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Debt Swaps: An Appropriate Instrument for Development Policy?

The example of German debt swaps

Kathrin Berensmann

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Foreword

This study is mainly based on a more comprehensive study on debt swaps for which the German Federal Ministry for Economic Cooperation and Development (BMZ) commissioned the German Development Institute (DIE). One of the aims of the study was to analyze the instrument of debt swaps and to look into whether there may be a need to reform, viz. to flexibilize, the modalities defined for this instrument by the German government.

Studies were conducted for the purpose in three countries (Indonesia, Jordan, Peru[1]), although the aim of these country studies[2] was not to present a comprehensive evaluation of debt swaps but to provide a picture of the actual implementation of the debt swaps under consideration.

In preparing the study a good number of expert interministerial interviews were conducted at home and abroad; their findings have likewise gone into the making of the study. The author wishes to take the present opportunity to thank all of her interview partners for their willingness to engage in highly informative discussions with her.

The overall research project was supported with funds from the BMZ. The author is solely responsible for the assessments and recommendations made in the present study.

1 The country analysis for Peru was carried out by Stefan Hochhuth. The present study refers to this analysis, pointing to it in many places dealing with Peru's experiences. For an in-depth examination of the case of Peru, see Hochhuth (2006).

2 The country studies included an 8–10-day stay in the countries concerned which was not used to evaluate the individual projects.

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Abbreviations

AA	German Federal Foreign Office
ADB	Asian Development Bank
BMF	German Federal Ministry of Finance
BMZ	German Federal Ministry for Economic Cooperation and Development
COFACE	Compagnie Francaise d'Assurance et de Credits d'Exportation
CPF	Counterpart fund
DC	Development cooperation
ECGD	Export Credits Guarantee Department
EIB	European Investment Bank
ERfKE	Education Reform for the Knowledge Economy program
FC	Financial cooperation
GDP	Gross domestic product
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit GmbH
HIPC	Heavily indebted poor country
IDA	International Development Association
IMF	International Monetary Fund
KfW	Kreditanstalt für Wiederaufbau
LDC	Least developed country
LIC	Low-income country
LMIC	Lower-middle-income country
MDGs	Millennium Development Goals
MIC	Middle-income country
NGO	Nongovernmental organization
ODA	Official development assistance
PRGF	Poverty Reduction and Growth Facility
PRSC	Poverty Reduction Support Credit
PRSP	Poverty Reduction Strategy Paper
SDRs	Special drawing rights
SECO	Swiss state secretary for economic affairs
SEQIP	Science Education Quality Improvement Project
SETP	Socio-Economic Transformation Plan
SME	Small and medium-size enterprise
TC	Technical Cooperation

Summary

The present analysis of German debt-conversion efforts indicated that debt swaps constitute a meaningful instrument of development policy. The study for this reason recommends that the use of the instruments should be further expanded and flexibilized. In view of the fact that the Paris Club rules on debt swaps are substantially more flexible than those set by the German government, the study recommends that the German rules be adapted to those of the Paris Club.

Instead of being used globally, though, debt swaps should be restricted to cases in which the debts concerned are unsustainable, it is possible to ensure that the funds involved will be used in ways that benefit development, and the country concerned consents to their use.

Advantages of the German debt-swap instrument

In particular, the German instrument of FC debt swaps offers the following advantages:

- **Increased development leverage**: Debt swaps provide the German government additional development leverage in its policy dialogue with recipient governments.
- **Debt reduction**: Debt swaps reduce levels of indebtedness. While in Jordan the instrument contributed substantially to reaching debt sustainability, the debt-reduction effect was low in Indonesia and Peru because the volume of the debt swaps carried out there was relatively low.
- **Simplified administrative procedure**: One particular feature of the German debt-swap instrument is the simplified administrative procedure it uses to select and carry out projects. One good indication of this is the fact that Germany has implemented far more debt swaps than the other members of the Paris Club.
- **Additionality**: Debt swaps make it possible for partner governments to carry out additional development measures that they would presumably not have carried out, or at least not on the present scale, without the funds made available by a debt swap. It should, though, be noted here that for methodological reasons it is generally difficult to demonstrate additionality by empirical means.
- **Catalyst effect**: A successfully implemented debt swap may have a catalyst effect on other donors. This could well be the case in Indonesia, where Germany was the first donor to implement a debt swap and other donors could follow the positive German example if it turns out to be successful.
- **Conditioned debt relief**: In all three countries under consideration here, debt swaps were based on conditionalities and a measure of control not so extensive as to overly restrict the partners in their own responsibility.
- **Creation / increase of ownership**: The projects involved are proposed by the partner countries, and since these projects are transacted via national budgets, they are elements of partner systems. In addition, this approach serves to signal to partner countries that their structures are recognized.

- **Inclusion of civil society**: Civil society can be involved in the implementation of debt swaps. One example of such involvement would be the counterpart fund in Peru.

- **Integration into German or multilateral DC structures**: The partner-country projects carried out in the framework of debt swaps may be seen as especially well integrated into German DC structures if these projects are implemented either along with or following German FC programs and/or TC programs. It would likewise be recommendable to integrate them into multilateral structures. This could well serve to promote a donor harmonization of the kind called for in the Paris Declaration.

Problems involved with the German debt-swap instrument

The advantages outlined above must, however, be weighed off against the following problems involved in German debt swaps:

- **Fiduciary risks and corruption**: In view of the fact that the projects bound up with debt swaps are carried out autonomously by the partner countries concerned and the uses to which the funds for these projects are put are less intensively monitored and controlled than the funds involved in other FC instruments used by the *Kreditanstalt für Wiederaufbau* (KfW), we can speak of a fiduciary risk and a corruption risk.

- **Major strain on partner budgets**: The high shares of partner funds required German debt swaps mean that partner countries have to make advance outlays in national currency and may thus be forced to seek loans in local currency, which may be more costly than FC loans.

- **Windfall effect**: There is a risk that partner countries may not make any additional funds available for projects conducted in connection with debt swaps. However, for methodological reasons, it is difficult to prove additionality by empirical means.

- **Poor monitoring, coordination, and documentation**: Other problems encountered in Peru included the fact that there is no clear-cut monitoring of the debt-swap program, the projects are not networked, the relevant documentation is poorly organized, and no official information work is done.

- **Rapid disbursement**: Another problem encountered in Peru was the speed with which the funds were disbursed. In this case the partner country has less incentive to make efficient use of the funds involved because it is not obliged to repay them.

Inflexible instrument used with a limited group of countries

The manner in which the modalities for German debt swaps are formulated gives rise to the following problems. And in particular, the group of eligible countries is severely restricted for the reasons named below:

- **HIPCs**: In connection with the HIPC Initiative these countries are eligible for 100 % FC debt cancellation, and for this reason they are no longer in need of debt swaps.

- **LDCs**: The KfW in any case provides countries with LDC status grants only, not loans.

- **Middle-income countries**: Since the only debts eligible for FC debt swaps are those that have already been restructured, with a high degree of concessionality, in the Paris Club framework, debt swaps are often not an attractive solution for highly indebted middle-income countries (LMICs and MICs). These countries tend to prefer new restructuring in the Paris Club framework.

Flexibility of the rules for debt swaps applied by the Paris Club

As far as the following points are concerned, the Paris Club's rules for debt swaps are far more flexible than those used by the German government:

- **Debt types**: Under the Paris Club rules all ODA debts are eligible for debt swaps. In Germany, on the other hand, only restructured ODA debt is eligible.

- **Debt-swap types**: The Paris Club rules allow for debt swaps other than debt-for-aid or debt-for-nature swaps, including e.g. debt-for-equity swaps.

- **Sectors**: The Paris Club imposes no rules on its members concerning the sectors eligible for debt swaps.

- **Uses to which debt swaps are put**: The Paris Club makes no stipulations on how debt swaps are used (projects, programs, basket-financing, or budget-financing).

Recommendations

In view of the problems outlined above, the present study comes to the following recommendations: In order to minimize the **fiduciary risk**, an internationally recognized auditor should, as provided for in any case, examine debt-swap projects on the basis of a final report. Annual partner reports are often not a sufficient basis for an assessment of the implementation of debt swaps, since these reports do not contain an objective analysis.

Improved donor coordination could provide **better leverage**. In Peru, for example, there was very little coordination of measures among donors. One goal of the Swiss debt-reduction program was to integrate other donors. The program's aim was to achieve significant levels of debt reduction. This is one reason why Switzerland participated in a number of internationally coordinated actions, including e.g. debt-buyback initiatives, which, according to the World Bank, could become increasingly important in the future.

Furthermore, the enhanced multilateral monitoring and investment instruments now available make it possible for donors to coordinate their contributions. More policy-based lending could be used in this connection.

Generally speaking, **flexibilizing**, and in this way expanding, the quantitative outreach of the debt-swap instrument would provide German DC with better avenues to improving its participation in and gaining more influence and policy space for its efforts to contribute to reaching the MDGs. In all three of the countries under consideration the funds mobilized through debt swaps for the most part contributed directly to reaching individual MDGs, and these funds were in part well integrated within multilateral development strategies. However, the contribution provided by German DC on the basis of debt swaps has been relatively small. In other words, while debt-swap projects may support partners in their efforts to reach the MDGs, the question is whether this type of project-financing provides better support for reaching the MDGs than use of the funds for the FC instruments offered by the KfW. Moreover, creating **linkages between internationally coordinated debt swaps** could prove to be a good way to provide a significant contribution to reaching the MDGs.

Debt swaps would be more attractive for some partner countries if German debt swaps were handled **more flexibly**, i.e. if they were brought more into line with the Paris Club rules and modified in the following ways:

- **Adaptation to the Paris Club rules**: Under the Paris Club rules debt swaps can generally be made available for all ODA debts. For Germany, this would serve to substantially enlarge the group of countries eligible for debt swaps.

- **Inclusion of commercial claims**: Under the Paris Club rules debt swaps can also be used for commercial claims, a practice that has been adopted e.g. by the UK, France, Italy, and Spain. While debt swaps for commercial claims are also permissible under German budget law, they are not approved under the German rules for debt swaps. This means that the use of debt swaps is restricted in Germany.

- **Enlarged scopes to make use of the funds involved**: Under the German rules a debtor country's counterpart or local funds can be used only for projects in certain sectors, these funds are not allowed to be transferred directly to a partner country's budget. Compared with the use of debt swaps for projects, budget-financing has the following **advantages**, which are similar to those offered by budget support: better donor coordination, increased ownership, reduced transaction costs, uniform budget frameworks, financing of current costs, and improvement of the policy dialogue. Budget-financing may, though, force donors to relinquish some of their own influence and leeway.

However, if these advantages of budget-financing are to be turned to account, the following **requisite conditions** must be given: functioning budgeting practices, effective planning and implementing structures, and satisfactory public budget management.

- **Expansion of the number of sectors eligible**: Projects conducted in the framework of German debt swaps are restricted to two sectors – environment, education – as well as to the broader field of poverty reduction. An expansion of sectors eligible is recommended.

For debt swaps the following **requisite conditions** should either be created or observed:

- **Requisite structural conditions**: One possible way to secure project quality is to **integrate debt swaps into existing DC structures** of German or other bi- or multilateral donors.

- Better **integration** of debt swaps into national strategies and more comprehensive approaches to poverty-reduction strategies could contribute to the sustainability of the projects and programs involved.

- **Good budget management** is a key condition required to ensure that the funds concerned are put to the uses agreed upon.

On the whole, it can be noted here that there is a need for reform leading to an adaptation of the current German rules to the more flexible rules used by the Paris Club.

1 The role of debt swaps for developing countries

The **aim of the present study** is to analyze the instrument of financial cooperation (FC) debt conversion (debt swaps)[1] and to examine whether there may be a need for reform in the direction of flexibilizing the instrument. For this purpose exemplary studies were conducted in three different countries (Indonesia, Jordan, Peru[2]). Even though these country studies do not contain any comprehensive evaluations of debt swaps, they do provide a good picture of the actual implementation of the debt swaps in question.

In essence, the instrument of FC debt swaps is used to pursue two goals: On the one hand to grant debt relief to highly indebted countries; on the other hand to steer available scopes for debt relief toward development-related uses. This gives donor countries the possibility to enlarge their development-related leverage in their dialogue with recipient countries.

Since the 1950s credits have been restructured or cancelled at regular intervals. However, this has seldom succeeded in breaking the vicious circle of debt restructuring and debt relief, new borrowing and insolvency.

In the past ten years multi- and bilateral donors have implemented a number of systematic debt-relief initiatives for low-income countries (LICs). These include in particular the Heavily Poor Countries (HIPC)-Initiative and the Multilateral Debt Relief Initiative.[3] Both initiatives have made debt swaps unnecessary for LICs. In addition, many countries have now been given least-developed country (LDC) status, which means that the funds they receive from the (KfW) are grants, not credits.

For lower-middle-income countries (LMICs), on the other hand, there has been no systematic debt relief initiative, and ad hoc mechanisms have been used instead. The only avenue open to LMICs is thus to reach agreement with their creditors, in the Paris Club framework, on debt reduction or restructuring or debt swaps. This lack of systematic approaches to debt relief or debt restructuring makes debt swaps an important option for LMICs to reduce their debt burden.

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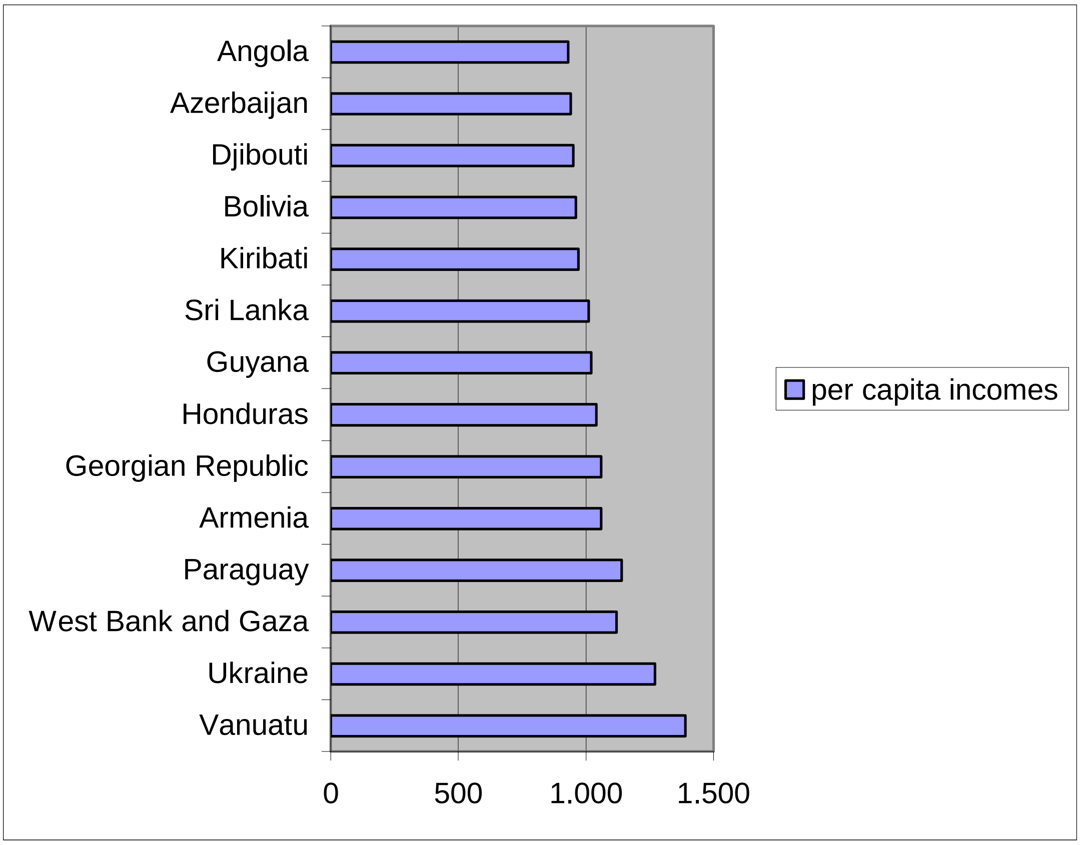
1 In the framework of debt swaps, part of the existing FC debt of the countries involved are cancelled subject to the provision that the country concerned uses a certain sum of local currency (20–50 % of the amount cancelled) for projects agreed on for the purpose.

2 Stefan Hochhuth conducted the Peru country analysis to which the present study refers, pointing to it in many places dealing with Peru's experiences. For an in-depth look at the case of Peru, see Hochhuth (2006).

3 According to the World Bank's definition, LICs are countries with a per capita income below US$ 825, while LMICs are countries with per capita incomes ranging between US$ 826 and 3255.

Figure 1: Per capita incomes of the poorest LMICs, in US$, 2004



Source: World Bank 2006a

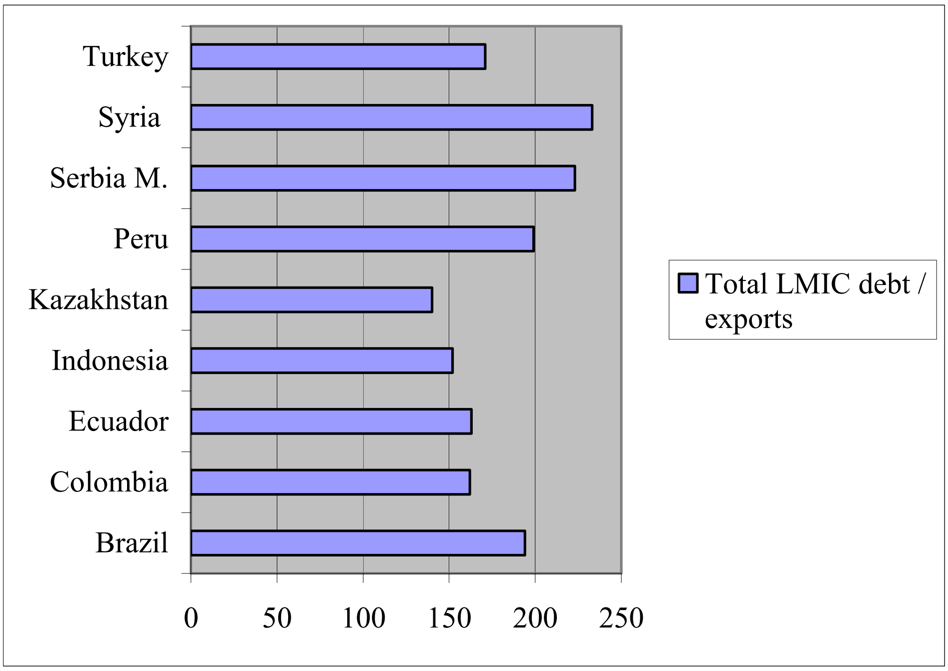
When it comes to reaching debt sustainability[4], LMICs have far fewer options than LICs, even though some LMICs have per capita incomes in part only marginally higher than those of many LICs (Figure 1).

In fact, some HIPCs, including e.g. Honduras, Guyana, or Bolivia, are classified not as LICs but as LMICs.[5] Like the HIPCs, some LMICs are also highly indebted (Figure 2).

4 We speak of external debt sustainability when a country is able to service its current and future debt without impairing its economic growth and without needing to restructure its debt (IMF / IDA 2001, 4). However, this definition does not take domestic debt into account, and this means that the definition does not include fiscal debt sustainability. Nor does it give consideration to whether or not public funds are used for appropriate development measures. But this IMF definition does provide the groundwork for a relatively objective, simple, and thus operationalizable application.

5 A country is eligible for the HIPC Initiative if it has IDA-only status and has received a loan in the framework of the Poverty Reduction and Growth Facility (PRGF). As of July 1, 2006, the cut-off point for IDA-only status has been a per capita income of US$ 1025, i.e. a level above the limit of US$ 825 for LICs (IMF / IDA 2006; IMF 2005). However, between 1998 and 2005, when the HIPCs qualified, the cut-off point for the IDA-only Facility was lower than US$ 1025. Nevertheless, some LMICs that were once categorized as HIPCs are granted multilateral debt relief, while other LMICs that have not been classed as HIPCs are ineligible for it. To qualify for the multilateral debt-relief initiative, countries that have not participated in the HIPC Initiative must have a per capita income below US$ 380 (IWF 2006).

Figure 2: Total LMIC debt in % of exports, 2004



Source: World Bank 2006b

But the question now is: Under what circumstances should a country be eligible to participate in debt swaps, and thus to have its debt reduced? Generally speaking, debt relief is one approach to providing financial resources to poor countries. An alternative avenue is to provide more grants in relation to credits or to alter the degree of credit concessionality. Debt relief is generally used to pursue three important goals (IMF 2002a, 3):

1. **To reach long-term debt sustainability**: The aim of debt relief is to contribute to reaching long-term debt sustainability and to enable the countries concerned to avoid debt traps.

2. **To support the Millennium Development Goals (MDGs)**: Both debt sustainability and the MDGs can be reached with the aid of comprehensive debt relief; on their own many developing countries are unable to generate the financial resources they need to reach the MDGs.

3. **Mitigation of exogenous shocks**: One aim of debt relief is to mitigate the negative impacts of exogenous shocks, which often impair the affected countries' ability to pay.

As important as these goals are, they have to be reached under the constraint of scarce financial resources. However, debt relief at the same time also involves a number of problems (IMF 2005a):

- **Distortion of resource allocation**: The financial resources made available for debt relief are no longer available for other development measures.

- **Orientation to past debt**: The crucial criterion for debt relief is past debt, which may be due to poor (economic) policies and institutions; a country's present debt level or its debt-service record is used as a criterion for high indebtedness.

- **Moral-hazard behaviors**: Debt reduction may encourage expectations of future debt relief and thus create an incentive for moral-hazard behaviors on the part of debtor countries. This would prevent the development of a credit culture. On the one hand, since, at least in tendency, countries with relatively poor economic policies and institutions are rewarded by debt relief, these countries are given little incentive to improve their economic policies. On the other hand, countries with relatively good economic policies and institutions are placed at a disadvantage. Furthermore, there are a number of arguments that can be advanced for the provision of loans; the latter are based on contracts that are generally binding in nature. In addition, loans – as opposed to grants or debt reduction – provide an incentive to improve debt management, and this is one good way for the countries concerned to regain access to the international financial market.

- **Loss of creditworthiness**: Granting debt relief entails the risk that – in particular – LMICs may lose both a measure of their creditworthiness and, at least temporarily, even access to the international capital markets.

Even though debt reduction does have its drawbacks, without some form of debt relief many LICs or LMICs have, in the long term, no chance of reaching debt sustainability. Since there are no systematic approaches available for debt relief for highly indebted LMICs, we can speak here of an instrument gap. Debt swaps could help to close this gap. However, the instrument of debt swaps should be used only if the following conditions are given:

- **High level of indebtedness**: One important precondition for the provision of debt swaps is that the country concerned has external debt that is no longer sustainable.

- **The funds involved are used for development-related purposes**: On its own, debt reduction does little more than address the symptoms, but without removing the causes, of underdevelopment. This is why economic reforms and/or a meaningful development-related use of at least part of the funds concerned constitute an important condition for a debt relief geared to paving a heavily indebted country's way back to long-term solvency.

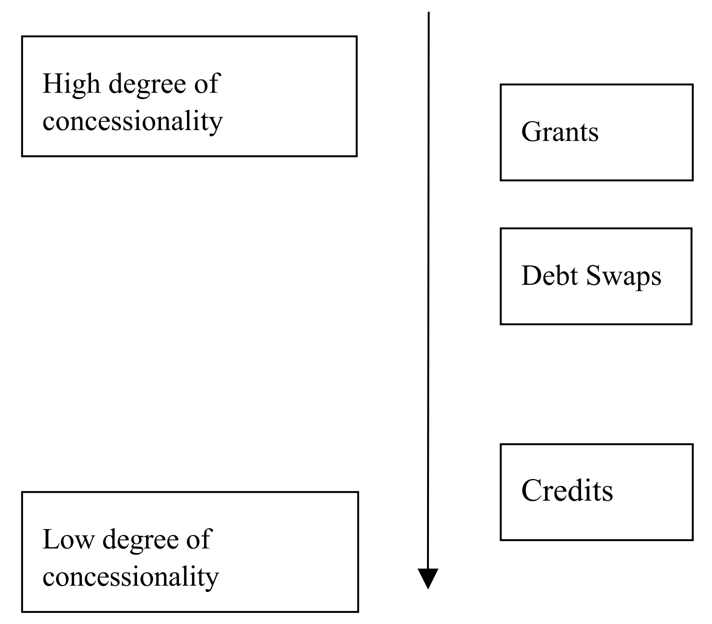
- **Consent of the country concerned**: The country concerned should be required to declare its consent to a debt swap.

2 Rules and modalities for debt swaps

2.1 The Paris Club's rules and modalities for debt swaps

Under the rules currently in effect for the Paris Club all official development assistance (ODA) debt is eligible for debt swaps, the reason being that there is consensus among creditors that they are free to achieve more generous terms on ODA debt. This means that when it comes to decisions on ODA the creditors have a broad spectrum of options available to them, ranging from different degrees of concessionality to provision of outright grants. Within this framework debt swaps tend to be closer to grants, because debt swaps as a rule involve provision of debt relief (Figure 3). However, there are upper limits for debt swaps for non-ODA debt, such as trade credits.

Figure 3: ODA modalities, measured in terms of their degree of concessionality



Source: Author

Distinctions are drawn here between different debt-swap types (Paris Club 2006a and 2006b; Fayolle 2006):

- **Debt for aid or debt for nature**: This option involves swapping FC-related claims directly for DC or environmental projects, which are then funded in local currency. One other option is for a creditor to sell his claims to a third party (e.g. a nongovernmental organization – NGO or a local institution), often at a discount, with this third party then investing in DC programs or in the environmental sector.

- **Debt for equity**: Here a distinction is made between a **direct swap** of debt for assets for the investor, with the latter purchasing local assets with local currency, and an **in-**

direct swap of debt for assets for the investor, with the creditor selling local currency to an investor (third party), and the investor purchasing assets with local currency.

- **Debt for exports**: Under this arrangement creditors' claims are met either directly, with local goods, i.e. with exports from the developing country concerned, or a creditor may sell his local currency to third parties, who then use it to purchase local goods.

While all ODA debts are eligible for debt swaps, non-ODA debt, e.g. claims stemming from trade credits, are subject to the following restrictions (Paris Club 2005):

- As a rule, low-income countries are permitted to convert 20 % – and in exceptional cases up to 30 % – of their non-ODA debt within the debt-swap framework. Such countries also have the alternative to opt for a sum of 15–20 million special drawing rights (SDRs).

- As a rule, middle-income countries are permitted to convert 10 % – and in exception cases up to 30 % – of their non-ODA debt within the debt-swap framework.

- There are nominal ceilings in effect for creditors holding small amounts of debt. One alternative for them is to opt for 15–30 million SDRs.

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 minimize moral-hazard behaviors on the part of debtors and to safeguard solidarity among creditors. 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.

One further characteristic of the Paris Club **rules and modalities for debt swaps** is that they include the following types (mechanisms) of debt conversion:

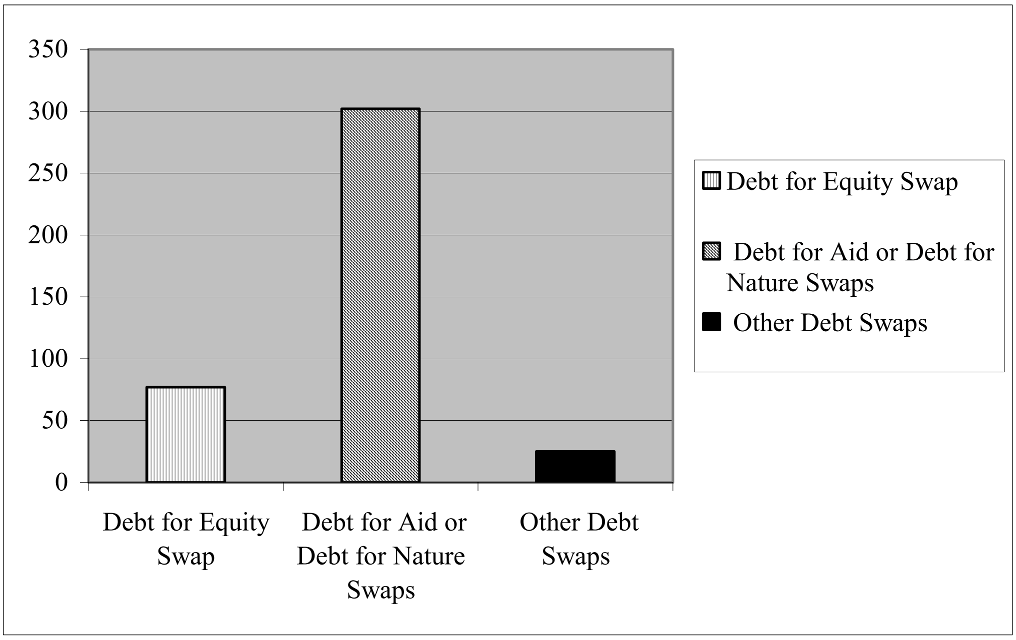
- Both short- and long-term debt is eligible for debt swaps.

- Debt swaps may remain in step with the original repayment schedule. This means that the debts concerned are cancelled within the period stipulated in the original debt-restructuring agreements reached in the Paris Club framework, i.e. the arrangement applies for the annuities agreed upon. In this case the debt-reduction effect makes itself felt only when these annuities fall due. For this reason a debt swap of this kind has tangible effects for both creditor and debtor only when the annuities fall due. However, since in this case the debt reduction applies to the debtor's nominal debt, the latter declines in consequence.

The Paris Club also permits its members to decide on the sectors in which they wish to use their debt swaps and how they wish to use the funds involved (projects, programs, basket-funding, or budget-financing).

Between January 2004 and October 2005 the following types of debt swaps were carried out in the Paris Club; they had a total volume of EUR 404 million (Figure 4).

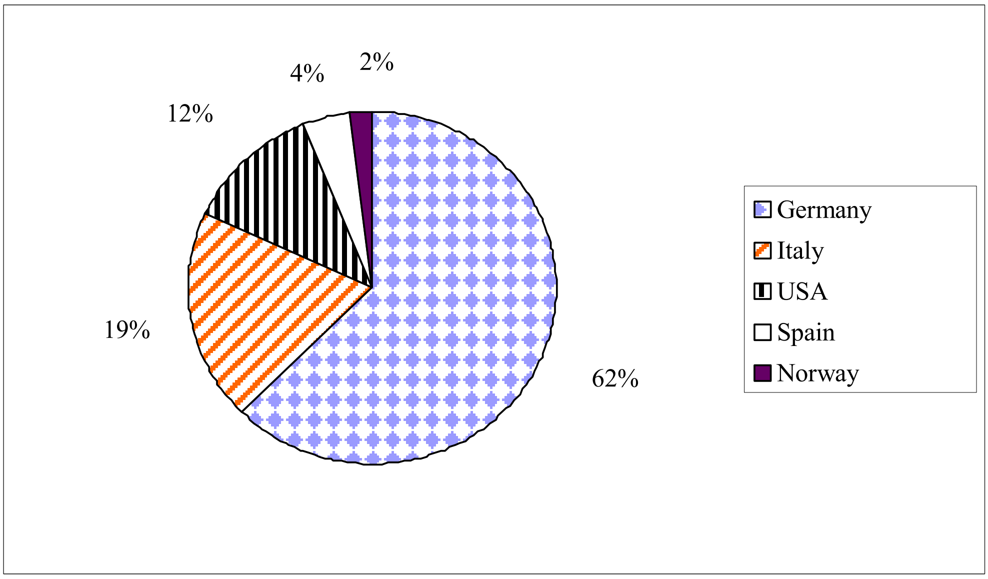
Figure 4: Debt swaps transacted in the Paris Club from 1/2004 to 10/2005, in US$ million



Source: Based on data published by the Paris Club (2005)

Most of these transactions were debt-for-aid or debt-for-nature swaps, amounting to a total of US$ 302 million (Figure 5). Debt-for-aid and debt-for-nature swaps accounted for roughly 75 % of all debt swap transacted; debt-for-equity swaps accounted for a good 19 %; and other debt swaps amounted to a total figure of roughly 6 %.

Figure 5: Percentages of creditors involved in debt-for-aid or debt-for-nature swaps



Source: Based on data published by the Paris Club (2005)

Between January 2004 and October 2005 the percentages of creditors opting for debt-for-aid or debt-for-nature swaps (amounting to a total of US$ 302) were quite unevenly distributed. Germany took the lead here, carrying out a total of 62 % of these swaps; it was followed by Italy (19 %), the US (12 %), Spain (4 %), and Norway (2 %).

2.2 The rules and modalities for debt swaps in Germany

In the framework of German debt swaps, Germany cancels a share of the existing FC debts of countries that have concluded debt-restructuring agreements with the Paris Club, provided that the country concerned uses a certain sum of local currency (20–50 % of the amount of debt cancelled) for projects on which agreement has been reached. Accordingly, the German government is authorized to convert restructured FC debt, and eligible countries are required to meet the following criteria:

- Per capita income below US$ 3,035/ 2003: This limit is oriented to the annual adjustment of the eligibility limits undertaken in keeping with the World Bank's definition lower-middle-income countries (LMICs).
- A previous restructuring agreement in the Paris Club framework is necessary that contains what is known as the swap option. In other words, the funds eligible for debt swaps must previously have been restructured with the Paris Club.
- Another condition for a debt swap is that the debtor countries concerned continue to meet the terms of existing debt-restructuring agreements.

The main precondition for a debt swap of this kind is that the debtor country makes available local currency funds amounting to 20–50 % of the sum of the FC debt swap (debt cancelled). The share of local currency funds required is specified on a case-by-case basis, with the ministries involved reaching agreement on the percentage of these local currency funds. The orientation variable used for the purpose is the debt-relief effect, determined on the basis of net present value. Poorest countries that have restructured their debt with the Paris Club under the Naples terms, which provide for cancellation of 67 % of commercial claims, are assigned a local currency funds share of 20 %.

Two **sectors** are eligible for the use of these local currency funds – environmental and resource protection and education as well as, in addition, general poverty-reduction measures.

In **institutional terms**, the measures involved should be integrated into either concrete bi- or multilateral projects in need of local currency funds or measures conducted by a government or an NGO.

Debt swaps are supposed to lead to **additional measures** (additionality), i.e. the local currency funds involved are expected to be used for new projects. Ongoing projects are eligible for support only if their funding is jeopardized, and recipient countries are required to furnish proof of this.

Box 1: Administrative procedure
The official administrative procedure is as follows. The BMZ applies the following criteria to select countries and to define the volume of a debt swap. Relative urgency of the recipient country's need for debt relief; basic political conditions in the recipient country; its track record in cooperation on debt management; its need for funds for environmental and resource protection, poverty-reduction measures, or education measures. In the framework of scheduled bilateral debt-restructuring talks (DC consultations/DC negotiations), or in some other appropriate form, the BMZ – following coordination with the *Bundesministerium der Finanzen* (BMF) and the *Auswärtigen Amt* (AA) – presents a debt-swap proposal to a partner country. If the partner country accepts the offer, the BMZ decides, in close cooperation with the partner country, what projects would be best suited for use of the local funds involved. The KfW concludes an agreement with the debtor country ("separate agreement") laying down the particulars of the debt swap, e.g. type of measures and institution responsible or a timetable for the implementation of the measures agreed on. The implementation of the measures is also monitored. This means that the institution responsible for carrying out the measures concerned is required to provide annual reports; if a partner-country governmental or nongovernmental organization carries out the measures, an independent auditor must be commissioned to prepare a final report (BMZ 2005a). The debt swap is then implemented as soon as the partner country has put the local currency funds to the uses agreed upon.
Source: BMZ 2005a

Comparison of German and Paris Club rules

We find here that the Paris Club rules on debt swaps are considerably more flexible than those used by the German government. This goes in particular for the fact that under the Paris Club rules all ODA debts are eligible for debt swaps. In Germany, by comparison, only restructured ODA debts are eligible for debt swaps. In addition, the Paris Club rules also provide for models other than debt for aid or debt for nature – e.g. debt-for-equity swaps.

Moreover, the Paris Club imposes no rules on its members regarding the volume of both swaps and the local currency funds to be raised. The share of local currency funds provided for can play a significant role in debt-swap negotiations and may at the same time serve as an important bargaining issue when it comes to talks on e.g. interest rates, redemption-free periods, etc. A high share of local currency funds offers the advantage that in this case the donor has greater influence on how these funds are used. One disadvantage of a high share of local currency funds must be seen in the lower debt-reduction effect that this entails.

2.3 German debt swaps in Indonesia, Jordan, and Peru

Measured in terms of its quantitative volume, the instrument of the debt swap plays a rather insignificant role in German FC. While up to EUR 100 million p.a. is available for debt swaps, total FC-related debt amounted to EUR 16.385 billion at the end of 2005.

However the sum of all debt swaps on which agreement had been reached by the end of 2005 (EUR 887.61 million) is relatively high.

It is furthermore important to note that these are only aggregate figures; in some individual countries debt swaps may play an important role in relation to overall FC-related debt. In other words, looked at in terms of their volume, debt swaps can be used to set development-policy accents. The debt swaps on which agreement was reached with Jordan between 1992 and April 2006 (EUR 213.6 million) accounted for close to 59 % of all Jordanian FC claims held by Germany at the end of 2005. The equivalent figure for Peru was roughly 45 % (Table 1).[6]

The following swaps could still be agreed upon under current bilateral agreements and the German modalities for debt swaps: EUR 124.6 million with Indonesia, EUR 2.3 million with Peru, and EUR 20.5 million with Jordan.

However, in the cases of Jordan and Peru the volume of debt in need of conversion

Table 1: FC and FC debt conversion for Indonesia, Jordan, and Peru, in Mio €

	Indonesia	Jordan[a]	Peru
FC-related claims, end of 2005	1150.0	362.0	318.0
Max. possible swap volume	198.2	234.1	147.0
Swaps agreed on thus far	73.6	213.6	144.7
Swaps still possible	124.6	20.5	2.3

Source: BMZ

a) In Jordan agreement was reached after 31 March 06 on another debt swap for EUR 30 million. This is why the state of implementation given here is 30 April 06.

is greater than the volume available for swaps. If the total volume were taken as a basis, Jordan would be eligible for an additional EUR 75 million in debt swaps and some EUR 123 million would be available for Peru for the same purpose.

If the whole of the ODA claims held by Germany could be used for debt swaps, the additional funds available for debt swaps for the cases under consideration here would be: some EUR 952 million for Indonesia, EUR 127.6 million for Jordan, and roughly EUR 171 million for Peru.

In **Indonesia** Germany has thus far carried out a debt swap in the education sector. This debt swap, with a volume of EUR 25.5 million, was carried out and concluded between 2003 and 2005 in the field of advanced teacher training; its aim was to improve primary-school science education. A second debt swap in the education sector, this time designed to promote junior secondary schools and involving a volume of EUR 23 million, is cur-

6 One limitation on the comparability of these figures is the fact that the terms of current FC-related claims do not coincide with the terms of the debt swaps concerned. All the same, comparing the sum of the debt swaps agreed on to now with claims stemming from FC loans does provide an indication of the relative significance of debt swaps.

rently in the process of implementation (2005–2007). A third debt swap, with a volume of EUR 25 million, in the environmental and forestry sector is still in the planning phase.

The share of local currency funds to be raised by the Indonesian side has been 50 % for all three swaps. However, this share was not determined on a net present values basis, as stipulated in the German modalities paper.[7] In view of the fact that the Indonesian government was and is particularly interested in reducing the country's debt level, a net present value calculation would probably not have played any major role in the transactions.

The two first debt swaps were well integrated within **Indonesia's national development strategies**, in which education is defined as a priority sector. These two debt swaps are of major relevance to development because they help the Indonesian government to pursue two goals: promotion of primary education and efforts to balance out regional disparities. The education sector accounted for only 3.5 % of Indonesia's overall budget for 2004; by 2006 this percentage is set to rise to 12 % and to reach 20 % by the year 2009.

In **Jordan** Germany has carried out six debt swaps since 1992 – in the water, environmental, and education sectors. The seventh swap is presently being implemented, and agreement has been reached on an eighth, although implementation has not yet got underway. The total volume of the debt swaps agreed on thus far is just short of EUR 214 million. Measured in terms of their volume, Germany is Jordan's leading provider of debt swaps.

The conversion rates agreed on in Jordan have amounted to 50 %. These rates were not set on the basis of a net present value calculation. One reason for this could be that Jordan was especially interested in reducing its debt level and therefore did not attach any particular importance to a calculation of net present value.

The debt swaps are well embedded in **Jordan's** national development strategies, with the local currency funds involved being used in sectors (water, education, poverty reduction) that have played an important role in both the National Agenda (Government of Jordan 2005) and the Socio-Economic Transformation Plan (SETP). Debt Swaps VII and VIII – education sector – are also integrated into the Education Reform for the Knowledge Economy program (ERfKE).

Thus far agreement has been reached with **Peru** on nine debt swaps, and another is in planning. While the conversion rates agreed on with Peru (30–40 %) are higher than those used for the Swiss debt swaps conducted there (25 %), the conversion rates agreed on for the Italian (total volume: US$ 186 million) and Spanish counterpart funds was 100 % (Hochhuth 2006, 12).

7 *"… The share of local funds to be provided by the debtor country is defined on a case-by-case basis; the debt-reduction effect of the debt swap, which is determined on a net present value basis, is taken into account here as an orientation variable…."* (BMZ 2005a, 1).

3 Integration into German and multilateral DC

The official German modalities paper[8] for FC debt conversion is the basis for the **formal integration** of debt swaps into German DC. The paper sets out the administrative procedure for debt swaps as follows:

i. The German government and the partner country reach agreement on a conversion of debt stemming from FC loans;

ii. the BMZ reaches agreement with the partner country on the projects to be carried out and then commissions the KfW with the task of implementation;

iii. the KfW is in charge of transacting the financial aspects of the debt swap. The so-called "separate agreement" with the partner government specifies the particulars of the measures to be carried out – e.g. sectors, institutions responsible for projects, goals, reporting obligations;

iv. the KfW, with the previous approval of the BMZ, implements the debt swap as soon as the partner country has met its contractual obligations.

Since the partner countries use funds of their own – and not FC funds – for debt swaps, the FC / TC guidelines do not apply here; but the partner is nevertheless obliged to have audits conducted by an internationally recognized consultant. The German modalities paper further contains the following stipulations on the monitoring of project implementation:

> *"… Project implementation must be monitored. In order to keep the related costs as low as possible, the funds will be … used in bilateral German or multilateral projects. In cases involving support to a governmental or nongovernmental organization of the developing country, an independent auditing agency must be called in."*
> (BMZ 2005a)

The separate agreements as a rule require partners to prepare both annual reports and a final report. The KfW monitors the conduct of the audits, and as soon as implementation has been completed, it recommends debt cancellation to the BMZ; based on the annual reports, the KfW may also recommend cancellation of part of a partner's debt.

Compared with the other FC instruments in use, this administrative procedure considerably reduced the intensity of the support activities required of the KfW. While partners are required to coordinate their choice of projects with BMZ and KfW, they then have a largely free hand when it comes to project implementation. Based on the annual and final reports, the KfW examines whether the measures/projects have been carried out in compliance with the separate agreement in question. This low level of support intensity may be seen as appropriate in that the partners use funds of their own for the projects, with FC funds being used only "indirectly." However, there is a risk here that project implementation may prove to be of poorer quality than projects implemented in the framework of the FC instruments used by the KfW.

8 For the German modalities paper, see the Annex.

One way to assure the quality of projects would be to integrate them into **existing DC structures** (German or those of other bilateral donors). German DC is in possession of functioning planning and implementation structures, in particular in the priority areas of German DC. Apart from the concrete administrative procedures, debt swaps are covered in the BMZ's country concepts.

In 2000 the following three priorities were agreed on for **Indonesia**: economic reform, transportation, health. Decentralization is a cross-cutting issue here (BMZ 2005b). The first two debt swaps concerned the education sector instead of these priorities. But in view of the fact that the projects carried out in connection with Debt Swaps I and II were complementary to the FC / TC cooperation project SEQIP I & II, these projects are well embedded in German structures on the ground. Together with the *Deutsche Gesellschaft für Technische Zusammenarbeit* (GTZ), the KfW coordinated the measures proposed for these projects (BMZ 2002).

This means that the debt swaps were granted for a program that had been carried out by KfW and GTZ even before the priorities were defined for German DC. This program was at a stage in which the partners were able to continue with the projects on their own responsibility.

Debt conversion in Indonesia has shown clearly that the structural preconditions, in particular functioning planning and implementation structures, must be seen as a very important criterion for the implementation of debt swaps. This often applies for programs carried out in the framework of the priorities set for German DC. But it would also be conceivable to use debt swaps for programs/projects of other donors.

Since thus far only one debt swap has been completed in Indonesia, the only reports available are annual reports. An external final report will be prepared in 2006 on the first debt swap. It will examine in particular whether the local currency funds were spent as stipulated.

The debt swaps carried out in Indonesia were in part well integrated in multilateral development strategies. In **Indonesia** the second German debt swap serves to complement the Indonesian government's project "Improving the Quality of Junior Secondary Education," which involves overall costs amounting to US$ 382 million. The World Bank has contributed US$ 296 million to this project and the Asian Development Bank (ADB) has assumed the role of "partner agency."[9] The school-building activities carried out in connection with the debt swap complement the activities of the World Bank. The KfW has in this way been able to avoid any duplications in procurement and funding.

Since 2001 the focus of German DC in **Jordan** has been on the water sector, including relevant environmental aspects. German DC focused on the water/wastewater sector in Jordan even before this priority was set. Debt Swaps I, II, and V have for this reason been embedded in the comprehensive German engagement in the field of wastewater collection and treatment.

9 The volume of the funds contributed by the ADB is unknown.

Making use of the leeway provided for in this connection, additional FC projects are being carried out in the field of primary-school construction. There is thus a direct link between Debt Swap IV and the school-construction program, and the swap has been used in the framework of the Education Reform for the Knowledge Economy program (ERfKE), which also includes other FC school-construction projects carried out by the KfW.

Even though Debt Swaps III, IV, and VI – the Social Productivity Program – are not directly associated with the German FC engagement, they – like the latter – do have a poverty-reduction thrust.

The use of parts of Debt Swap VIII to finance a technical college is not integrated into German DC structures. This is one reason why the dialogue with the Jordanian side turned out to be relatively difficult.

The KfW has reviewed the use of the funds on the basis of the annual reports prepared by the Jordanian partners on Debt Swaps I-IV. While the separate agreements with the KfW require partners to submit external final reports, the KfW has not called for such reports either for Debt Swaps I-IV or for Debt Swap VI, the reason being that the partners provided comprehensive and detailed project documentations in the annexes to their annual reports. For Debt Swap V a final report will be prepared and submitted to the BMZ.

In **Jordan** Debt Swaps III, IV, and VI are being carried out in the framework of joint projects involving the KfW, the World Bank, the Arab Fund for Economic and Social Development, and the Islamic Bank for Development. The World Bank, the Arab Fund for Economic and Social Development, and the Islamic Bank for Development have made credits available and the KfW has provided a grant. The Jordanian government has provided its own – required – contribution of 20–37.5 % with the aid of the debt swaps.

Debt Swap VII and the KfW FC projects in the field of primary-school construction are integrated into a national education reform project – ERfKE – which is supported by several donors (European Investment Bank (EIB), World Bank, Islamic Development Bank). The focus here is on provision of physical infrastructure, i.e. on the program's third component. The Jordanian education ministry has assumed responsibility for coordinating the activities of the various donors. For example, the Jordanian side has provided its own required share of the funding for a World Bank school-construction project with the aid of the German debt swaps. Here the World Bank is providing 65 % of the funding, with 35 % coming from the German debt swap.

The greater part of the debt swaps carried out in **Peru**[10] are also embedded in German DC structures and the German priority areas set for Peru. The projects underway in connection with Debt Swaps I and II are being carried out in the context of the FC-TC cooperation project on nature conservation areas / PREOFANPE. The KfW has reviewed project progress in connection with its monitoring of the FC project. The projects carried out in connection with Debt Swap IV are directly linked to the Alto Mayo (alternative development) FC-TC cooperation project. An expert funded by the KfW supported the responsible institutions in formulating the measures provided for.

10 For more information related to what follows on Peru, see Hochhuth (2006, 28–32).

The Peruvian institution responsible for Debt Swap V works together with KfW and GTZ. The KfW prepared the concept for the project planned for Debt Swap V. The institution responsible for the projects has concluded a contract with the GTZ that was funded on the basis of funds stemming from the debt swap. In addition, the GTZ intends to carry out a TC project with the same institution.

The measures carried out under Debt Swaps VI and VII to combat youth unemployment are not directly linked to KfW projects, but the KfW does regularly review project progress on the basis of talks with institutions in Lima responsible for FC projects.

While Debt Swap VIII is not directly linked to KfW or GTZ projects on the ground, the counterpart fund is integrated into the DC structures in Peru to the extent that the German ambassador and his representative as well as the head of the KfW office in Lima and his representative have seats on the CPF executive committee.

Use of debt swaps – budget-financing: debt-for-budget swaps

Instead of being used for individual projects, the local currency funds generated from debt swaps could also be allocated directly to the budgets of partner countries. Beside basket-financing, budget support is an instrument of program-oriented joint financing. In the actual sense of the term, direct allocation of budget-swap funds to a partner country's budget is not budget support. In this case donors do not make funds directly available for a partner country's budget, the partner uses the local currency funds generated by a budget swap to boost his own funding for certain sectors. The following will for this reason use the term budget-financing.

Compared with the use of debt swaps for projects, budget-financing has the following advantages, which are similar to those described for budget support[11]:

- **Donor coordination**: Here the possibility is given to engage in joint financing with other donors, an approach could well lead to more harmonized processes.

- **Increased ownership**: Budget-financing further increases ownership because the funds involved are no longer tied to specific purposes.

- **Reduction of transaction costs**: The approach would significantly lower the KfW's monitoring- and auditing-related transaction costs. Budget aid in the framework of debt swaps may be particularly appropriate in cases in which a donor has not developed sufficient DC structures of his own in a given country. In this case it as a rule proves relatively costly to monitor and control projects.

- **Uniform budget framework**: A uniform budget framework serves to support partner reform programs**.**

11 For a good overview on budget support and other forms of program-financing as well as on the advantages and drawbacks of these instruments, see Klingebiel / Leiderer / Schmidt (2005) and Koeberle / Stavreski (2006).

- **Financing of current costs**: One advantage in the use of debt swaps as budget aid is that the funds involved can also be used to cover current costs. One central bottleneck in efforts to reach the MDGs must be seen in the lack of possibilities open to partner countries to finance their current costs (Wolff 2005).

- **Improved policy dialogue**: The approach makes it possible to concentrate better on important sectors, since budget-financing is used in sectors defined as priority sectors in national Poverty Reduction Strategy Papers (PRSPs). On the whole, budget-financing increases the significance of DC, and this enables DC, in the form of joint program-oriented financing, to make important contributions to reaching the MDGs, e.g. with the aid of budget-financing.

However, if these advantages of budget-financing are to be turned to account, the following conditions must be met:

- **Functioning budgeting procedures**: In order to ensure that the uses to which these funds are allocated can be monitored, a country must be able to prepare a verifiable budget.

- **Functioning planning and implementation structures**: Partners must build adequate structures that enable them to develop, implement, and analyze strategies.

- **Satisfactory public budget management**: One central risk is that a partner may not report promptly and reliably on the uses to which relevant budget funds are allocated. In this case donors are unable to reconstruct how such funds have been used. Good budget management is the only way to counter these fiduciary risks.[12]

If, instead of being made available for projects, the local currency funds are allocated directly to a partner's budget, a donor should examine, on a case-by-case basis, whether the requisite conditions have been met in the countries in question.

Quite apart from the fiduciary risks involved, donors may be forced here to relinquish some of their own influence and policy space: In this case the options open to individual donors may be restricted because their contribution to a partner budget is relatively small on account of the local currency share required in debt swaps. This could reduce the German government's development-related leverage in the countries concerned.

In Mozambique, France had the local currency funds (EUR 10 million) from a debt swap (EUR 30 million) allocated directly to the budget for a certain sector. In selecting a suitable sector, France sought orientation in Mozambique's PRSP. The most important reasons for this approach were that the French DC structure in Mozambique was not sufficiently developed to enable France to monitor the use to which the funds were allocated. In addition the sum involved was relatively "small," which meant that the transaction costs for implementation and monitoring would have been inordinately high.

12 See Shand (2006) for a good overview of different types of fiduciary risk in connection with budget support.

4 Advantages and drawbacks of the German debt-swap instrument

4.1 Advantages of the German debt-swap instrument

German debt swaps may, for the following reasons, be seen as a meaningful instrument of development policy:

Reduction of external debt: Since the external debt of partner countries declines nominally in proportion to the debt swaps agreed upon, the FC debt conversion instrument may be said to provide a contribution to reducing the external indebtedness of the beneficiary countries. But gauged in terms of the overall debt of partner countries, the role debt swaps play differs from country to country.[13]

Partner-country debts are cancelled within an agreed-on period of time, and this means that the annuities agreed on are cancelled; that is the debt concerned is cancelled neither in one sum agreed on in a debt swap nor on completion, by the partner country, of the measures agreed upon in connection with a debt swap. In other words, for the partner country the debt-reduction effect occurs only as the annuities fall due; there is no comprehensive and prompt debt-reduction effect. But such debt cancellation does serve to reduce a partner country's total debt, a factor that played an important role for Jordan in particular.[14]

Measured in terms of the following three indicators, in 2004 **Indonesia**'s external debt was relatively high (Table 4):

- its debt-service ratio amounted to 22 %;
- its total debt as a percentage of exports amounted to 152 %; and
- its total debt as a percentage of national income amounted to 56.5 %.

In 2003 Indonesia's total external debt amounted to roughly US$ 140.6 billion. While the debt relief provided through the three German debt swaps agreed on between 2004 and 2005, a total of EUR 73.5 million, has contributed to reducing the country's external debt, its quantitative impact has for this reason been relatively low. Since the German debt swap in Indonesia was the first one carried out there by a donor, it may have a catalyst effect. Other donors could follow the German example in using this instrument.

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13 The nominal value of the debt swaps implemented by members of the Paris Club between 1991 and 2005 was US$ 5.6 billion, a relatively small sum when seen in relation to the volume of the debt cancelled on a multi- and bilateral basis. Since 1983 the members of the Paris Club have cancelled a total of some US$ 503 billion in debt (Fayolle 2006; Paris Club 2006a).

14 For the creditor (Germany) this has the advantage that the loss of revenue involved is distributed across the remaining term of the credits.

Table 2: The debt situation in Indonesia, 2000–2004

	Debt service as a % of exports	Total debt as a % of exports	Total debt as a % of national income
2000	22.5	194.5	93.7
2001	23.6	203.4	88.7
2002	24.7	193.3	68.1
2003	25.5	189.6	59.7
2004	22.1	151.6	56.5

Source: World Bank 2006b

While **Jordan**'s external debt situation has improved substantially since 1990, in 2004 it was – measured in terms of the three following indicators – still relatively high (Table 3):

- its debt-service ratio amounted to 8.2 %;
- its total debt as a percentage of exports amounted to 95.5 %; and
- its total debt as a percentage of national income amounted to 69.8 %.

Table 3: The debt situation in Jordan, 1990–2004

	Debt service as a % of exports	Total debt as a % of exports	Total debt as a % of national income
1990	20.4	270.8	219.0
1995	12.4	158.3	118.8
2000	12.6	125.4	85.6
2001	10.6	120.8	82.2
2002	8.5	116.7	83.8
2003	15.9	114.3	81.1
2004	8.2	95.5	69.8

Source: World Bank 2006b

The debt swaps transacted in **Jordan** have contributed substantially to improving the country's debt sustainability. In the period between 1990–2004 Jordan's total external debt fluctuated between US$ 7.3 and 8.3 billion. The debt swaps agreed upon between Jordan and all donors since the early 1990s (US$ 800 million) accounted for roughly 10 % of the country's total external debt.

While **Peru**'s external debt has also declined substantially since 1994, in 2004 it was – measured in terms of the following three indicators – still relatively high (Table 4):

- Its debt-service ratio amounted to 17.1 %;
- its total debt as a percentage of exports amounted to 195.8 %; and
- its total debt as a percentage of national income amounted to 48.0 %.

Table 4: The debt situation in Peru, 1995–2004

	Debt service as a % of exports	Total debt as a % of exports	Total debt as a % of national income
1995	15.9	395.5	59.4
2000	25.6	288.4	55.5
2001	22.2	278.3	52.4
2002	32.8	271.8	50.9
2003	21.3	249.2	50.9
2004	17.1	195.8	48.0

Source: World Bank 2006b

Between 1994 and 2004 **Peru**'s external debt ranged between US$ 26 and 30 billion. The German debt swaps, with a total volume of EUR 147.5 million, therefore accounted for less than 1 % of the country's total external debt. For this reason the German debt swaps have not, on their own, significantly improved Peru's debt situation[15] (Hochhuth 2006, 11–12).

Simplified procedure: One especially good aspect of the German debt-swap instrument is its simplified procedure concerning both the selection and implementation of projects. The most important selection criterion is the sector in which the projects are to be implemented. Once German representatives have reached agreement, in the so-called separate agreements, with a partner country on the most important features of a debt swap, the partner assumes full responsibility for its implementation.

Additionality: One aim of the German debt-conversion instrument is to generate additional local funds for poverty reduction as well as for the education and environmental sectors. Debt swaps make it possible to implement additional development measures that the partner would not have been able to undertake without the funds made available by debt cancellation.

One of the conditions stipulated in the German government's modalities for FC debt conversion is additionality.

15 The debt restructured in 1996 in the Paris Club framework (Paris Protocol, 20 July 1996) had a total volume of some US$ 6.7 billion, with a German share of roughly DM 440 million (Hochhuth 2006, 11).

> *"Additional measures are carried out in the framework of debt conversion. The additionality of the described measures in the developing countries is achieved by using the local currency funds for new projects.*
>
> *Moreover, ongoing measures are eligible if there is no possibility to continue to fund them without the use of this instrument, e.g. on account of any current budget-consolidation processes. The recipient countries are obliged to furnished proof of this in suitable form."*
> (BMZ 2005a, 3)

It is as a rule difficult to monitor additionality since it would have to be clear ex ante what projects would have been implemented without the additional funds made available in connection with debt conversion (fungibility of money). This requires, first, information on a country's budgeting practices both before and after debt relief has been granted in the framework of a debt swap. Second, the projects carried out in connection with a debt swap would have to be itemized in the partner country's budget, i.e. what is needed is a highly itemized budget. It is thus, for methodological reasons, generally difficult to demonstrate additionality empirically.

For BMZ and KfW the criterion of additionality is mainly given if the countries concerned conduct additional – i.e. new – projects in the framework of a debt swap and if these projects were not included in their current budget.

In **Indonesia**, for example, the funds for the third debt swap are required to be explicitly earmarked in the national budget; the swap will partly be dedicated to the forestry sector.

Increased development leverage: Debt swaps provide the German government with additional development leverage in the policy dialogue with recipient countries. In debt swaps the sectors in which projects are to be implemented by partners are coordinated with the KfW and set down in the separate agreements. This makes it possible to set incentives for partner countries to initiate reforms in sectors important in terms of development. It at the same time provides a means to move partners to make investments in sensitive sectors, as e.g. in the case of Indonesia.

The projects involved in the third debt swap in Indonesia are being carried out in a politically sensitive sector, forestry. And the German debt swap may serve to open the door for other projects in the same sector.

Catalyst effect: A successfully transacted debt swap may also have a catalyst effect on other donors. The German debt swap in Indonesia is the first of its kind. No other donor has been able to carry out a debt swap in Indonesia, and for this reason the German debt swap in Indonesia is being followed with great interests by other donors. If this first swap should receive a positive evaluation in a final report, it would be entirely possible that other donors might follow Germany's lead and carry out debts swaps of their own in Indonesia.

Conditioned debt relief: Debt conversion involves conditionality and control, though these are not so extensive as to overly restrict partners in their own responsibility.

Increase of ownership: The projects involved are proposed by the partners, and they become components of partner systems by being transacted via national budgets. This furthermore signals to partners that their structures are recognized. This is one reason why the implementation of projects in the framework of debt swaps is relatively simple.

In **Indonesia** parents and villagers have been involved in the implementation of the projects carried out in connection with the first debt swap. The construction measures are managed by a school committee consisting of school administration, parents, and the community at large. This participation of the people concerned goes some way toward increasing ownership.

Involvement of civil society: Civil society can be involved in the implementation of debt swaps. One example here is the counterpart fund in Peru. The fund's decision-making body includes two representatives of Peruvian civil society, who were appointed at the proposal of the Peruvian government and with the approval of the German side. Civil society was also represented in the founding committee, which prepared a paper on the goals, working procedures, and appropriation of the counterpart fund; the paper served as an agreement and was signed, in 2002, by the Peruvian government and the KfW (on behalf of the German government). The start of the fund's work was, though, delayed for roughly six months because the Peruvian government was willing to accept only one of the civil society representatives from Mesa de Concertacón. As a second representative, the government nominated a person from the conferences of university rectors, who was then appointed to the decision-making body. Even though two representatives of civil society have seats in the CPF's decisions-making body, a more exact analysis would be needed to be able to assess the actual influence of civil society. Also it is still unclear whether the representatives of the conference of rectors in fact act in the interest of civil society (Hochhuth 2006, 10).

Integration into German DC structures: The partner-country projects carried out in the framework of a debt swap may be seen as particularly well integrated into the German DC structures if these projects are implemented either along with or immediately subsequent to German DC programs and/or TC programs.

Involvement of German business enterprises: German companies are generally eligible to become involved in debt swaps. However, in the first place, "tied aid" distorts competition and second, the volume of these swaps is relatively low, which means that the impact of German companies would be limited in any case. In Indonesia two German companies (Leipold in Cologne and Klett in Stuttgart) supplied some of the equipment for the schools involved, the reason being that comparable Indonesian products were of poorer quality. No German companies are involved in the debt swaps in Jordan and Peru (Hochhuth 2006, 16).

4.2 Drawbacks of the German debt-swap instrument

A number of problems that have been encountered are due to the way in which the modalities for the implementation of German debt swaps are formulated. In particular, eligibility is restricted to the following **groups of countries**:

- **HIPCs**: The 100 % cancellation of FC-related debt in connection with the enhanced HIPC Initiative means that these countries are no longer in need of debt conversion.

- **LDCs**: For many countries with LDC status, the KfW provides only grants instead of credits.

- **Middle-income countries (MICs)**: Under the legal provisions currently in force in Germany, debt conversion is not a particularly attractive option for highly indebted middle-income countries (LMICs and MICs) because the only debts eligible for conversion are those that have already been restructured with a high degree of conditionality in the Paris Club framework. This means that German debt swaps are coupled to multilateral debt-relief arrangements. The following conditions apply here: The only debts eligible for conversion are restructured FC claims with a number of redemption-free years (normally 10) and low interest rates, and the recipient country is obliged to raise, from its national budget, counterpart funds amounting to 20–50 % of the sum to be converted; these local currency funds must be made available promptly and be used for new development-related measures.[16] In this case a debtor country would exchange its traditionally restructured debt for a debt swap that may be costly in the short term.

For these reasons FC debt conversion, in its present form, is becoming less and less relevant as an instrument. Flexibilizing the debt swaps in such a way as to bring it into line with the Paris Club rules on debt swaps could be one way to counteract this trend. Since under the Paris Club rules all ODA debt is eligible for debt swaps, this would make it possible to make full use of the scopes which the Paris Club provides for (Paris Club 2005). Table 5 lists the countries that would be eligible for debt swaps under the legal provisions currently in force in Germany.[17]

Table 5: Still outstanding opportunities for *Debt Swaps* in Germany, in Mio. €

Egypt	106.5
Bosnia and Herzegovina	30.2
Indonesia	124.6
Jordan	20.4
Kyrgyzstan	8.5
Pakistan	910.0
Peru	2.3
Serbia and Montenegro	218.0
Syria	178.0

Source: Data provided by the BMZ

16 LMICs and MICs are as a rule required to commit local currency funds amounting to 40–50 % of the debt swap concerned.

17 The swap commitments made to HIPCs were omitted since these debts have been cancelled.

Table 9 in the Annex shows that it would be possible to enlarge the group of eligible countries to include the countries that generally have FC-related debt and could prove to be interested in making use of a flexibilized debt-swap instrument; these countries would include e.g. the Dominican Republic, El Salvador, Georgia, Guatemala, Indonesia, Kenya, Morocco, Namibia, Peru, the Philippines, Serbia-Montenegro, or Tunisia.

In addition, debt swaps entail the following risks: Since the debtor country is required to make available, in local currency, 20–50 % of the sum in question for national partner projects, this means a major **burden** for the current partner **budget**. Suspension of the interest payments on the sum to be swapped does relieve the partner budget, but, in a given budget year, the debt-service payments that would have accrued during the term of the debt swap are as a rule lower than the amount of the local currency funds the partner country is required to raise for a debt swap. In addition, the debt eligible for cancellation in the framework of a German debt swap must already have been restructured with the Paris Club, and this means that it has a high degree of concessionality. As a rule, debt restructuring of this kind entails an extension providing for 10–15 redemption-free years. At the point of time when the debt swap is actually implemented, the debtor country is often in this redemption-free phase, in which it is only required to keep up its interest payments. This means that the country in question is forced to make advance outlays in local currency and may have to take out loans in local currency, which may be more costly than FC loans.

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. In most cases, neither the Indonesian and Jordanian partners nor the German government have conducted net present value calculations, even though the German modalities for FC debt conversion specify that the level of the partner local currency share must be determined on the basis of a calculation of the net present value of the debt-reduction effect anticipated for the debt swap.[18]

In view of the fact that net present value is a crucial factor for the costs of debt swaps, there is some question as to why this value was often not calculated. Net present value would not play a crucial role if the budgets of partner countries were not additionally burdened by debt swaps, i.e. if there were no project additionality requirement. This could be an indication of a windfall effect, or – compared with a nominal debt that stands to be immediately reduced by the debt relief provided in connection with a debt swap – net present value may play a subordinate role for a partner country.

Since the implementation of the German debt swaps, the Indonesian government has not run a high budget deficit: Measured in GDP terms, the Indonesian budget deficit ranged

18 *"The local currency share to be raised by the partner country will be determined on a case-by-case basis; the debt-reduction effect of the debt conversion, calculated on a net present value basis, will be used for purposes of orientation"* (BMZ 2005a, 1).

between -0.6 and -0.9 % between 2002 and 2005 (Table 6). And for this reason the overall Indonesian budget was not overly burdened.

Table 6: Development of the budgets of Indonesia, Jordan, and Peru, balance as a % of GDP

	Indonesia	**Jordan**	**Peru**
1995			-2.8
1996		-2.9	-1.0
1997		-2.6	0.0
1998		-5.9	-0.5
1999		-3.5	-3.0
2000		-4.7	-3.2
2001		-3.6	-2.3
2002	-1.5	-4.9	-2.2
2003	-1.9	-1.0	-1.7
2004	-1.4	-1.7	-1.1
2005	-0.6	-6.4	-1.0

Source: IMF, various country reports

Jordan's budget deficit fluctuated substantially between 1993 and 2005. While in 1995 the Jordanian budget deficit was -0.1 % in GDP terms, the figure for 2005 was -6.4 %, i.e. Jordan's deficit (in GDP terms) was relatively high in 2005.[19] Even so, the Jordanian budget was placed under additional strain, and that in a situation involving a high budget deficit, e.g. in the years 1998, 2000, 2002, and 2005.

Peru's budget deficit fluctuated between 0.0 % and -3.2 % in GDP terms in this period, i.e. it was relatively low. Mobilizing the local currency share seems not to have presented a problem for Peru; according to the KfW, thus far all tranches have been disbursed on time, and there appear not to have been any delays due to slow mobilization of the local currency funds required (Hochhuth 2006, 12).

Generally speaking, none of the other countries under consideration here faced overly high expectations as regards the requirements concerning both counterpart funds and addition-

19 It was not possible to calculate the shares of expenditure for the debt swaps in the individual sector budgets because the relevant data were not available.

ality. As difficult as it is to prove additionality, the principle should be retained in the modalities in a modified form, e.g. as a stated objective. But the principle should not be understood to imply that a partner budget must be increased to include the whole of the counterpart funds; this should apply only for the individual sectors concerned, e.g. the education or environmental sectors or the broader field of poverty reduction. This is why additionality is here regarded in the sense of budget reorganization, with the budgets of the sectors agreed upon being increased. There is in any case no reason to expect that these budgets will be increased in keeping with the amount of the counterpart funds. After all, the reason why these countries are granted debt relief in the first place is that they are no longer able to keep up their debt-service payments.

Fiduciary risks and corruption: Since the projects involved in debt swaps are conducted by the partner countries themselves, and the German side does not monitor the uses to which the funds are put as closely as in the case of other FC instruments used by the KfW, the approach entails both a fiduciary risk and the danger of corruption. But neither in Indonesia nor in Jordan are there any indications that the uses to which the financial resources have been put have not been in line with the agreements concerned.

Transparency International’s corruption index is an indicator that can be used to assess this risk. Jordan ranks 37th on the index and Indonesia comes in place 65. Of the countries under consideration, Indonesia does worst on the index, with a ranking of 137 on a list including a total of 158 countries (Transparency International 2005). However, the annual reports submitted thus far for **Indonesia** in connection with the German debt swaps contain no indications that the funds involved have not been used in accordance with the stipulations made. In 2006 a final report by an independent international auditor is due on the first debt swap with Indonesia; one of its tasks is to examine whether the funds have been used in keeping with the terms agreed on.

Nor does the German side have any information indicating that **Jordan** has used the funds provided in connection with the debt swaps for any purposes other than those set out in the separate agreements. The KfW has verified correct use on the basis of the annual reports prepared by the Jordanian partners on Debt Swaps I-IV.

High transaction costs in the transition phase: In the transition from projects within FC or TC to projects within debt swap projects there is a risk that partners may not yet be able to carry out the programs involved without aid from donors.

Restricted choice of sectors: The projects carried out in the framework of debt swaps are restricted to two sectors, education and the environment, or to the broader field of poverty reduction. In individual countries this limited number of options may restrict the use of the counterpart funds, as e.g. in **Jordan**.

Roughly half of the funds used in Jordan for debt swaps were invested in the water sector. However, all of the projects funds involved were used for wastewater projects, wastewater being part of the one of the sectors stipulated for debt swaps – namely the environment. In the water sector it is difficult for the Jordanian side to prove that the projects have been carried out in regions inhabited mainly by poor people. This has made it impossible to assign these debt swaps to the field of poverty reduction. Enlarging the sectors eligible would make it possible to include priority sectors in the countries concerned.

No inclusion of commercial claims: Under the Paris Club rules it is possible to use debt swaps for commercial claims, a practice engaged in e.g. by the UK, France, Spain, Italy, and Switzerland. While German budget law does permit debt swaps for commercial claims, such swaps are not approved under the German rules for debt swaps.

5 Debt swaps for commercial claims

The Paris Club rules permit **debt swaps** for **commercial claims**, a practice engaged in e.g. by the UK, France, Spain, Italy, and Switzerland. Under German budget law, debt swaps would also be possible for commercial claims. In the UK and France commercial claims are sold to investors[20], and these transactions must thus be seen as debt-for-equity swaps.

It would generally be possible for Germany to carry out **debt swaps** for **commercial claims** in cases in which the countries concerned are priority partner countries or partner countries for German DC. The volume of the commercial claims held by the German government against LICs amounts to over EUR 2.9 billion[21] (Table 7), and the figure for LMICs is EUR 2.6 billion (Table 8).

Table 7: Claims held by the German government against LICs (German DC partner countries), in Mio. €

Country[a]	Claims from FC	Commercial claims	Total
India	2,453	182	2,635
Kenya	137	6	143
Kyrgyzstan	34	3	37
Nigeria[b]	108	1,735	1,843
Pakistan	1,079	234	1,313
Tajikistan	-	3	3
Vietnam	153	39	192
Total	**4,321**	**2,940**	**7,261**

Source: BMF 2005

a The table includes only countries against which the German governments holds at least EUR 3 million in commercial claims.

b In 2005 Nigeria had some of its debt cancelled in the Paris Club framework; this has not been considered in the table.

20 As a rule these are foreign investors from the creditor country or local investors. Foreign investors not from the creditor country are also generally eligible to participate.

21 However, it should be noted that the debt relief granted to Nigeria in 2005 has not yet been deducted and the German government continues to hold commercial claims on Nigeria amounting to EUR

It should be noted, though, that non-ODA debts – e.g. commercial claims – are subject to certain limits under the Paris Club rules. These stipulate that 10–30 % of existing commercial claims are eligible for debt swaps, with agreement being reached on the exact percentage on a case-by-case basis (Paris Club 2005).

In general, decisions on whether a country is granted debt swaps for commercial claims should be made on a case-by-case basis. This is meant to ensure that countries with low debt levels – e.g. China – are not granted such debt swaps. Here there is a need to develop criteria, including debt ceilings, good governance, etc.

Table 8: Claims held by the German government against LMICs (German DC partner countries), in Mio. €

Country[a]	Claims from FC	Commercial claims	Total
Egypt	2,214	338	2,552
Algeria	47	588	635
Bosnia-Herzegovina	57	47	104
Brazil	70	504	574
PR China	1,459	104	1,563
Dominican Republic	35	10	45
Ecuador	24	26	50
Guatemala	64	4	68
Indonesia	1,150	551	1,701
Jordan	362	28	390
Colombia	77	22	99
Morocco	413	19	432
Macedonia	22	9	31
Peru	318	26	344
Philippines	253	8	261
Syria	281	268	549
Thailand	166	43	209
Turkey	1,031	13	1,044
Total	**8,043**	**2,608**	**10,651**

Source: BMF 2005

a The table includes only countries against which the German governments holds at least EUR 3 million in commercial claims.

Under the Paris Club rules, debt-for-equity swaps may include two different swap types:

- **Direct swap** of debt for investor assets: The investor purchases local assets with local currency.
- **Indirect swap** of debt for investor assets: The creditor sells his local currency to an investor (third party), who buys local assets in local currency (Fayolle 2006).

1.7 billion. Furthermore, the BMZ's country list refers to the year 2004. And in addition, HIPC countries are not included here.

The general aim of debt-for-equity swaps is to reduce total indebtedness and to increase capital inflows to debtor countries. In debt-for-equity swaps the creditors acquire debtor equity securities. In exchange, the debt concerned is at least reduced in the amount of these shares, which means in effect that that the debtor's debt service is converted into a dividend transfer (Bulow / Rogoff 1988; Burda / Wyplosz 1994; Deutsche Bundesbank 1997).

One important advantage of debt-for-equity swaps is that in this case the government of the creditor country offers domestic business enterprises an incentive to invest in developing countries. However, in effect this means that these investors are indirectly subsidized. It is questionable whether indirect subsidies provided via debt swaps are preferable to direct subsidies. In addition, these debt swaps may entail the risk of a windfall effect in the case that the companies involved would in any case have invested in the countries in question.

5.1 France

In a French debt-for-equity swap, a debtor country is permitted to buy back the debt it owes France before it falls due, and to do so in local currency and at a discount price; here the debtor country buys the debt instruments from French/foreign investors who have purchased the instruments from the French government. The investors then use the debt instruments for local projects.

Investment selection is a two-stage process. In the first stage the debtor country's finance ministry informs potential investors of the tender. In the second stage the French finance ministry, in cooperation with the French export agency (*Compagnie Francaise d'Assurance et de Credits d'Exportation* – COFACE), selects an investor. The selection criteria are the types of project in question and the offer made by the investor in the tendering process.

The French debt-for-equity swap functions in the following way:

1. France and the debtor country sign a bilateral agreement setting out the terms of the debt swap, including e.g. type of investment (sectors), transferable debts, debt-buyback rate, criteria for investors, etc.

2. The debtor country sends an information sheet to the potential investors.

3. The investors propose projects to the debtor country's finance ministry, which certifies its authorization for the tendering procedure.

4. The French finance ministry invites the investors to submit offers for the sale of the debt they hold. A bidding procedure is expected to include at least three investors.

5. At the end of a certain term set for bidding, the French finance ministry analyzes the bids that have been accepted.

6. Once it has analyzed the projects proposed, the French finance ministry publishes a list of investors.

7. The winning investors purchase the debt from COFACE, which operates on behalf of the French government.

8. Within a period of two weeks, the investors transfer their debt instruments to the debtor government, which purchases the debt in local currency and at a price somewhat higher than the transfer price.

9. The investors use their proceeds from the sale of the debt instruments to raise their capital stock or the shares they hold in companies in the debtor country (French Treasury 2005).

The reason why these debt-for-equity swaps entail debt reduction is that the debt-buyback rate is lower than the debt's nominal value. The partner country buys back its debt not at its nominal value but at a market discount on which it has reached agreement with the French government and which is substantially lower than its nominal value.

Example[22]

A developing country buys back from the investor, in local currency, the debt it owes the French government; let us say this debt has a nominal value of EUR 100 million and the debtor country buys it back for EUR 56 million. The investor is aware of this buyback value and offers, say, EUR 40 million. Assuming that this investor wins in the bidding procedure, he will buy the debt from the French government for EUR 40 million. The government of the debtor country then gives this investor the equivalent of EUR 56 million in local currency. The investor has thus made a gain worth EUR 16 million in local currency. The investor then makes a capital investment in local currency worth a total of EUR 56 million (Figure 6).

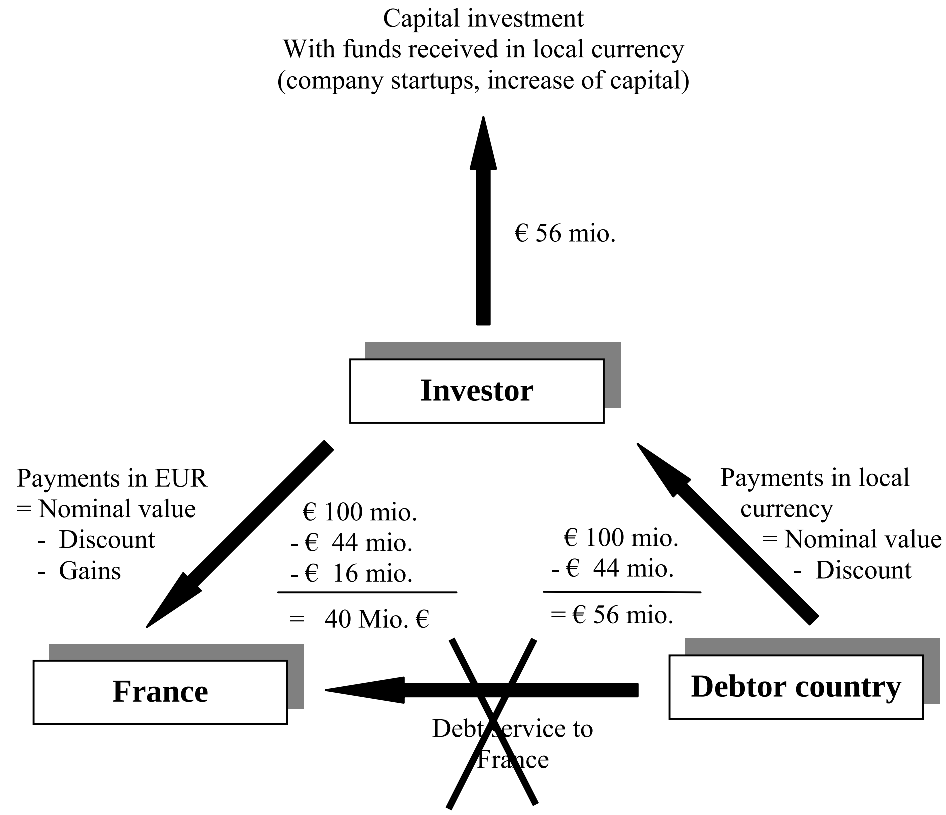
One other advantage this type of debt conversion has for the debtor is that it entails an inflow of direct investment which may lead to a transfer of know-how. This serves to increase the – usually low – capital stock of developing countries. In addition, investors are unlikely to withdraw their direct investments quickly from a developing country because their engagement there is as a rule more long- than short-term. Furthermore, direct investments reduce external debt since the latter are not regarded as debt instruments.

Debt-for-equity swaps also have the advantage of reducing investment costs since investors in this way acquire local currency on favourable terms. The investor's profit margin is based on the differential between the price paid to the French government and the price received from the debtor country.

However, there is a risk of windfall effects for the case that an investor would in any case have invested in the partner country. One example that may be cited here is France Telecom, which carried out a debt swap of this kind in Jordan. Even though the profit margin was no higher than 2–3 %, the swap was still profitable for the French investor because France Telecom would likely have invested one way or the other.

22 This is of course a fictive example.

Figure 6: How the French debt-for-equity swap works



Source: Based on data from the French Treasury (2004).

5.2 The UK

The UK has conducted debt-for-equity swaps since 1992. These transactions involve swapping a developing country's public external debt – which has already been restructured in the Paris Club framework – for debt in local currency.[23]

There are three central actors involved here:

- **The UK Export Credits Guarantee Department (ECGD)**: This institution offers British exporters credits and insurance for their investments abroad. The ECGD provides British exporters guarantees for their claims for the case that a company in a developing country defaults on its payments. The government of a developing country provides ECGD security for the exporter's claims against the local company concerned. This means that ECGD then holds a claim not against the company but against the government of the developing country involved.

23 The following remarks on modalities involved in British debt-for-equity swaps are based on ECGD (2003, 2006a, 2006b, 2006c and 2006d).

The reason why a debtor country's debt is reduced by these debt-for equity swaps is that ECDG permits it to repay its debt at a discounted rate.

- **The investor**: An investor offers, in hard currency, a certain, discounted price for ECGD's claims against a developing country. In return the investor is given, by the government of the country concerned, a certain sum in local currency (the repayment rate in local currency) which, while discounted, is still higher than the price the investor pays to ECGD in hard currency. The investor then invests the differential – in local currency – in local projects.

- **The debtor government**: The debtor government reaches agreement with the investor on the repayment rate and the type of investments to be made.

The British debt-for-equity swap works as follows:

1. ECGD invites potential investors to tender for claims it holds against a developing country. However, these claims must be part of the foreign debt of a developing country that has already been restructured in the Paris Club framework.

2. An investor approaches ECGD, stating his interest in acquiring all of part or a claim, and then submits a formal application. While both national and international investors are eligible to participate in the tendering procedure for a debt swap, the investors as a rule stem either from the UK or the developing country concerned. Their applications must contain detailed information on tender price and the type of investments planned in the developing country concerned.

3. The first assessment criterion for a tender to ECGD is the price offered. If the latter is below the minimum price set by ECGD, the department calls on the investor to submit a new offer.

4. In a second step, ECDG then analyzes the tenders it has received, for the most part on the basis of the following criteria: tender price, project type, social and economic impacts of the investments proposed in the regions in question, environmental impacts, and the know-how of the companies concerned in the investment areas under consideration.

5. Either prior to or during the application procedure with ECGD, the investor is expected to have conducted negotiations with the government of the developing country concerned over the repayment rate and the types of investment envisaged.

6. If the both negotiations between the developing country and the investor and ECGD's analysis come to a positive result, the debt swap is concluded.

Figure 7 depicts the mode of operation of the British debt-for-equity swap. ECGD sells claims it holds against a developing country to, say, a British investor. The investor buys from ECGD, in hard currency, a share of the sovereign debt in question at a discounted price. The investor then swaps his debt instrument with the debtor government for local currency and invests in the developing country in question.

Example[24]

ECGD has provided security for export-related claims of EUR 10 million held by a British company against a company in a developing country. The government of a developing country has in turn provided a guarantee that it will honor the claims held by ECGD in the case that the company of the developing country defaults on its payments. Assuming that the company of the developing country fails to pay its debts, ECDG pays EUR 10 million to the British company for its claims. ECGD then holds claims of EUR 10 million against the government of the developing country.

ECDG invites tenders for this claim, and a British company offers EUR 5 million for it. In parallel, the investor negotiates with the government of the developing country over the repayment rate and reaches agreement with it on a sum of dinar 7 million, which will be invested in the developing country. ECGD then grants the developing country debt relief amounting to EUR 10 million (Figure 7).

All of the actors involved in this debt swap enjoy a number of benefits. To start out with the developing country's benefits (ECGD 2003, 2006a, and 2006b):

- **Additional investment in the country's development**: The amount the country owes – in local currency – is invested in the country's social and economic development.

- **Attraction of investment**: The developing country attracts additional direct investment, obtaining the benefits outlined above.

- **Debt-reduction effect**: The developing country's debt is reduced because the amount it repays to the investor in local currency is lower than the nominal value of the principle claim, and this reduces its debt level.

- **No effect on currency reserves**: The swap is transacted between debt in foreign, hard currency and local currency, and this has no effect on the country's currency reserves.

ECGD mainly has the following benefits:

- **Cash**: ECGD obtains immediately cash for a long-standing and uncertain claim.

- **Low transaction costs for ECGD**: ECGD is not involved in the negotiations between the potential investor and the developing country concerned. In addition, ECDG is not involved in verifying the implementation of the investment concerned.

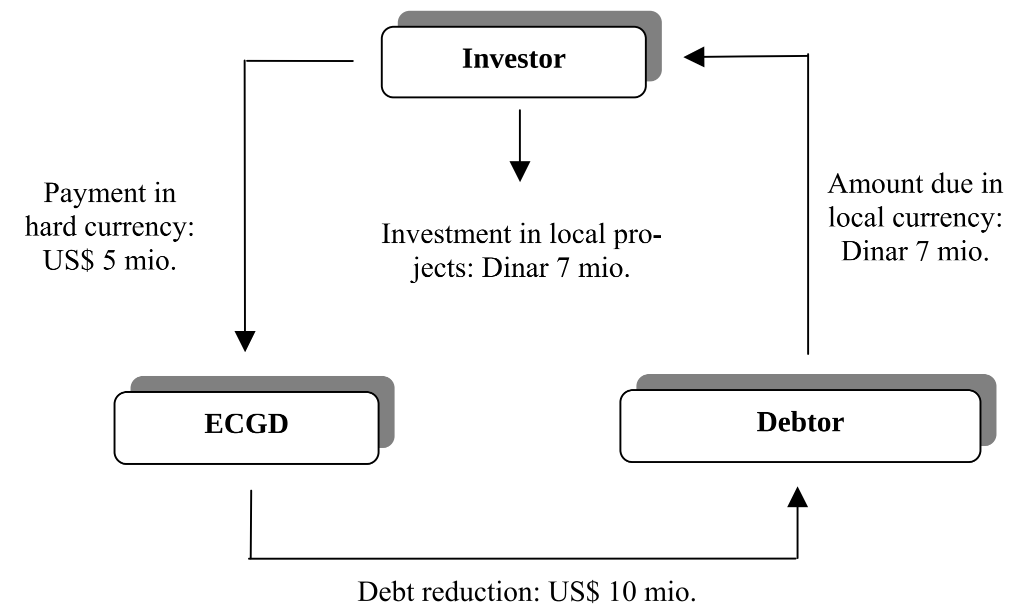
The investor's benefits include:

- **A profit**: the purchase price in hard currency is lower than the sum which the developing country's government is obliged to repay to the investor in local currency.

24 This is of course a fictive example.

However, these benefits must be balanced off against a small number of drawbacks. As in the case of the French debt swap, this approach involves the risk of a windfall effect, i.e. for the case that the British company would have invested one way or the other. In addition, ECGD loses part of the claims it holds. But all in all, it can be said that the benefits of this debt swap outweigh the drawbacks.

Figure 7: How the British debt-for-equity swap works



Source: Based on ECGD (2003)

Experience with British debt-for-equity swaps

Thus far little experience has been gained with these debt-for-equity swaps, the reason being that relatively few of them have been implemented since the instrument was adopted.[25] Between 1992 and 1997 debt swaps of this kind were carried out in three countries:

- Egypt: In 1993 US$ 75 million was invested in the Egyptian financial sector.
- Tanzania: In 1995 some £ 15 million was invested in the healthcare sector for the development of a lab designed to investigate the impacts of malaria.
- Mozambique: In 1995 £ 25 million was put to use in the agricultural sector to support agricultural products.

A revised version of this type of this instrument was used in Jordan to carry out three debt-for-equity swaps; these were transacted in the framework of an official British-Jordanian

25 The following information was made available by ECGD. However, in-depth information concerning the terms for swaps is treated as confidential; this would include e.g. the level of conversion rates, the duration of negotiations, or the number of investor tenders received.

debt-conversion agreement finalized in 2001. Under the agreement ECGD is making £ 90 million available for debt swaps (Jordan Times 2001):

- A British airline has bought a Jordanian airline catering company for £ 23 million.
- A Jordanian company has invested £ 4.5 million in an oil-recycling plant.
- A Jordanian company has built an information and technology center for £ 69.5 million.

The UK has proposed one debt swap in **Indonesia**. But even the preparatory process has proven difficult; the British investor and the Indonesian government have thus far been unable to reach agreement on the conversion rate.

While the debt-swap models for commercial claims do, on the whole, offer a number of advantages, relatively few such swaps have been transacted in the UK and France.

5.3 The Swiss Debt Reduction Facility

The Swiss Debt Reduction Facility is another example of an approach to commercial debt conversion.[26] The long-term aim of the Swiss debt-reduction program was to restore regular relations between debtors and creditors, to support the economic and social development of the developing countries concerned, and to buy up all existing bilateral claims. The program included the following elements:

- The facility's was to be used to buy back or cancel publicly guaranteed debt;
- to participate in internationally coordinated buybacks and debt-cancellation actions involving commercial bank claims;
- to provide contributions to financing arrears owed to multilateral financial institutions; and
- to promote the use and dissemination of computer-based debt management programs designed to make debt management easier and more transparent.

Since in 1978 Switzerland had cancelled all of the ODA-related debt owed to it, the program covered only commercial debt. The facility was used to purchase 95 % of the uninsured share of the commercial claims (own-risk shares) held by Swiss exporters and commercial banks for an average of 20 % of its nominal value, a sum amounting to CHF 350 million. In addition, the guaranteed shares of the Swiss export-risk insurance were transferred to the facility. This meant that the total volume of funds available for debt conversion was CHF 1.3 billion.

The Swiss state secretary for economic affairs (Seco) derived the following lessons from the debt program:

26 On the following discussion of the Swiss Debt Reduction Facility, see Hochhuth (2006, 14–15).

- The conversion rate plays a key role for the development of debt swaps. Switzerland demanded a 25 % rate, which meant granting a high degree of concessionality. This served to underline the development-related significance of the facility.

- In the case of MICs the aim of the Swiss Debt Reduction Facility was to reintegrate the countries concerned into the world market. However, administration of the facility proved to be complicated and cost-intensive. When the facility was being developed, it appeared to offer an efficient approach, but in the meantime IMF and World Bank have developed systems (e.g. the IDA Debt Buyback Facility, HIPC) that would seem to be more efficient.

- Generally, the facility was to focus on providing debt relief when a country's debt sustainability was at risk. In Seco's view, counterpart funds should, under the framework conditions given today, be used only under certain circumstances, e.g. if budget support proves impracticable. But in most cases Seco at present prefers other instruments when the aim is to (re)integrate developing countries into the world economy; these include e.g. promotion of microfinance, SME promotion, budget support (not for MICs), private-public partnerships or trade promotion, or participation in international initiatives like the IDA Debt Buyback Facility or the HIPC Trust Fund.

6 Policy recommendations

The **aim of the present study** was to analyze the instrument of FC debt conversion (debt swaps) and to examine whether there may be a need to reform, i.e. to flexibilize, the instrument. Exemplary analyses of the debt swaps carried out in a number of different countries (Indonesia, Jordan, and Peru) were conduced in this framework.

The analysis of German FC debt conversion found that the German debt swaps are a meaningful instrument of development policy. The study for this reason recommends that the instrument be expanded and flexibilized. In view of the fact that the Paris Club rules on debt swaps are considerably more flexible than those applied by the German government, the study recommends that the German rules should be adapted to the Paris Club rules.

However, debt swaps should not be used indiscriminately; their use should instead be restricted to cases in which a partner's debt has become unsustainable, it is possible to ensure that the funds involved will be used only for purposes meaningful in development terms, and the country concerned consents to their use. In view of the problems outlined above, the present study comes to the following recommendations:

In order to minimize the **fiduciary risk** involved, an internationally recognized auditor should, as provided for in any case, audit debt-swap projects on the basis of a final report. Annual partner reports are often not a sufficient basis for an assessment of the implementation of debt swaps, since such reports do not contain an objective analysis. Furthermore, in order to ensure that an objective audit is carried out, audits should be conducted not by national partner-country audit offices but by an independent auditor.

Improved donor coordination could provide **better leverage**. In Peru, for example, there was very little coordination of measures among the donors involved. One goal of the Swiss debt-reduction program was to integrate other donors. The aim was to achieve significant levels of debt reduction. For this reason Switzerland participated in a number of internationally coordinated actions, including e.g. debt-buyback initiatives, which, according to the World Bank, could assume new importance in the future (Hochhuth 2006, 18–19).

Moreover, the enhanced multilateral monitoring and investment instruments now available make it possible for donors to coordinate their contributions. In this connection the KfW has urged that more policy-based lending should be used in Peru. This would mean linking credits to political conditionalities. Such credit lines are provided by the World Bank in the framework of its Poverty Reduction Support Credits (PRSCs) as well as by the IMF in the framework of its Poverty Reduction and Growth Facility (PRGF). This approach makes it possible to provide coordinated and concessional credits conditioned on the implementation of certain adjustment measures (Hochhuth 2006, 20).

Generally speaking, **flexibilizing**, and in this way expanding the quantitative outreach of the debt-swap instrument would provide German DC with better avenues to involvement in and more policy space for its efforts to contribute to reaching the MDGs. In all three of the countries under consideration the funds mobilized through debt swaps have for the most part contributed directly to reaching individual MDGs, and these funds were in part well integrated within multilateral development strategies. However, the contribution provided by German DC on the basis of debt swaps has been relatively small. In other words, while debt-swap projects may support partners in their efforts to reach the MDGs, the question is whether this type of project-financing provides better support for reaching the MDGs than use of the funds for the FC instruments offered by the KfW. Moreover, creating **linkages between internationally coordinated debt swaps** could prove to be a good way to provide a significant contribution to reaching the MDGs.

Debt swaps would be more attractive for some partner countries if German debt swaps were handled more **flexibly**, i.e. if they were brought more into line with the Paris Club rules and modified in the following ways:

- **Adaptation to the Paris Club rules**: Under the Paris Club rules debt swaps can generally be made available for all ODA debts. In Germany, by comparison, the only countries with eligible debt swaps are those that have already reached debt-restructuring agreements in the Paris Club framework.

- **Inclusion of commercial claims**: Under the Paris Club rules debt swaps can also be used for commercial claims. While such debt swaps are also permissible under German budget law, they are not approved under the current German rules for debt swaps. This means that the use of debt swaps is restricted in Germany. In the UK and France, on the other hand, commercial claims are sold to investors (debt-for-equity swaps).

The debt-for-equity swaps used in France and the UK offer a number of **advantages**:

1. The developing country concerned has the following advantages: additional investment in national development, a debt-reduction effect, and attraction of investment.

2. The creditor country's government institution will mainly have the following advantages: immediate availability of cash and low transaction costs.

3. The investor's advantages include the following: a profit since the purchase price in hard currency is lower than the sum which the developing country repays to the investor in local currency.

But there are also some **disadvantages** that need to be considered here. One problem must be seen in the risk of a windfall effect for the case that the companies involved would have invested one way or the other. Another relevant aspect is that the government institution of the industrialized country concerned relinquishes a share of the claims it holds. Even though on the whole this debt-swap type entails more advantages than drawbacks, relatively little use has been made of it.

- **Enlarged scopes to make use of the funds involved**: Under the German rules a debtor country's counterpart or local funds can be used only for projects in certain sectors, these funds are not allowed to be transferred directly to a partner country's budget. Compared with the use of debt swaps for projects, budget-financing has the following **advantages**, which are similar to those offered by budget support: better donor coordination, increased ownership, reduction of transaction costs, uniform budget frameworks, financing of current costs, and improvement of policy dialogue. However, if these advantages of budget-financing are to be turned to account, the following **requisite conditions** must be given: functioning budgeting practices, effective planning and implementing structures, and satisfactory public budget management. This may, though, mean that donors will have to relinquish some of their own influence and policy space.

- **Expansion of the sectors eligible**: Projects conducted in the framework of debt swaps are restricted to two sectors – environment, education – as well as to the broader field of poverty reduction. In many countries this lack of options may restrict the uses to which the counterpart funds may be put, as e.g. in the case of **Jordan**.

For debt swaps the following **requisite conditions** should either be put in place or complied with:

- **Requisite structural conditions**: One possible way to ensure project quality is to **integrate debt swaps into existing DC structures** of German or other bi- or multilateral donors. The debt swaps carried out in Indonesia and Jordan have shown that certain structural preconditions, in particular functioning planning and implementing structures, constitute a very important criterion for the successful implementation of debt swaps. This is often the case with programs carried out in the framework of the priorities of German DC. However, it would also be conceivable for debt swaps to be used for programs/projects of other donors.

  Better integration of debt swaps into national strategies and comprehensive approaches to poverty-reduction strategies could contribute to the sustainability of the projects and programs involved (Hochhuth 2006, 20).

- **Good budget management** is a key condition required to ensure that the funds concerned are put to the uses agreed upon.

In general terms, there is a need for reform leading to an adaptation of the current German rules to the more flexible rules used by the Paris Club.

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Annex

Debt swap provision of the Paris Club

"Paris Club agreements may contain a provision which makes it possible for creditors to voluntarily undertake debt swaps. These operations may be debt for nature, debt for aid, debt for equity swaps or other local currency debt swaps. These swaps often involve the sale of the debt by the creditor government to an investor who in turn sells the debt to the debtor government in return for shares in a local company or for local currency to be used in projects in the country.

In order to preserve comparability of treatment and solidarity among creditors, the amounts of debt swaps that can be conducted are capped at a certain percentage of the stock of the claims of each individual creditor.

The terms under which these operations can take place are contained in the standard terms of treatment. To ensure full transparency between creditors, debtors and creditors submit a report to the Paris Club Secretariat informing about transactions undertaken." (Paris Club 2006b)

Table 9: Foreign claims of the BRD[i] in Mio. €

Country	Claims from FC	Claims from trade	**total**
Afghanistan	-	37	37
Albania	87	2	89
Algeria	47	588	635
Antigua + Barbuda	-	3	3
Argentina	50	1,114	1,164
Armenia	59	-	59
Azerbaijan	49	-	49
Bermuda	-	50	50
Bolivia	56	-	56
Bosnia and Herzegovina	57	47	104
Botswana	-	19	19
Brazil	70	504	574
Bulgaria	8	168	176
Cambodia	-	2	2
Cameroon	344	547	891
Chile	58	34	92
Columbia	77	22	99
Congo	52	87	139
Costa Rica	8	-	8
Cote d'Ivoire	305	88	393
Croatia	33	28	61
Cuba	-	112	112
Dominican Republic	35	10	45
DPR Korea (North Korea)	-	116	116
DR of the Congo	136	315	451
Ecuador	24	26	50
Egypt	2,214	338	2,552
El Salvador	115	-	115
Ethiopia	-	1	1
Gabon	23	192	215
Georgian Republic	95	-	95
Ghana	13	3	16
Greece	7	-	7
Guatemala	64	4	68
Guinea	-	3	3
Guinea-Bissau	-	1	1
Honduras	4	-	4
India	2,453	182	2,635
Indonesia	1,150	551	1,701
Iran	-	4	4
Iraq	-	1,505	1,505
Israel	542	1	543
Jamaica	55	-	55
Jordan	362	28	390
Kasakhstan	32	-	32
Kenya	137	6	143
Kyrgystan	34	3	37
Lebanon	1	-	1
Liberia	142	40	182
Libya	-	1	1
Lithuania	-	1	1
Malaysia	0,2	37	37
Morocco	413	19	432
PR China	1,459	104	1,563
Republik Korea (South Korea)	13	105	118
UAE Adschman	-	1	1
UAE Dubai	-	4	4
Yemen	-	1	1

Mauretania	-	1	1
Mauritius	5	-	5
Mazedonien	22	9	31
Mexico	-	82	82
Moldova	5	2	7
Mongolia	69	-	69
Myanmar	433	155	588
Namibia	88	-	88
Nicaragua	4	-	4
Nigeria	108	1,735	1,843
Pakistan	1,079	234	1,313
Palastine	-	2	2
Papua-Neuguinea	17	-	17
Paraguay	32	1	33
Peru	318	26	344
Philippines	253	8	261
Poland	-	8	8
Polynesia (franz.)	-	17	17
Portugal	19	-	19
Romania	10	-	10
Russia (ex. UdSSR)	-	7,366	7,366
R.F: Russia	-	78	78
Sambia	-	185	185
Sao Tomé u. Principe	-	5	5
Saudi Arabia	-	35	35
Senegal	109	-	109
Serbia-Montenegro	225	399	624
Seychellen	3	-	3
Sierra Leone	-	15	15
Zimbabwe	295	53	348
Singapure	-	249	249
Sri Lanka	344	-	344
Southafrica	70	1	71
Sudan	-	153	153
Suriname	-	3	3
Swasiland	18	-	18
Syrien	281	268	549
Tajikistan	-	3	3
Taiwan	-	25	25
Thailand	166	43	209
Togo	-	24	24
Tonga	3	-	3
Czech Republic	-	4	4
Tunesia	224	2	226
Turkey	1,031	13	1,044
Uganda	-	1	1
Ukraine	-	237	237
Uruguay	12	-	12
Uzbekistan	105	-	105
Venezuela	-	38	38
Vietnam	153	39	192
Belarus	-	1	1
Central African Republic	-	3	3
Cyprus	0,5	-	0,5
Total	**16,385**	**18,577**	**34,962**

Source: BMF 2005

i Private sector included.

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