
NOTES AND TOPICS

Swapping Debt for Nature

Brian Dollery, David Schulze and Leigh West

Recent debate on the desirability of a carbon tax for Australia has shown that environmental issues can be linked with economic policy. It should thus come as no surprise were this approach to be extended to other areas of policy. One candidate especially ripe for attention is foreign aid. If supporters of current levels of foreign aid can plausibly claim that such aid achieves beneficial environmental outcomes beyond its intended objectives, then they can recruit to their cause the political influence of the formidable environmental lobby. And the federal government, by maintaining current budget allocations of foreign aid, can appease two vocal interest groups simultaneously. 'Debt for nature' swaps provide an ideal instrument for developing common ground between environmentalists and foreign aid proponents.

However, whatever its initial appeal, the mechanism should be viewed with the scepticism that eventually led the federal government not to proceed with a carbon tax.

What Are Debt for Nature Swaps?

A debt for nature swap typically involves a non-governmental organisation (NGO) buying the hard-currency debt of a less developed country (LDC) at a discounted rate on the secondary financial market. The NGO then exchanges the debt with the debtor country either for local-currency funding for a conservation project in that country, or for an undertaking from the LDC government to make changes to laws and/or policies for specific or general conservation projects (thus giving rise to a so-called 'debt for policy' swap). The local-currency funding option may take the form of a 'debt for cash' swap, whereby the LDC government provides a local cash equivalent to fund projects. Alternatively, under a 'debt for debt' swap, the LDC government provides government bonds, with the regular interest payments being used to fund projects, and the principal, on maturity, generating an endowment for a local NGO.

The Origins of Debt for Nature Swaps

Swaps had their origins in the international debt crisis of the 1980s, when commercial banks began to sell increasing quantities of LDC debt for less than face value on

the secondary financial market. The market developed in the early 1980s, when it became apparent that many highly indebted countries would have difficulty in paying their foreign debt. Creditor banks 'began to liquidate, reduce, and diversify their developing-country debt portfolios by offering individual loans for sale at a discount' (Weinert, 1990:6), which indicated falling market confidence in debtor countries' ability to service their debts. For example, in 1986 Mexican government debt could be bought for 57 per cent of its face value; Brazilian government debt for about 75 per cent; Philippines debt around 60 per cent; while Bolivian debt could be purchased for a 90 per cent discount on its face value (Weinert, 1990:442).

The volume traded on the secondary market grew rapidly during the 1980s from a face value of US\$2 billion in 1985 to \$70 billion in 1990 (General Accounting Office, 1991:8). As secondary markets grew in size, the then vice-president of the United States World Wildlife Fund, Dr Thomas Lovejoy, proposed in 1984 that conservation groups should consider purchasing LDC debt on the secondary financial market to provide some debt relief to LDCs in exchange for local-currency resources that would be used to carry out environmental and development projects in these countries (Agency for International Development, 1991).

The Extent of Debt for Nature Swaps

The first debt for nature swap was carried out in 1987. Under this swap the American bank, Citicorp, acted as the agent for the environmental group, Conservation International, buying US\$650,000 of Bolivia's then \$5 billion foreign debt from a Swiss bank for \$100,000; that is, at 15 per cent of its face value. In exchange for cancelling the debt, the Bolivian government agreed to make changes to Bolivian law to allow the maximum protection of the Beni Biosphere Reserve in the Amazon Basin, which was being destroyed by cattle ranching and lumbering operations, and to set aside 1.2m hectares for three additional areas surrounding the reserve. The Beni region is rich in biological diversity and is well-known for its large stocks of mahogany, jacaranda and tropical cedar. It is also home to the nomadic Chimané Indians, 13 endangered species (including the jaguar and the giant armadillo) and over 500 different varieties of birds (Gibson & Curtis, 1990:354). The exchange agreement also mandated the Bolivian government to establish a \$250,000 local-currency equivalent fund for the protection and administration of the reserve and its additional buffer zones. The Bolivian government was to contribute \$100,000 to this fund, while the United States Agency for International Development was to contribute the balance (Post, 1990).

By 1993, 31 debt for nature swaps had been negotiated in 15 countries, retiring more than US\$177m of debt at a cost of fractionally less than \$47m. The average purchase price of these transactions was 38 per cent of the face value of the debt. In many cases, the exchange enabled the debt purchasers to leverage on average almost three times the amount invested, and as a result generated the local currency equivalent of \$129m in conservation funds in addition to the non-monetary components of the exchanges (World Bank, 1994). The majority of swaps involve Cen-

tral and South American countries, which account for about 88 per cent of the face value of debt purchased; of the total \$177m exchanged, Costa Rica accounted for just under \$80m.

How Effective Are Debt for Nature Swaps?

In some respects, debt for nature swaps seem to have been rather successful. An NGO contemplating funding a conservation project in an LDC has many options available to it, some of which Sundaram (1990) explored in looking at a specific transaction involving Ecuador. Taking the financial particulars of the actual transaction, Sundaram calculated the returns to the NGO from three options: proceeding with the swap at the agreed conversion rate and thereby provide funds for the project; investing the money in a United States bank and convert the periodic interest payments into *suces* at the prevailing exchange rate to fund the project; and converting the amount into *suces*, investing it in an Ecuadorian bank at the prevailing interest rate and using the periodic interest payments to fund the project. On the basis of the purely financial aspects of the transaction, Sundaram concluded that the swap transaction in this particular case was by far the most attractive option.

Another issue is who benefits from the swap transaction. Some commentators believe that the gains are shared by the commercial banks and the foreign and local NGOs, but that the LDCs end up paying a subsidy to the other parties. This subsidy is the difference between the amount paid by the NGO for the debt and the amount the LDC pays in local currency for that debt. However, Gibson and Schrenk (1991) maintain that all parties benefit from the transaction. The commercial bank benefits by removing an outstanding and possibly high-risk debt from its portfolio, and the NGO gains by generally receiving more in local currency than it would have received from directly purchasing local currency. The LDC gains through reducing its level of external debt and being able to use the money to protect the country's natural resources.

Nevertheless, the overall impact of debt for nature swaps on overall debt levels remains controversial. Marilyn Post (1990) compared the external debt level of 15 key debtor LDCs, estimated at \$465 billion (in 1986 dollars), with the face value of debts written off as a result of debt for nature swaps. She concluded that the impact on external debt levels was very small. In contrast, von Moltke (1994:3), an ardent exponent of debt for nature swaps, believes that the effectiveness of swaps in alleviating LDC debt pressures should not be measured against the outstanding principal but rather 'against the effective annual rise in principal attributable to a country's inability to service its debt'. He argues that debt levels are stabilised when interest payments are not increasing the level of indebtedness, and that, measured against this, debt for nature swaps could contribute significantly.

The Future of Debt for Nature Swaps

To date, countries involved in debt for nature swaps have been concentrated in South and Central America, and the exchanges have involved relatively small

amounts of debt. Proponents of debt for nature swaps have argued that their future success in providing debt relief and conservation funds lies in expanding the coverage of countries and the amount of debt written off. However, several factors give cause for doubt on these fronts. One of the main obstacles to the expansion of swaps in money terms is the taxation treatment for the donation of outstanding debt by commercial banks. For example, American banks are reluctant to donate debt because any deduction in taxation claimed for a debt for nature swap in a foreign country has to be made against foreign income sources; banks would much prefer to make such deductions from domestically sourced income (General Accounting Office, 1991:12). Gibson and Schrenk (1991) have identified a number of other disincentives. The most significant revolves around the problem of whether donated debt should be valued at the amount of local currency paid by the NGO in exchange for the debt at secondary financial market prices or at the market exchange rate of the local currency received in the transaction. Commercial banks are concerned that valuing donated debts at the generally lower secondary market price may 'contaminate' the remainder of the debt portfolios for that particular country, resulting in the need to establish additional reserves for potential loan losses. Conservation International (1991) sees an additional obstacle in relation to the coverage of countries in that most sub-Saharan African countries owe most of this debt to multilateral agencies and other governments, which are reluctant to write off outstanding debt. This is in contrast to the South and Central American countries, which owe most of their debts to commercial banks that have been willing to trade their outstanding debts on the secondary financial market. Accordingly, the outlook for debt for nature swaps is not promising.

From the perspective of rational policy formulation by the Australian government, several additional difficulties remain. First, it is by no means obvious that debt relief is a sensible means of promoting economic development in poor countries. Indeed, it has been cogently argued that far from encouraging wealth creation in LDCs, debt relief simply rewards past incompetent policymaking and hence contributes to its perpetuation. Even if debt relief is included as an objective of Australia's foreign-aid policy, the so-called Brady plan of international debt reduction is already in operation and by all accounts working well outside Africa (Suter, 1992). Under the Brady plan creditors can choose among three options: reductions in outstanding debt, decreases in interest rates, and new loans. Given the apparent success of the Brady plan, especially in South and Central America, any Australian efforts directed at debt relief should aim at supporting this program rather than pursuing the somewhat dubious alternative embodied in debt for nature swaps. Second, most indebted LDCs are characterised by chronic political instability and endemic corruption. There is thus no guarantee that agreements reached under debt for nature swaps will be honoured in the long term. After all, these self-same regimes did not meet previous debt obligations. Third, since foreign-aid funds expended on debt for nature swaps could have been much more productively employed on domestic environmental projects, or used to pursue *bona fide* national interests in

foreign relations, debt for nature swaps represent an inefficient compromise between alternative objectives.

In sum, despite its obvious political attractions, policy-makers should ensure that any future proposals for debt for nature swaps join those for a carbon tax in the rubbish bin.

References

- Agency for International Development (1991), *Innovative Development Approaches – Recycling Old Debt for New Ventures: Debt for Nature and Debt for Development Swaps*, Number 4, Washington.
- Conservation International (1991), *The Debt-for-Nature-Exchange: A Tool for International Conservation*, Washington.
- General Accounting Office (1991), *Report to Congressional Requesters – Developing Country Debt: Debt Swaps for Development and Nature Provide Little Debt Relief – PC-AA-208*, Washington.
- Gibson, J. & R. Curtis (1990), 'A Debt-for-Nature Blueprint', *Columbia Journal of Transnational Law* 28(33): 331-412.
- Gibson, J. & W. Schrenk (1991), 'The Enterprise for the Americas Initiative: A Second Generation of Debt-for-Nature Exchanges', *George Washington Journal of International Law and Economics* 25(1): 1-70.
- Post, M. (1990), 'The Debt for Nature Swap: A Long-Term Investment for the Economic Stability of Less Developed Countries', *International Lawyer* 24: 1071-98.
- Sundaram, A. (1990), 'Swapping Debt-for-Debt in Less-Developed Countries: A Case Study of a Debt-for-Nature Swap in Ecuador', *International Environmental Affairs* 2(1): 67-79.
- Suter, S. (1992), *Debt Cycles in the World Economy*, Westview Press, Boulder.
- von Moltke, K. (1994), *Debt for Nature: An Overview*, World Wildlife Fund, London.
- Weinert, R. (1990), 'Swapping Third World Debt', pp.422-32 in P. King (ed.), *International Economics and International Economic Policy: A Reader*, McGraw-Hill, New York.
- World Bank (1994), *World Debt Tables 1993-94. External Finance For Developing Countries, Volume 1: Analysis and Summary Tables*, Washington.

Brian Dollery and David Schulze are Senior Lecturers in Economics at the University of New England. Leigh West is an officer at the Department of Finance, Canberra. The views expressed here do not necessarily reflect those of the Department of Finance. The note itself draws extensively on Leigh West, 'Debt-for-Nature Swaps' (unpublished Honours Dissertation, Department of Economics, University of New England, 1994), but offers different conclusions.