

Joint Meeting of the EU Water Initiative's EECCA Working Group
and the EAP Task Force Environmental Finance and Water Networks
26 – 28 April 2006
Almaty, Kazakhstan

Lessons from Experience with Debt-for-Environment Swaps in Economies in Transition

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Structure of the Presentation

- Purpose and scope of the paper
- Definition of the debt-for-environment swaps (DFES)
- Background and history
- DFES – Major risks
- DFES – Major opportunities
- Main lessons learnt
- Concluding remarks – When to consider a DFES
- Next steps

Purpose and Scope of the Paper

- To present lessons from NMCD work on DFES in selected CEE and EECCA countries which may be valuable for other EECCA and beyond
- To present key steps in designing, negotiating and implementing DFES in a low-income country
- Scope
 - The paper will draw from experiences of Poland, Bulgaria, Georgia and the Kyrgyz Republic, but also of other relevant cases
 - The paper will focus on external public and publicly-guaranteed long-term debt owed to official bilateral creditors

Definition of a Debt-for-Environment Swap

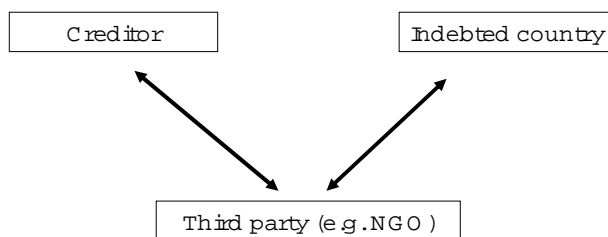
- A transaction that cancels a country's external debt for its commitment to spend an equivalent amount, or a portion of the reduced liabilities in the country, in local currency on agreed conditions, to finance "brown" (industrial) or "green" (biodiversity) environmental projects
- These transactions can be
 - Bilateral when governments swap official debt
 - Facilitated by a third party (environmental NGO or broker); when the transaction involves mainly private (commercial) debt
- Debt can be swapped for environment, equity, aid (development/health/education)

Two Major Types of Debt Swap

- Direct bilateral swaps



- Swaps through intermediaries



Background and History

- 1980s: introduction of the debt swap mechanism
- 1985: Chile – the first country to establish an institutionalised debt-for-equity swap programme
- 1987: Bolivia – the first debt-for-nature swap
- 1980s: mostly three-party debt swaps, involving conversion of commercial debt
- 1990: introduction of bilateral swaps as part of the Paris Club framework agreement with debtor countries
- Debt-for-equity swaps have been the most important source of debt reduction over the years but
- DFES in CEE have generated significant resources for environmental investments

Examples of Debt Swaps Worldwide

	Start Time/Time Period	Available Funds (in USD)
Poland	1992-2010	571
Peru	1993-1995	50
Philippines	n.a.	22
Philippines	1993	17.7
Colombia	n.a.	18
Bulgaria	1996	6.67
Costa Rica	1988	5.4
Mexico	1991-1996	3.84
Madagascar	1991-1994	3.48
Bolivia	1992	2.76
Bolivia	1987	0.25
Brazil	1992	2.2
Guatemala	1993	1.9
Ghana	1991	1

DFES - Major Risks

- May undermine country credit rating and increase the cost of future borrowing
- May distort negotiations on unconditional debt relief or restructuring
- May cause fiscal and inflationary distortions
- May create expectations that foreign taxpayers will fix the problem
- Macroeconomic and political instability can lead to lack of confidence by creditors
- Fiscal difficulties can lead to lack of fiscal resources to service the swap at a national level
- May create potential for possible mismanagement of DFES funds and round-tripping (re-conversion of local currency debt conversion proceeds into hard currency for illegal gain)

DFES – Major Opportunities

- Current context favourable to debt reduction mechanisms
- Can raise more money for environment than other debt swaps – e.g. Poland
- Can contribute to poverty alleviation by facilitating local growth and creating more jobs
- Can contribute to peace and security in the region
- Can help attract co-financing from other sources
- Can help build local institutional capacity in managing public environmental expenditure in accordance with international good practices

Major Lessons Learnt (1/3)

- DFES should not be proposed if overall macroeconomic situation in the country is improving and the external debt level is not unsustainable
- DFES should be designed as part of the country's overall debt management strategy
 - Debtor country should use the momentum of existing international processes allowing DFES
 - DFES should not limit the opportunities for unconditional relief or restructuring in the future but
 - DFES should be proposed immediately after unconditional relief has been exhausted and should be prepared early in the process
 - DFES are best achieved within the framework of negotiations with Paris Club creditors
- Note that not all debt is eligible for conversion (e.g. debt to IFIs), the expected DFES revenue might be low and lead to frustration
- Cooperation between the Ministry of Finance (leading the process) and the Ministry of Environment (building the case), as well as strong support and commitment at a high political level are crucial to the success of the scheme

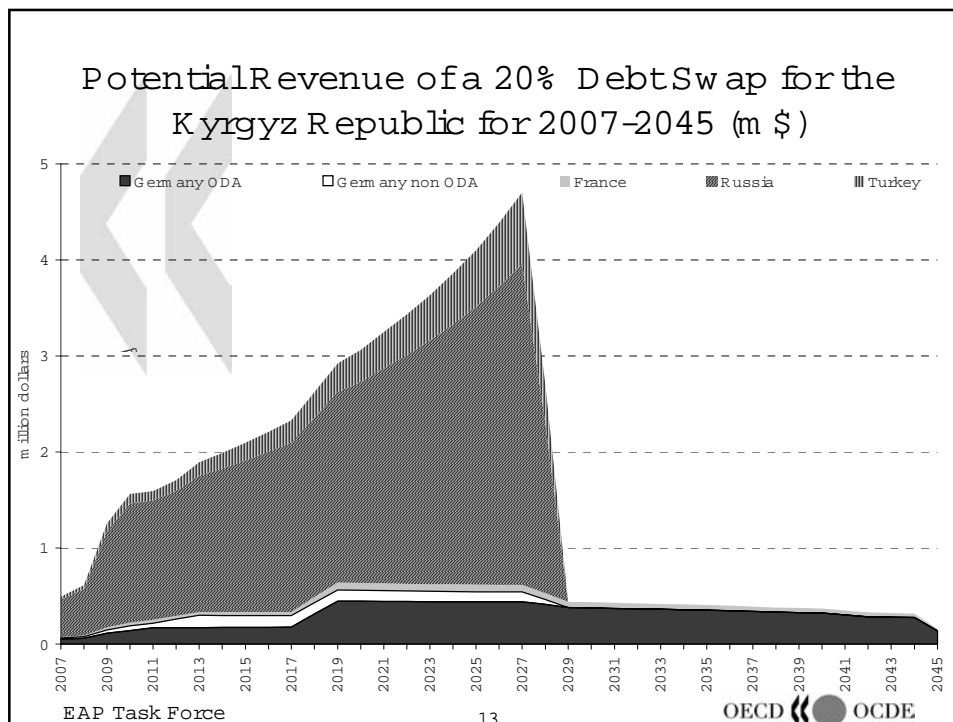
Debt Service Indicators of Selected EECCA - 2003

	External Debt	
	% Exports	% GDP
Armenia	120.5	38.0
Azerbaijan	49.7	21.1
Georgia	161.8	49.5
Kyrgyz Republic	263.4	102.9
Moldova	171.7	89.2
Tajikistan	115.1	64.8
Uzbekistan	110.9	49.4

Major Lessons Learnt (2/3)

In developing a DFES scheme and in order to attract interest of potential creditors, the debtor country needs to prepare:

- Thorough analysis of the debt portfolio and revenue streams
 - careful identification of priority creditors, with alternative scenarios for potential DFES revenue
 - careful assessment of the amount of debt to be swapped
 - analysis of the fiscal capacity of the country to service DFES scheme and finance domestic expenditure from the swap
- Credible expenditure programme
 - should respond to both the debtor and creditor countries' priority concerns
 - should be realistic (the DFES size should be carefully calculated), narrowly-focused on a few priorities, and demonstrate a solid pipeline of attractive projects
 - should leverage additional sources of finance



- ### Major Lessons Learnt (3/3)
- Design an institution to manage the DFES resources
 - analysis of the country's legal framework to setup a DFES institution
 - involvement of both Ministry of Environment and Ministry of Finance in the design and management of the entity as well as concerned creditors
 - comparison of administrative costs of managing the DFES entity with the potential annual DFES flows - an indicator of the viability of the future institution (administrative costs < 5-6% of annual revenue)
 - demonstration of debtor country capacity and commitment to manage DFES resources in an efficient and accountable way - need for clear and transparent rules and procedures
 - debt swap facility - center of "professional excellence" - a way to maintain creditors' trust and attract additional finance (including additional debt swaps)
- EAP Task Force 14 OECD OCDE

Concluding Remarks When to Consider a DFES

- Low-income country, eligible for IDA support
- Unsustainable external debt level
- Existence of well-designed Poverty Reduction Strategy and Strategy for Debt Management
- Debt restructuring agreement with the Paris Club and a special clause enabling bilateral currency swaps
- Stable political and macroeconomic environment to reassure creditors
- No risk of default after the swap
- Fiscal capacity to finance domestic expenditure from swap resources
- Support and commitment at a high political level, particularly the Ministry of Finance
- Commitment to transparency, efficiency and accountability
- Well-designed project pipelines meeting both debtor and creditor countries' interests

Next Steps

- Comments on the key lessons by Network members
- Drafting the publication – end of 2006
- Draft reviewed by experts and experts' workshop – early 2007
- Final version prepared for the next EECCA Environmental Finance Network meeting – Spring 2007
- Publication disseminated at the next «Environment for Europe» Ministerial Conference in Serbia, October 2007