Salvador swap, Cassimon et al. (2009b) also find a great level of policy alignment, but they note that this is an exception in swaps undertaken by Spain. They also conclude that there is evidence of coherence between the US–Indonesia debt-for-nature swap and the latter's environmental and developmental strategies (Cassimon et al., 2011).

The need to achieve alignment with sectoral strategies underlies calls in the literature for excellent collaboration between the environment and finance ministries (GCE, 2006; Moye, 2001; OECD, 2007).

Coherence with existing policies in the creditor country

Some assessments have discussed the coherence of debt swaps with existing aid policies in the creditor country. Berensmann (2007) states, in relation to German swap experience, that they are well-aligned with German development cooperation if they are implemented either along with or following German financial or technical cooperation programmes. Spain's interventions were found to be aligned with that country's strategy for each respective country (GCE, 2006).

Policy conditionalities and tied aid

The literature discusses concerns with conditionality and the weakening sovereignty of the debtor country, as well as concerns with tied aid. The ODG (2005), for instance, calls for ensuring that no conditionalities are attached to the debt swaps. According to UNESCO (2006), «Many debtor countries prefer debt cancellation over debt-for-development swaps because they view swaps as essentially debt relief with conditionality.» In certain contexts, debt swaps might give the creditor an amount of control over spent funds that it otherwise would not have had (Buckley, 2011). This would have been the case with France's imposition of swaps on debt cancellation that the country had already committed to undertake in the context of the HIPC Initiative (Buckley, 2011). In particular, in the context of debt for education swaps, several studies caution about conditionalities that may affect the role of the state in the sector, such as privatisation (GCE, 2006) or the creation of an «education market» for foreign investors (ODG, 2005). Kaiser and Lambert (1996) warn more generally about the attachment of conditionalities in the context of structural adjustment programmes.

As for tied aid, analysis of Spain's experience reveals that the aid offered in debt swaps continued to be tied to purchases of NGOs or companies from Spain, thus diminishing the efficacy of the swaps (GCE, 2006). A provision tying aid was present in all debt swaps, in spite of government assertions that the instrument would not feature such a practice. An exception was the Spain–El Salvador debt swap, which, after setting tied aid as a rule, exceptionally allowed the Binational Committee to open bidding when advisable in light of the characteristics of the project (GCE, 2006). Vera (2007), with similar findings, notes a trend towards a hardening of these conditions in Spanish agreements. A CSO practitioner notes that tying debt swaps – in cases where their subject was the relief of concessional loans that had been tied when originally provided – would effectively amount to a double tying of aid (Croce, 2020). There is evidence that other creditors, such as Italy and the United States, also tied their debt swaps (Ugarteche, 2004). This same author also finds that Canada and Germany are examples of creditors that did not tie their debt swaps

(Ugarteche, 2004). Discussing Germany, Berensmann (2007) notes the undesirability of tying aid but finds that in Germany–Indonesia swaps, two German companies supplied some of the equipment for the schools involved, with the apparent reason being that comparable Indonesian products were of poorer quality. No German companies were involved in Germany’s swaps in Jordan and Peru (Berensmann, 2007).

Allowing for tied aid was a drawback in Poland’s EcoFund case, Cassimon et al. (2009a) finds. In the same vein, the OECD (2007) provides the example of the first debt-for-environment swap signed by Poland, with Finland as an example of the economic inefficiencies that can emerge with tied procurement. The prices asked by Finnish contractors were so excessive that even after the 20% budgetary subsidy, they were higher than those offered in the market. As a result, in its first year of operations, the Finnish fund was unable to finance any project (OECD, 2007).

Sea Turtle near Sri Lanka



3 Lessons from the HIPC Initiative and the MDRI

The HIPC Initiative was the largest sovereign debt relief initiative on record and represented the first attempt to deal with all debt of eligible countries (bilateral, multilateral, and private) in a comprehensive manner. It was also the first one to include a reduction in the debt owed to multilateral institutions (OED, 2003). The HIPC Initiative was launched in 1996 and its terms revised in 1999 (Enhanced HIPC Initiative). In 2005, the HIPC Initiative was supplemented by the MDRI, which allowed for 100% relief on eligible debts by three multilateral institutions – the IMF, the World Bank, and the African Development Fund – for countries completing the HIPC Initiative process. In 2007, the Inter-American Development Bank also decided to provide additional («beyond HIPC») debt relief to the five HIPCs in the Western Hemisphere.

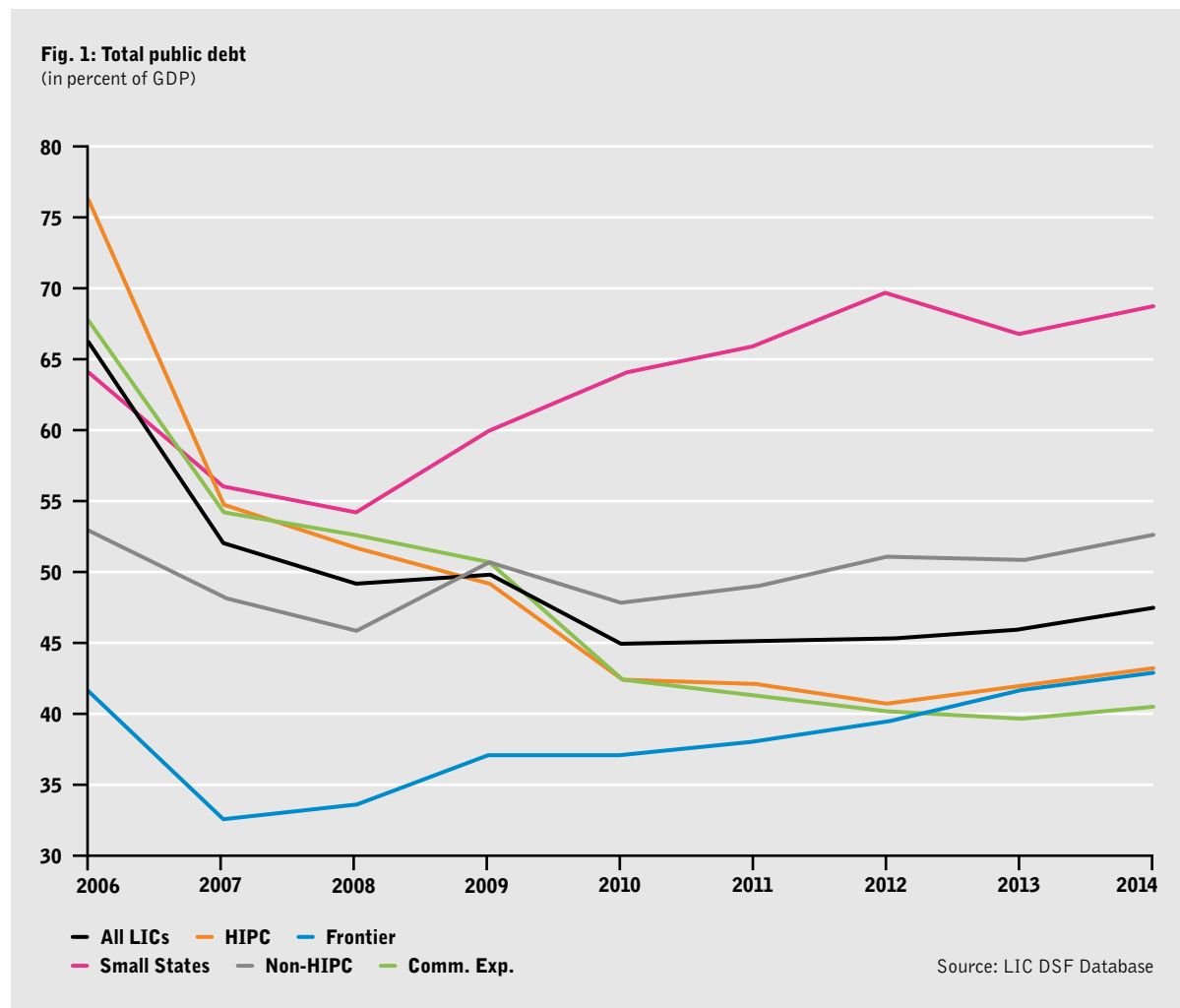
Out of 39 countries eligible for the HIPC Initiative and the MDRI, 36 have reached the Completion Point – the point in the initiative where the debt relief becomes irrevocable. Of the remaining three, Somalia recently reached the Decision Point – a point in the initiative when countries begin to receive debt service relief on an interim basis – and two other countries, Eritrea and Sudan, have yet to reach the Decision Point. The cost of HIPC debt relief to the participating creditors has so far been US\$76.2 billion, and the costs of the MDRI to the multilateral creditors that have participated has been US\$43.3 billion (IMF, 2019).

A first feature to highlight in the HIPC Initiative is that it provided debt reduction of a size sufficient to translate into a meaningful expansion of the fiscal space for recipient countries. The amount of debt relief under the initiative was determined based on target debt ratios that were considered low enough to achieve debt sustainability. Eligible countries would qualify for debt relief if either their ratio of the NPV of debt to exports exceeded 150% or – for countries with open economies (a minimum 30% export-GNP ratio) and substantial tax revenue (a minimum of 15% of GNP) – the ratio of their NPV of debt to tax revenue exceeded 250%.

In its enhanced version, the Enhanced HIPC Initiative entailed two stages. At first, the potentially eligible country would build a track record of implementing World Bank–IMF programmes for three years. At that point, called the Decision Point, the Bretton Woods Institutions would determine whether, after all traditional debt reduction mechanisms have been tried, the country's debt was sustainable. If this was not the case, the international community designed a package of debt relief to bring the debt levels below the pre-determined thresholds. If this was the case, a package of debt relief was designed. In order to obtain full debt relief, the country needed to continue a series of reforms for three or more years. When this was achieved, the country would reach what was called the Completion

Point and the promised debt stock was written off. Between the Decision and Completion Points, creditors already awarded debt service relief on an interim basis.

Regardless of the views one may have about the choice of indicators and numerical thresholds,⁶ there is clear evidence that the initiative provided a significant boost to the fiscal space in beneficiary countries. In 2015 the IMF found that HIPCs, on average, had been able to reduce debt service-to-GDP by more than two percentage points after reaching the Decision Point. The same report shows debt-to-GDP ratios of HIPCs were significantly lower than those of non-HIPC countries (see Figure 1). Debt service to exports in HIPCs went down by near 15 percentage points between 2000 and 2010 (IMF, 2019).



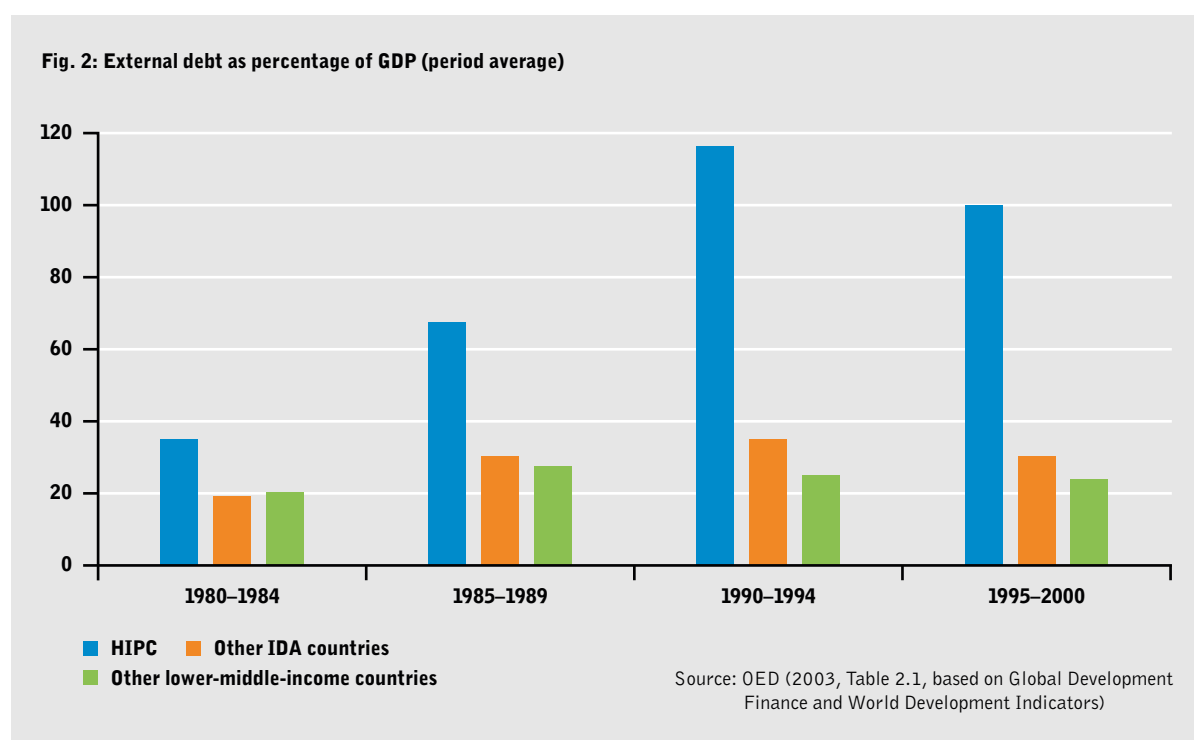
An ancillary lesson one can derive from the amount of debt relief in the HIPCs is that taking decisive action to reduce a sovereign's debt burden at an early stage can significantly reduce costs to all parties involved. This is consistent with findings by sovereign debt

⁶ For some of the criticisms and debates, see Martin (2004), Northover (2008), G-24 (2003), and OED (2003).

restructuring experts. According to Hubbard (2002): «Costs of postponed [...] restructurings are real and substantial. Delays in restructuring can drain a country’s resources and increase the ultimate costs of restoring financial sustainability.» The IMF (2013b) found that allowing an unsustainable debt situation to fester is costly to the debtor, creditors, and the international monetary system.

The history of the lead-up to the HIPC Initiative really illustrates the point. The international community only agreed to comprehensive initiatives such as the HIPC Initiative and the MDRI after more than two decades of repeated piecemeal debt reschedulings and progressively increasing debt reductions for the beneficiary countries. Birdsall and Williamson documented that the countries that would eventually become HIPCs were already exhibiting potentially troubling debt ratios in the early 1980s (Birdsall and Williamson, 2002). Between 1976 and 2002, low-income countries restructured their Paris Club debt nearly 250 times, with twelve countries restructuring eight or more times (Leo, 2009). Even the initial HIPC debt thresholds proved to be too high to set the country on a sustainable debt path, and the Enhanced HIPC Initiative lowered them.^[7]

Figure 2 shows the progression of the magnitude of HIPC debt in the 1980s and 1990s. Tackling the debt issues of HIPCs in a comprehensive way at an earlier stage could have cost creditors significantly less. The cost to debtors in terms of avoiding protracted rounds of rescheduling and relief, increased stability, and resuming growth sooner would also have been significantly lower.



7 HIPC target ratios were 200% to 250% of NPV for the debt-to-export ratio, and 280% of NPV for the debt-to-revenue ratio.

A second important feature of the HIPC Initiative and the MDRI is that they required all creditors – bilateral, multilateral, and commercial – to share the burden. For compliance, they only relied on political commitment and moral suasion.

The approach of the HIPC Initiative innovated upon the treatment of multilateral debt. In the years leading up to the initiative, the notion of cancelling or swapping multilateral debt was floated by experts, although it was resisted (Kaiser and Lambert, 1996). The main argument against the cancellation of multilateral debt rests on the de facto preferred creditor status that these institutions enjoy, that is, the fact that sovereign borrowers typically continue to service their loans from international financial institutions, even when defaulting on their other debts. As the argument goes, multilateral development banks need to protect their «AAA» credit ratings on the international capital markets and, if they were seen to be allowing debtors to default on loans, they would no longer be given access to international funds at below-market interest rates (APG, 1994).^[8] In the case of the IMF, even though there is no such rating to protect, preferred creditor status has generally been observed: The IMF has rarely not been paid on time, and even less frequently not been fully repaid (Schadler, 2014). Two specific factors militate against renegeing on obligations to the IMF. First, delayed repayment – let alone default – to the IMF confers pariah status to countries. Second, when a country's return to stability takes longer than initially envisaged and the threat of arrears is acute, the IMF works with the country to put a follow-up lending arrangement in place. In effect, this is evergreening, albeit in the context of a new programme to strengthen policy adjustments to ensure that economic stability and the capacity to repay the IMF are restored (Schadler, 2014).

Eventually, one of the innovations of the HIPC Initiative and the MDRI was that, for the first time, debt relief included reduction of debt owed to the multilateral institutions, including the IMF (Birdsall and Williamson, 2002). However, partly to maintain their formal status as preferred creditors, the institutions were not to write off the debt owed to them on their own books, but rather, the debt service owed to them was to be paid through special trust funds created for that purpose and financed by bilateral donors. Partial contributions did come, though, from the institution's own resources. In the case of the IMF, proceeds from the sale of part of its gold reserves were used – and in the case of the World Bank, the transfer of some of its net income from its non-IDA lending (Birdsall and Williamson, 2002). An important factor leading to such an outcome was that, after several rounds of bilateral debt relief, the multilateral debt had become a major share in the total debt of the targeted countries. Bringing their debts to sustainable levels could, thus, no longer be done without dealing in some way or another with multilateral debt (Birdsall and Williamson, 2002).

8 However, according to the same source, the argument is debatable, as ratings seem to depend more on the callable capital of the institutions (APG, 1994).

The participation by bilateral Paris Club creditors was in some cases beyond the HIPC initiative and MDRI's requirements. But participation by official non-Paris Club and commercial creditors has remained a challenge (IMF, 2019). The share of such creditors amounted to 13% and 6% of the debt of HIPCs, respectively (IMF and IDA, 2011), thus, there was not a major impact on the initiatives. However, the lack of participation could have made a difference at the margins for an estimated 22 countries and could have meant that their debts would have remained unsustainable, in spite of other creditors providing debt relief above their required shares (Martin, 2004).

According to the IMF (2019), non-Paris Club creditors responsible for 17% of the debt owed to such subgroup have yet to participate in the initiatives. Commercial creditor participation is reportedly higher, at more than 90% (Martin, 2020). However, participation by commercial creditors was extremely complex to secure. Most of the relief they provided involved operations through the IDA's Debt Reduction Facility, which provides grants to enable countries to buy back debt at a discount (Fall Gueye et al., 2007). Though the proportion of non-participating creditors is small, several of them have sued for the full amounts of their claims plus interest, in some cases obtaining favourable rulings. For instance, a 2007 estimate observed that the debt subject to lawsuits represented 10% of the remaining debt that countries would have after debt relief (Fall Gueye et al., 2007).

Another feature of the HIPC Initiative worth discussion is its ambition to achieve long-term debt sustainability and the provisions to that effect. Once a country reaches a sustainable debt level, maintaining it in the long term depends on multiple factors, some beyond the control of the debtor and creditors in question. In that regard, the objective of the HIPC Initiative to provide a «permanent» exit from the rescheduling process and a «clear» exit from unsustainable debt (OED, 2003) may have been overly ambitious to begin with.

Although there is no question that the debt sustainability of HIPCs improved significantly as a result of the initiative, their average debt service, as a percentage of exports and of GDP, troughed in 2010 and has been increasing ever since (IMF, 2019, Table AIII1). A more recent assessment reports that the median public debt level in HIPCs is similar to that of non-HIPCs (IMF, 2019, Table AIII1). The trend reflects increased access and reliance on non-concessional sources (IMF, 2015).

It was clear early in the HIPC Initiative that maintaining debt sustainability would depend on multiple factors, such as levels and terms of new borrowing; the productive use of additional resources to generate revenues and promote growth; and export stabilisation and diversification (Gilman and Mitchell, 2004; OED, 2003). Importantly, the HIPC Initiative was not designed to protect recipient countries from exogenous shocks (Martin, 2004).

To maintain debt sustainability in the long term, the international community placed emphasis on setting limits to new borrowing in non-concessional terms. The IMF's Debt Limits Policy and the IDA's Non-Concessional Borrowing Policy – recently replaced by the

Sustainable Development Finance Policy – are meant to curb the growth of unsustainable financing. The work that the Bretton Woods Institutions have done with a range of partners has also given increased attention to strengthening fiscal and debt management capacity in borrowing countries, and there has been unquestionable progress on this front. But these measures only represented a partial response to the factors affecting debt sustainability in the target countries.

A fourth element to highlight in the HIPC Initiative and the MDRI, and one that approximates them to debt swaps, is their innovative requirement that resources released by debt relief would have to be used for poverty reduction and social spending. This requirement was introduced formally with the Enhanced HIPC Initiative (Birdsall and Williamson, 2002). To operationalise it, the beneficiary countries would be required to develop a Poverty Reduction Strategy Paper (PRSP) and, although the performance criteria in the initial HIPC Initiative already included both structural and social measures, the Enhanced HIPC Initiative was to «give more weight than under the [original] framework to social and poverty-related reforms» in the assessment of performance required to reach the Completion Point (OED, 2003).

Five principles underpinned PRSPs (OED and IEO, 2005): 1) country-driven, involving broad-based participation, 2) comprehensive in recognising the multidimensional nature of poverty and proposing a commensurate policy response, 3) based on a long-term perspective for poverty reduction, 4) results-oriented and focused on outcomes that benefit the poor, 5) partnership-oriented, involving the coordinated participation of development partners.

It is important to highlight the role that interim debt relief played in providing the breathing space for the adequate completion of demanding requirements such as PRSPs were. The introduction of the poverty reduction link, especially when several countries were already midway through the steps of the HIPC Initiative, might have either delayed the delivery of debt relief or provided an incentive for countries to rush the PRSP process. To address this concern, the Enhanced HIPC Initiative committed to provide interim debt relief between the Decision and Completion Points. This meant that HIPCs would, already at the Decision Point, free up more fiscal space by stopping payments on the expected debt stock to be cancelled, while they were working on completing the steps to reach the Completion Point.

With this approach, debt relief under the HIPC Initiative enabled poverty-reducing expenditures in the beneficiary countries (IMF, 2013a, 2019). Some evaluations more concretely identify a link between the targeting of social sectors in country programmes and the requirements in the Enhanced HIPC Initiative (IEG, 2006; OED, 2003). A number of evaluations of poverty reduction strategy requirements in the initiative found some indications of positive effects on increasing country ownership, broadening stakeholder participation, as well as increasing transparency in the use of funds and accountability (Driscoll and

Evans, 2005; IEO, 2004; OED and IEO, 2005). It is important to highlight the important role that PRSP processes played in increasing the involvement of parliaments in formulation and implementation (IMF and IDA, 2003a).

This does not mean that the PRSP approach or its implementation were perfect. The literature recognises tensions that were never fully resolved, for instance between country «ownership» and the limits set by the conditionalities in the IMF and World Bank programmes that countries had to follow (CIDSE, 2004; Richardson and Coyle, 2003). The IEO (2004) reports that, among the main external criticisms of PRSP processes, there was «too little broadening of the participatory debate on macroeconomic policy» and that «alternative policy options are rarely explored».

Another tension inherent in the programmes was the prioritisation of poverty-reducing spending – social, health – versus growth-enhancing investments that might contribute to poverty reduction in the longer term (OED and IEO, 2005). As put by Driscoll and Evans (2005),

Under pressure to demonstrate results, many donors have opted for the quick wins of targeted social sector spending instead of seeking to address the paucity of analytical work on pro-poor growth, and support longer-term government action to bring it about.

Finally, in spite of results-orientation being one of the pillars of PRSPs, monitoring and evaluation provisions appear to have been a weak spot. Each PRSP was supposed to lay out arrangements for monitoring and evaluation over time. But an IMF and IDA (2003a) assessment found that discussions on monitoring had tended to focus on improving data availability and quality, and much less on institutional arrangements, which were mostly set out in only general terms.

The IEG (2006) – examining 28 completed PRSPs with a four-year implementation on average – states that the main element HIPC were tracking was poverty-reducing expenditures, more specifically social services. It also says this was mostly due to the World Bank and IMF decision to track HIPC spending. This seems consistent with the fact that recent IMF statistical updates can account for the poverty-reducing impact of debt relief. But it raises broader questions about the institutional changes that PRSPs were supposed to trigger at the country level and their sustainability beyond the achievement of debt relief. Evaluations in the early years mentioned the novelty of the approach and the expectation that progress would take time (OED, 2003). Moreover, it was clear that the changes the PRSPs were meant to inspire were long-term. However, although some evaluations found evidence of countries institutionalising desirable changes in domestic policy processes (OED, 2006; OED and IEO, 2005), the absence of more recent follow-ups makes it difficult to assess to what extent those were sustained.



Flood in Jakarta, Indonesia

bungasiratt / Flickr (CC BY-NC 2.0)

4 Conclusions

This paper started from the premise that the options available for confronting the emerging debt crisis in developing countries should also consider how such options can best contribute towards addressing the climate crisis. Towards that purpose, drawing on the lessons from the experience with debt-for-development swaps, the HIPC Initiative, and the MDRI identified in the last two sections, this section lays out some conclusions.

A DCI could be designed to significantly expand the fiscal space and create the incentives for investing in climate change adaptation and mitigation. To fulfil these purposes, the DCI will have to be a transaction that is capable of combining debt cancellation and swaps in creative ways.

The experience with debt swaps shows that their contribution to debt sustainability has been marginal, at best. It is clear that, without a meaningful debt cancellation component, at least a number of countries facing acute debt distress will be unable to free up fiscal space to invest in climate priorities. A precedent for such a combination of debt relief and debt swap can be found in the Polish EcoFund, in which creditors unconditionally cancelled half the debt and added the opportunity for a debt swap for up to an additional 10% of the debt. Such a concept could be taken one step further and incorporate the debt swap portion as mandatory. Another way to make the debt swap a mandatory part of the initiative would be to conceive of the whole transaction as a single debt swap whose conversion rate implies a large debt cancellation portion.

The swap component could add to the foreign exchange savings inherent to plain debt relief those derived from the conversion to domestic debt. In a situation where developing countries are expected to struggle with foreign exchange shortages for some time, this is no small feat. A scheme in the form of UNESCO Advisory Panel's Debt Conversion Development Bonds (Bond, 2012) could help, at least some countries, frontload the benefits while preserving scarce fiscal revenue.^[9]

A commitment of the magnitude that a successful DCI requires will represent a significant effort for creditors. But a lesson of the history of debt crises is that the failure to reduce debt burdens to manageable levels in a timely fashion ultimately carries greater costs to all parties. To these costs, one should add the potential future costs of inaction on climate (Stern, 2006; The Economist Intelligence Unit, 2015). In fact, the DCI could be seen by creditors as an opportunity to ensure at least part of a debt haircut goes towards investments in a global public good.

9 See more on this proposal in Section 2.1 under the «Balance of payments impacts» discussion.

A comprehensive approach to creditors will be important. This is to foster a sense of fair burden-sharing, and also because – compared to the HIPC Initiative and the MDRI – the current landscape of creditors places a greater onus on the DCI to be comprehensive if it wants to be relevant. A defining characteristic of the new buildup of debt in low-income countries is that it involves a significant change in its composition, with a trend towards increased borrowing from non-Paris Club and commercial creditors (IMF, 2015, 2018). Even if the Paris Club lifts the rules capping the volume of non-ODA debts that can be subject to swaps – which may be recommendable – the potential of a DCI would be much reduced if one only contemplates traditional bilateral official creditors. Not only do they represent a smaller share of debt. A more crucial point is that the domestic goodwill and political support in Paris Club members that was so critical to the success of the HIPC Initiative and the MDRI is unlikely to be found nowadays for an initiative lacking broad and fair burden-sharing.

Although the G20 offers a forum that can enable coordination with at least some non-Paris Club creditors, the challenges of involving the private sector have become apparent in the G20 Debt Service Suspension Initiative (DSSI). In launching the initiative, the G20 invited private creditors to contribute on comparable terms, but so far there are no cases of private creditors granting a moratorium on payments to any DSSI beneficiary country. Beneficiaries of the initiative have actually refrained from requesting such a concession out of fear of the negative repercussions that it may have on their access to financial markets and credit standing. Although it is far from a foregone conclusion that this would be the impact, or that it would last (DFI, 2009; Scope Ratings 2020), private creditors have consistently lifted such concerns (IIF, 2020). Experts and organisations have developed several proposals that could address such an issue (UN, 2020a, 2020b), but so far none of them have gained enough traction.

Multilateral development banks, in turn, expressed concern that granting a suspension of repayments on their loans to DSSI beneficiary countries would risk impacts on their credit ratings and ability to frontload assistance to their members. They proposed, instead, that their participation be in the form of a «positive net flows» approach, meaning that they will disburse more funds to DSSI client countries than what they are receiving as repayments during the suspension period.

Given the current landscape of creditors, a DCI could offer a platform – similar to what the HIPC Initiative did in its time – for coordinated official action in order to adopt measures that could incentivise or compel private creditor participation. The official creditors could also coordinate appropriate policy action to enable multilateral development banks to contribute further to debt cancellation without affecting their creditworthiness and ability to lend to client countries at below-market rates.

With some adjustments, the programmatic approach that the HIPC Initiative took to link debt relief to poverty reduction could serve as a useful model for the climate-support

component in a DCI. Compared to what Cassimon et al. (2009a) have termed «micro-ear-marking» in the debt swaps of the decade preceding the HIPC Initiative, the approach of this initiative represented an improvement. It acted like a swap in providing a link between debt relief and a development objective, and it created the incentives for institutional change as well as strengthened participation and accountability. At the same time, it sought to provide flexibility for homegrown choices and to work with, and strengthen, country systems in a holistic way.

To follow on such a model, borrowers seeking to receive debt relief would have to develop and commit to implement a comprehensive climate plan («DCI plan»). From the outset, this approach would tackle potential issues of misalignment with a national environmental or development strategy examined in the debt swaps literature. Many countries have already fairly advanced climate plans or other bases to develop one – such as National Adaptation Plans and Nationally Determined Contributions – and should not, of course, have to reinvent the wheel.

Another benefit of adopting this more programmatic approach is that it would amplify some of the governance benefits found in debt swaps. In the same way that debt-for-nature swaps helped raise the profile of environmental issues and the parts of government promoting them in the overall governance structure, a DCI plan would raise the urgency and profile of adaptation and mitigation institutions and their say in the growth and development strategy.

The incentives that swaps provided for participatory, transparent, and accountable governance would have broader impact when applied to the design of a comprehensive climate programme. Building on the experience in HIPCs, the DCI plan could provide a platform for both parliamentary engagement and broad-based consultation with non-government stakeholders. The concerns with government ownership that emerged in some debt swaps – due to government being outnumbered in the governance arrangements by CSOs, some of them foreign ones – are rendered moot.

Importantly, the DCI plan would not be expected to focus on climate alone, but to recognise its interlinkages with poverty, inequality, and job creation, and to seek to address and integrate them. A DCI plan could also include policy actions that contribute towards adaptation or mitigation, even where an expense or investment amount is not necessarily attached to it. The government of Seychelles committing to protect 30% of its seas as part of its debt swap is a useful example in that regard.

As discussed in the previous sections, monitoring and evaluation suffered from weaknesses in both the debt swaps and the HIPC Initiative. Moreover, the monitoring of a DCI plan is expected to present greater complexities than a poverty reduction strategy and definitely calls for a longer time horizon. However, one could also see the glass half full and consider the positive impacts that the HIPC Initiative has prompted in governance, transparency,

and accountability. Its bet on strengthening homegrown processes and institutions as being the best way to ensure long-term engagement still seems to have been the right one. Having said that, a commitment from the outset to have a periodic review of the implementation of DCI plans for a number of years could be an improvement on monitoring and evaluation. For instance, this could take the form of a triennial review for the next 15 years – in a multilateral forum bringing together participating creditors and debtors.

A lesson from experience with swaps is that the DCI would need to be, for each beneficiary, on a scale large enough to justify the transaction costs. The fact that it would be multi-creditor and have a single-country strategy that is managed through the existing institutions should create efficiency and scale. Having said that, the transaction costs of a PRSP were not low and added to the hurdles for accessing debt relief under the HIPC Initiative. The same thing can be expected in a DCI. The adoption of a mechanism similar to «interim» debt relief in the HIPC Initiative – where debt service was cancelled at an early stage, pending final compliance with all the requirements – would, to some extent, soften this concern.

The concerns that IMF and World Bank policy conditionality raised in the PRSP process could play out in a DCI, and actually on a larger scale. Yet, seeing how much creditors still rely on the IMF and World Bank – an example is the central role the institutions were given in the G20 Debt Service Suspension Initiative – it is unrealistic to expect a DCI to entail less involvement on their part. The issue, then, is that if the institutions were seen as being unwilling to consider a broader set of alternative economic policies to accommodate pro-poor growth, the policy spectrum only broadens when including climate matters. It is true that the institutions have come a long way in expanding their knowledge on both poverty and climate issues in the years since the initial PRSP experience. But the involvement of an international organisation with a climate mandate in an equally deciding role could be a desirable feature in a DCI. Of course, it is desirable, to the extent possible, that economic policy conditionalities be kept to a minimum and have broad social acceptance in the debtor country. Conditionalities should also exclude any form of tied aid.

A DCI should also build on the lessons of the post-HIPC Initiative experience to further protect the long-term debt sustainability of borrowers. There is a role for limits on new non-concessional financing and measures to strengthen fiscal and debt management. But these measures can only go so far in addressing the underlying drivers of the indebtedness process. Higher levels of borrowing have also been driven by external growth, trade trends, and insufficient access to non-concessional sources in the face of growing investment needs

to fulfil an ambitious development agenda.^[10] Built-in biases in financial markets play a role, too.^[11]

In some countries, the growing frequency of natural disaster shocks compounds such effects, with a study reporting that the debt-to-GDP ratio in the Eastern Caribbean Currency Union grows by almost 5 percentage points the year a storm strikes, with a cumulative debt increase of 5% of GDP eight years later (IMF, 2015). This is not to mention the current public health shock many countries are experiencing.

Although the deeper systemic factors affecting debt sustainability require long-term and multilateral policy actions that exceed the modest scope of a DCI, there are two areas in which the approach to the HIPC Initiative could be improved upon. First, a DCI could offer a component promoting state-contingent loans in beneficiary countries. This could mitigate their exposure to future growth and trade downturns as well as make their debt profiles more resilient to shocks. Second, by increasing climate resilience, the DCI plans would be contributing towards diminishing the impacts of natural disaster shocks on the economy. They could go one step further and be required to address economic diversification.

An initiative that rises up to both the debt and climate challenges of the current moment is possible, provided there is political will. By incorporating the lessons from swaps and debt relief in the design of such an initiative, the international community could ensure a reaping of the benefits of previous initiatives while avoiding some of their shortcomings.

10 As put by the G-24 (2018): «The success of adjustment and reform efforts to strengthen inclusive growth and improve debt sustainability will equally depend on a supportive external trade and financial environment, timely contingency financing and the adequate flow of concessional financing for LICs.»

11 Ken Ofori-Atta (2020), Minister of Finance of Ghana, recently commented that «Africa is caught in a web of a financial architecture that I believe is inimical to our progress and development. I believe we pay close to 600 to 800 basis points for an African risk premium when we come to the market. So if we look at a debt service of about \$44bn a year for Africa, clearly \$20 to 25 billion of this should not be paid but for the structure of the financial services infrastructure.»

Annexes

Annex 1: What is overseas development assistance?^[12]

ODA consists of financial flows provided to a country or to a multilateral institution that are:

- 1) provided by official agencies, including state and local governments, or by their executive agencies;
- 2) concessional (i.e. grants and soft loans); and
- 3) administered with the promotion of the economic development and welfare of developing countries as the main objective.

So, for instance, aid provided with military purposes does not qualify as ODA, nor do flows with a commercial purpose (e.g. export credit agencies).

ODA can take the form of (i) grants, where financial resources are provided to developing countries free of interest and with no provision for repayment, or (ii) soft loans, which have to be repaid with interest, albeit at a significantly lower rate than if developing countries borrowed from commercial banks.

To qualify as ODA, the grant element needs to meet a certain threshold. The grant element is the difference between the nominal value of the loan and the sum of the discounted future debt service payments to be made by the borrower (NPV), expressed as a percentage of the loan's face value. For instance, a loan on market terms has a 0% grant element, and a pure grant has a 100% grant element. For the loans in between those extremes, the calculation will depend on how low the interest rate is, compared to market terms, and how long the repayment period is, including whether there is a grace period to begin payments. The threshold varies according to different institutions but, for instance, the OECD requires a 25% grant element for a loan to qualify as ODA.

Until 2018 – and this was the methodology prevailing at the time most of the literature reviewed for this paper was produced – grants and loans were valued in the same way: by recording the flows of cash that were granted, or the face value of loans that were lent to developing countries, deducting any repayments on the loans. These «cash basis» or «flow basis» methods were used to produce ODA headline figures until 2018 (reporting on 2017 ODA spending). Under the new methodology, only the «grant equivalent» of loans is now recorded as ODA.

12 This annex largely draws upon OECD (2019).

ANNEX 2: The Polish EcoFund experience^[13]

Before 1991, the Polish government was negotiating with the Paris Club an extensive package for rescheduling its post-communist debt. The rescheduling package included up to 50% of debt relief offered by most creditors to Poland, with the recognition of the pioneering role that Poland was playing in driving radical market and democratic reforms in the post-communist block of Eastern Europe. It was obvious to all parties that this was a unique opportunity for unconditional debt relief.

The debt-for-environment swap initiative was carefully prepared in parallel to these negotiations, but launched only after the extent of negotiated rescheduling and unconditional debt reduction was perceived as final. As a result, Paris Club creditors agreed to create an opportunity for additional bilateral debt swaps of up to 10% of the value of the original debt (i.e. 20% of the remaining debt).

The USA used this opportunity almost immediately, agreeing to swap the allowed maximum, that is, 10% of its debt. In order to avoid fiscal bottlenecks, the transaction did not include a one-off swap of the entire debt stock. Instead, the Polish government promised to transfer every year an agreed percentage of the debt repayments due – in national currency – to a local financing facility, the EcoFund, which was established to manage project pipelines.

Over the years, the EcoFund has facilitated five additional swaps from other creditors, each on slightly different terms. Altogether, the Polish scheme has generated an unprecedented amount of over half a billion USD – more than all other debt-for-environment and debt-for-nature swaps in the world taken together. Due to its outstanding performance and very solid expenditure programmes, the EcoFund has also attracted additional multimillion donor grants for environmental purposes.

Source: OECD (2007)

13 This annex reproduces OECD (2007, Box 9).

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