



Association for the Development of African Education

# Making Debt Work for Education

*— How Debt Swaps Can Contribute  
to African Education*

*Neil Saravanamuttoo and Christopher Shaw*

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## PREFACE

This document is based upon three articles by the authors that originally appeared in the *DAE Newsletter* (Vol. 5, No. 2; Vol. 6, No. 1; and Vol. 6, No. 3). The authors would like to thank Ado Vaher of UNICEF and John Ross and Daniel Grimshaw of the Debt-for-Development Coalition for their comments on this paper.

## EXECUTIVE SUMMARY

1. Despite the fact that since 1987 debt swaps have retired over US\$750 million worth of foreign debt worldwide, the debt swap instrument is still misunderstood and not used to its full potential. Debt swaps are a tool for reducing foreign debt, while at the same time generating local funding for development projects.

2. Presently, there is a fair degree of scope for using debt-for-development swaps when dealing with sub-Saharan African education. \$10 billion flows out of the region annually to service external debts—an amount greater than what the governments spend on education. From 1980-1990, debt servicing charges in Africa rose from 3% of GNP to 6%. During the same period, public spending on education fell from 4.5% of GNP to 3.5% and enrolment levels in primary education fell from 79% to 72% of all children of that age group. In other words, as the debt burden increases, African states slip further away from being able to provide basic education for all. There is little reason to believe that debt relief itself would have a positive impact on the level of education spending, although a debt swap would be one way to channel those savings into the education sector.

3. It is the existence of a highly-discounted secondary market for developing country debt notes that allows debt swaps to take place. External agencies (usually NGOs) use their foreign exchange to buy debt notes at a fraction of their face value. These notes are then handed over to the debtor country's central bank, which repays the agency or NGO in local currency and with a premium. Two results occur: the central bank retires the debt note and the agencies use the local currency to undertake development projects in-country.

4. Debt swaps can work to everyone's advantage. The debtor country retires some foreign debt, it does so at a discounted price and with local currency (that is then used in-country for developmental purposes). The external agency addresses two

issues—debt relief in addition to its specific project—and furthermore, the agency gains a premium on its initial investment. Debt swaps are particularly well-suited for agencies that wish to concentrate on basic education. Many funding agencies (particularly official multilateral and bilateral organizations) allocate their resources for the foreign exchange costs of a project, leaving local currency costs to the recipient government. However, the spending requirements for basic education are almost entirely in local currency. Debt swaps produce the project funds in local currency and swaps can be viewed as a mechanism for converting foreign exchange into local currency at a premium.

5. Debt swaps must be carefully planned to avoid the manifestation of potential concerns. There are five potential concerns: inflation; transaction risks; the leverage subsidy; additionality; and, round tripping, although they can be overcome if the debt swap is carefully planned. Specifically, two measures should be undertaken: first, governments should allow only development projects that are high national priorities and represent new resources into the economy to be financed by a swap; and second, the proceeds from the debt swap should be placed in a dollar-denominated escrow account, with the funds converted into local currency only when needed and at the prevailing exchange rate. Debt swaps that are carefully planned can work smoothly and avoid any potential problems.

6. Not all developing countries are suitable for swapping debt. There are five prerequisites for a successful swap: the country is considered severely indebted with no likelihood of being able to repay its debts in full; the country has sufficient levels of appropriate debt (i.e. those types of debt that can be discounted); concerns related to the sector in which the project will take place have been addressed; the country has a reasonably sound macroeconomic environment, such that the projects initiated under a debt swap can be supported by national resources when the debt swap proceeds run out; and, the country has sufficient management capacity to undertake a swap.

7. Official overseas development agencies would do well to incorporate debt swaps as one of their available instruments.

Many official agencies have already been forgiving their official development assistance (ODA) debt, although debt swaps are forgiveness with the added payoff of generating local funds. Furthermore, "Paris Club" negotiations, where debtor countries negotiate mostly non-ODA debt relief with their official government creditors, encourage debt swaps as part of a larger debt-relief package. Multilateral agencies, due to their status of the "lenders of last resort" require that their debt be paid back in full, however, they may find that debt swaps are a suitable compromise that allows countries to deal with the substantial debt overhang, while paying off the debt in local currency used for financing development projects.

8. African governments can encourage debt swaps by establishing permanent debt-for-development swap mechanisms (commonly known as debt-for-development funds). These funds, by establishing a procedure for screening and approving potential projects, determining a redemption price and identifying sources of debt, make a debt swap operation routine and easy to undertake for all parties. Furthermore, governments can use swaps to strengthen the capacity of local non-governmental organizations, by requiring, as a condition of the swap, that local NGOs be involved in project implementation.

9. The external debt situation of African countries is not static and arrears in payment of interest and principle have added to the debt burden. In some cases, the debt burden has been reduced with debt relief from official and commercial sources. This debt relief can be increased through the use of debt swaps. At present, the external debt situation of many sub-Saharan African countries is such that a debt-for-development swap is a useful instrument, however, it is unsure how long this window of opportunity will remain open.

# 1. INTRODUCTION

1.1 The premise that education is a central pillar of development is widely accepted. Recognition of the importance of human resource development has led to widespread acceptance among governments and donor agencies of the goal of “education for all”. Achieving this goal, however, has become increasingly elusive—in part because of rapidly increasing populations, but also because national education budgets in many developing countries have been falling in real terms in recent years. There are a number of reasons for stagnating education budgets, one of which is the impact of debt. In sub-Saharan Africa, US\$10 billion annually flows out of the region to service foreign debts—an amount slightly greater than what governments in the region have been able to spend on education.

1.2 One creative idea addressing the twin concerns of high debt servicing and low social spending is the “debt-for-development swap”. By conservative estimates, debt swaps have retired over \$750 million of the foreign debt owed by developing countries, yet this instrument is still largely misunderstood and its potential unrecognized. The purpose of this paper is to provide a thorough understanding of what debt swaps are, how they work and what donor agencies and governments can do to expand their use. This paper will specifically push the case for using debt swaps to support improved education in sub-Saharan Africa, although many of the lessons can be applied in other sectors and in other regions of the world.

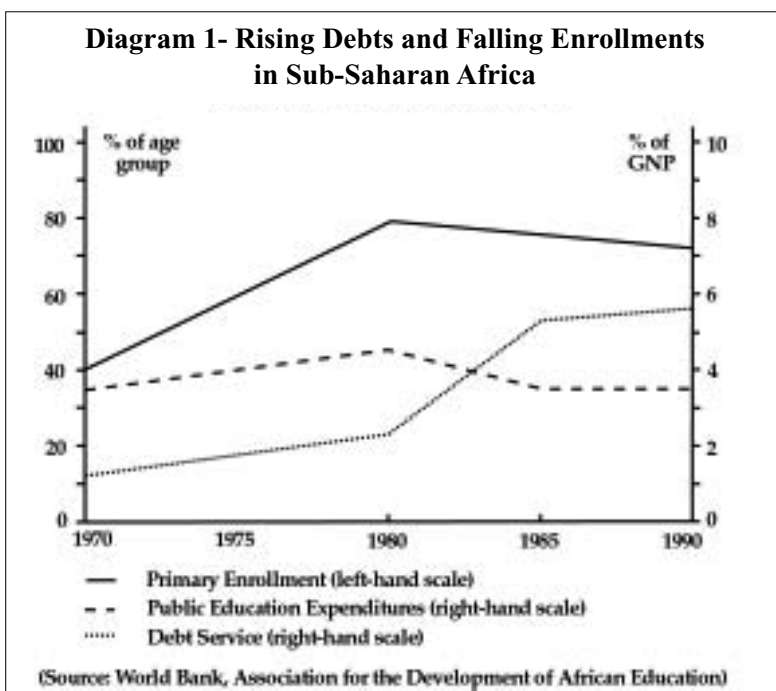
## 2. THE IMPACT OF DEBT ON EDUCATION IN AFRICA

2.1 Before presenting the mechanics of swapping debt, it is necessary to have a clearer picture of the seriousness of the debt situation in sub-Saharan Africa and how this impacts upon school enrollments. Between 1970 and 1980, primary enrollment for the region increased from 40% to 79% of the age group, however, that figure has declined since 1980 (see **Diagram 1**). By 1990, only 72% of African children of the relevant age group were in primary school. It comes as no surprise that this decline has corresponded to falling real levels of spending on education. Between 1980 and 1985, sub-Saharan African spending on education, as a proportion of GNP, actually decreased from 4.5% to 3.5%. For many African countries, this spending was still hovering around 3.5% in 1990—short of the 5% of GNP that developed countries tend to spend on education. These cutbacks occurred as the debt crisis was taking hold in Africa: in the period 1980 to 1990, debt service charges increased from 3% of the region's GNP to approximately 6%. Clearly, as the debt overhang continues to hit sub-Saharan Africa, education budgets suffer accordingly. And with continuing high levels of debt servicing expected in the 1990s, there appears little prospect that education budgets will be able to keep pace with demographic pressures, let alone increase enough to provide universal basic education.

2.2 Consider the gravity of debt in sub-Saharan Africa. Although in absolute terms the African debt is not overwhelming, the relative size of the sub-Saharan African debt is very large. This debt accounts for fully 83% of total sub-Saharan African GNP, compared to the Latin American foreign debt at 36% of total GNP. This means that retiring even small amounts of African debt can make an impact.

2.3 Most sub-Saharan African countries are classified as severely indebted (see **Diagram 2**) and the \$10 billion that flows out of the region each year to service long-term debts is crippling govern-

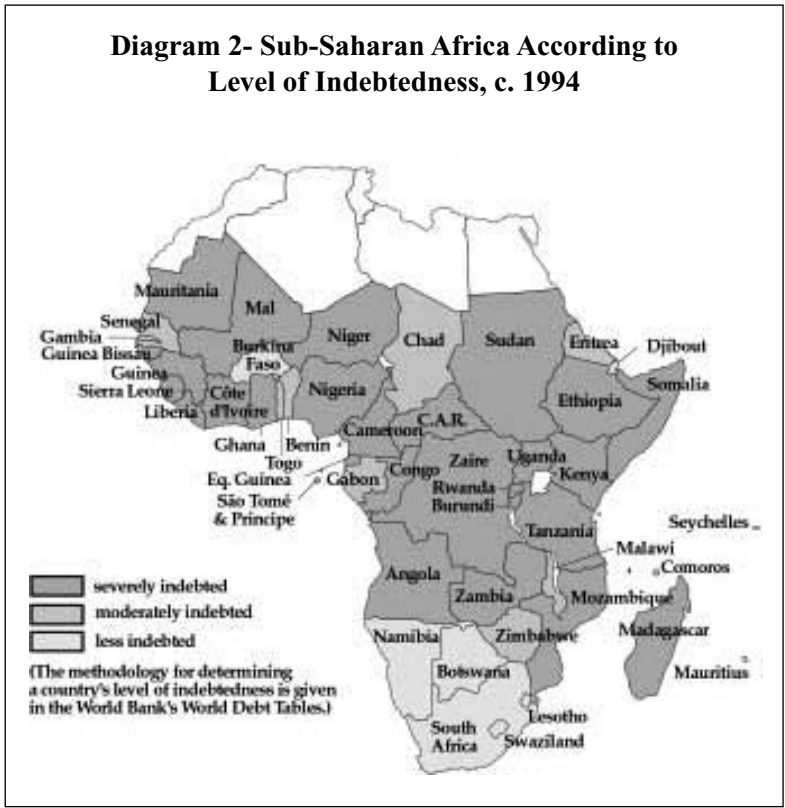
**Diagram 1- Rising Debts and Falling Enrollments  
in Sub-Saharan Africa**



ment spending, especially in the social sectors of health and education. Sub-Saharan Africa could greatly benefit from swapping some of that debt for development. To date, debt swaps in the region have retired approximately \$250 million (albeit out of a total foreign debt of some \$150 billion) and created over \$70 million in local funding for projects.

2.4 If high debt servicing is crippling African education, then would simply cancelling the debt be enough to get all children in school? Initial investigations suggest no. Cancelling debt will free resources for African governments, but where these resources get spent is another matter. Sadly, education is not always given as high a priority as it deserves and any “windfall gains” from debt relief are likely to be directed elsewhere. Part of the difficulty is the perception among macroeconomic planners that education is a consumption good, rather than an essential investment in human capital. Because

**Diagram 2- Sub-Saharan Africa According to Level of Indebtedness, c. 1994**



the education sector is considered “non productive”—in that it is non-tradable, does not generate revenue, does not improve the balance of payments or the government budget deficit—and because the payoffs from education come some years later, it is viewed as costly social welfare spending. This ignores the fact that there is no example of significant economic growth occurring in a society without widespread basic education. It also ignores the broader approach to development in which social improvements, poverty reduction and economic growth go hand in hand. Education and health lay the groundwork for a productive economy. Although the logic of this argument is widely accepted, it is still often overlooked. Consequently, health and education are likely to be given a low priority for any funds freed up through debt relief. Thus, if increased basic education

is to be achieved, the funds made available through debt relief will have to be specifically earmarked. A debt-for-development swap, as explained below, presents itself as one of the most effective means for channelling this gain into education.

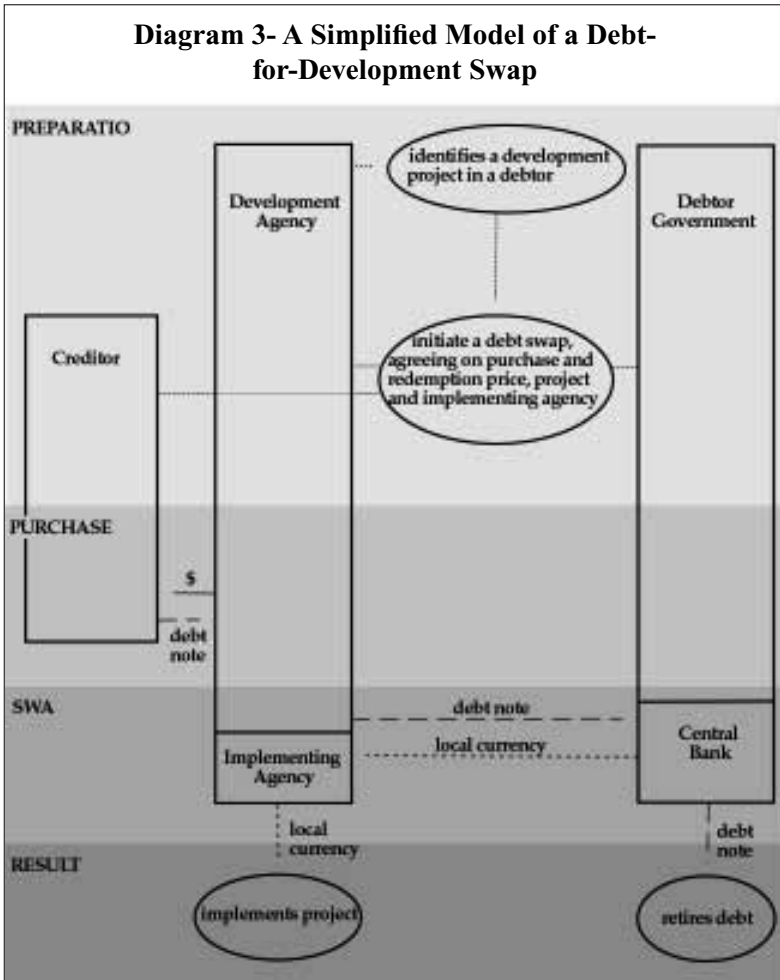
### 3. THE MECHANICS OF SWAPPING DEBT

3.1 A debt swap occurs when a development agency, taking advantage of a highly-discounted secondary market for debt, provides debt-relief to a developing country in exchange for the country's local financing of an agreed project. In this context, a broad definition of development agency is used, to include any organization—such as official governmental agencies, non-governmental organizations or private foundations—that is an external funding agency working towards developmental goals in-country.

3.2 Debt swaps arose as a response to the debt crisis of the 1980s, when many developing countries started running into difficulties repaying the foreign exchange they had borrowed from international commercial banks. The banks saw—and continue to see—that developing country borrowers might default on their loans. Rather than carry non-performing loans in their portfolios, (which, in many cases, requires that banks increase their provisions against bad debt and can reduce a bank's access to new capital) the commercial banks prefer to write-off such debts, selling them at highly discounted prices or even donating them to a development agency. By writing-off these debts, the banks clear their books of non-performing loans. Furthermore, the banks recover a small proportion of the money owed through selling the debt note (at a heavily discounted price) and, in some cases, through a tax break. With creditors willing to sell their debt notes on a secondary market, however, an opportunity arises for a third party to use their foreign currency to buy the debt note. The third party can then negotiate with the debtor country to provide local financing for a given project in exchange for the debt note being retired. This process, which is illustrated in **Diagram 3**, is explained in further detail below.

3.3 Most debt-for-development swaps follow four phases and involve four main parties. The first party is the development agency, until now principally international non-governmental organiza-

**Diagram 3- A Simplified Model of a Debt-for-Development Swap**



tions—supported by advice and services from an international professional debt trader. The second party is the debtor government of the developing country, working through its central bank and other specialized government departments. The third party is the creditor holding the debt note. The fourth party is the local institution that receives the local funds and implements the development project. The four phases are: preparation; the purchase of the debt on the secondary market; the actual swap; and finally, the results phase.

3.4 During the preparation phase, the development agency

identifies a project of joint interest to itself and the indebted country that is suitable for financing by a debt swap. Projects are deemed suitable for swapping if they meet two basic requirements: the project addresses an issue of high national priority and the project has a high local cost content. Once the agency and government have agreed upon a project to be supported by a swap, the debtor country must identify debt notes that it wishes to service.<sup>1</sup> With the help of an international professional debt trader, the agency determines if the creditors holding these debt notes are willing to sell them on the secondary market and at what discounted price. When specific debt notes have been identified, the external agency negotiates with the indebted country the terms of the swap, such that the agency will provide foreign debt relief in exchange for the country's local financing of the project. Agreements must be reached between the external agency and the debtor government on two further issues: the amount of local funds that government will allocate to the project in relation to the amount of foreign debt to be retired, and the choice of organization responsible for receiving the local funds and managing the implementation of the project. In the past, the local implementation agency has often been the development agency itself (or a local field office of the international NGO that bought the debt note). However, there is nothing preventing debt swaps from working such that the external development agency finances the debt swap and contracts a third party to undertake the implementation of the project. When agreement on these issues has been reached, the remaining three phases can be undertaken.

3.5 With the help of a professional debt trader, the development organization buys the outstanding foreign debt from the creditor bank on the secondary market at a discounted price (*the purchase price*). The agency then hands over the debt note to the local implementation

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<sup>1</sup>Since a number of developing countries are unable to pay off their outstanding debts in full, debtor countries make a distinction between those debts that they wish to service and those that they do not (the decision is made largely upon expectations of access to new capital from the creditor). If a country has decided not to service the debt owed to a particular creditor, then it will have little interest in swapping that debt note, although if the country wishes to maintain positive working relationships with the creditor then it may be interested in partial servicing of that debt note through a swap.

agency (as noted above, this is often simply the local operation of the international development agency). The actual swap can now take place. The agency hands over the note to the debtor country's central bank, and in exchange for the debt note, the central bank provides the implementation agency with local currency at the agreed rate (*the redemption price*). In the final phase, two actions take place. The debtor country's central bank extinguishes the debt note, and in so doing, retires the debt (at its *full face value*). And the cash is used by the local agency to implement the development project.

3.6 The mechanism of swapping debt for development funds relies upon price differentials. The first price differential is the deep discount between the *face value* of the original debt and the *purchase price* of the debt note (often less than 50¢ on the dollar). This price differential is set by the market value of secondary debt. The second differential is the difference between the *face value* of the original debt and the *redemption price* paid to convert the foreign debt to local project funds. This differential is fixed by negotiation between the development agency and the indebted government. The amount of local funds created varies from swap to swap, however, it lies between the debt's discounted price and the full face value of the debt. Typically, a debt swap will create local funds worth 150-200% of the purchase price.

3.7 Exactly how debt swaps work is most easily seen in an example. In early 1993, the River Blindness Foundation bought \$1 million of Nigerian debt on the secondary market for \$400,000 (at a purchase price of 40¢ on the dollar). This was redeemed for \$500,000 of local currency (at a redemption price of 50¢ on the dollar) to support the distribution of drugs used to combat onchocerciasis ("river blindness"). Hence by using a debt swap, the River Blindness Foundation was able to multiply its project funds by a factor of 1.2, while helping to retire a portion of Nigeria's commercial debt. For other examples of debt swaps, see **Boxes 1 and 2** and the **Technical Annex**.

3.8 The explanation given above, in referring to creditor banks and a secondary market, implies that all swaps involve the debt owed

## Box 1 - UNICEF Debt-for-Development Swaps

UNICEF has done much to show how far forward debt swaps can be taken. Since 1989, 21 swaps in countries as diverse as Sudan, Madagascar and Zambia have retired \$193 million of debt at a cost of \$25 million and generating \$48 million of project funds. These swaps were financed *in addition* to regular country programs, through special fundraising campaigns or the donation of debt (as seen in the table where the purchase price is \$0), and therefore, represent new money. UNICEF's success has involved three critical factors: projects are always formulated in partnership with government to address national priorities; projects are chosen for their sustainability and high local-cost content; and, projects are chosen with a life-span of 3-4 years to guard against inflation or currency devaluation.

<i>Swap</i>	<i>Face Value</i>	<i>Purchase price (PP)</i>		<i>Redemption price (RP)</i>		<i>Leverage (RP/PP)</i>
	<i>in US\$ of Debt</i>	<i>in US\$ on Secondary Market</i>	<i>(as % of face value)</i>	<i>in US\$ -- Local Funds Generated</i>	<i>(as % of face value)</i>	
Sudan 1989-1992 <sup>a</sup>	59,355,000	0	0%	3,285,000	5.5%	n/a
Jamaica 1992 <sup>b</sup>	4,000,000	2,877,000	71.9%	4,000,000	100%	1.4
Madagascar 1992 <sup>c</sup>	4,000,000	2,000,000	50%	4,000,000	100%	2
Philippines 1992 <sup>d</sup>	486,000	245,000	50.4%	329,000	67.7%	1.3
Philippines 1993 <sup>e</sup>	250,000	0	0%	180,000	72%	n/a
Bolivia 1993 <sup>f</sup>	15,000,000	2,400,000	16%	3,600,000	24%	1.5
Philippines 1993 <sup>f</sup>	1,226,000	864,000	70%	1,000,000	82%	1.2
Madagascar 1993 <sup>g</sup>	2,000,000	940,000	47%	2,000,000	100%	2.1
Senegal 1993 <sup>h</sup>	24,000,000	6,000,000	25%	11,000,000	46%	1.8
Madagascar 1994 <sup>i</sup>	1,200,000	576,000	48%	950,000	79%	1.6
Madagascar 1994 <sup>i</sup>	2,000,000	1,000,000	50%	2,000,000	100%	2
Peru 1994 <sup>j</sup>	10,880,000	0	0%	2,720,000	25%	n/a
Zambia 1994 <sup>k</sup>	66,614,000	7,328,000	11%	10,990,000	16.5%	1.5
Mexico 1994 <sup>k</sup>	1,870,000	1,015,000	54%	1,658,000	88.7%	1.6
Total	192,881,000	25,445,000	13.2%	47,713,000	24.7%	1.9

- a. 7 swaps in water, health and sanitation sectors
- b. primary health care, women and street children sectors
- c. education, health and nutrition sectors
- d. children in armed conflict
- e. primary education sector
- f. education sector

- g. 2 swaps in water, health and sanitation sectors
- h. health, water, education sectors
- i. cyclone emergency
- j. UNICEF country program
- k. health and education sectors

to commercial banks. Historically, swaps began with commercial debt, although in recent years the debt owed to official bilateral creditors has been used for this purpose. Using official debt alters the scenario described above somewhat, in that it is problematic to speak of a “secondary market” for official debt (as official creditors—mostly in the form of export credit boards—often do not have the same flexibility as do commercial banks in discounting debt). Nonetheless, there have been a limited number of swaps involving debt notes owed to official creditors.

## 4. THE APPEAL OF DEBT SWAPS

4.1 Swapping debt offers a genuine win-win scenario. Consider the advantages of debt swaps from the perspective of the recipient government. Foreign debt is retired, it is retired at a discount and the government pays for the debt with local currency (instead of drawing down scarce foreign exchange). Furthermore, that local currency does not leave the country but is used to finance specific national development projects. Finally, retiring foreign debt, and clearing up a country's arrears, may give new access to much needed capital that the country would otherwise be denied.

4.2 Now consider swaps from the perspective of the external development organization. Debt swaps allow the organization to address two critical issues simultaneously: the retirement of debt and the generation of local development funds. Furthermore, for non-governmental organizations, swapping debt can allow the agency to multiply its investment. International NGOs buy the debt note at a discount using their foreign currency, but recipient countries, who place a relatively higher premium on scarce foreign exchange, are often willing to provide more for the development project in local currency than the NGO actually paid itself. Therefore, foreign NGOs are able to gain a leverage on their initial investment by exploiting the mismatch between the *value* associated with their scarce foreign exchange and the *value* of local currency. In other words, debt swaps are a mechanism for NGOs to exchange their currency at a premium.

4.3 In addition, debt swaps hold a particular attraction for educational aid in that they allow us to avoid the problem of a mismatch between the type of funds available and the type of funds needed. In a continent where 30% of all children are still denied basic education, foreign aid to Africa must be harnessed to achieve the goal of "education for all" (which is reflected in the policy objectives of most agencies). Yet during the 1980s, aid to African education concentrated primarily on higher education. This is clearly not working

## Box 2 - Selected Debt-for-Development Swaps in Africa

The following table describes some of the debt-for-development swaps that have taken place in sub-Saharan Africa. Only one swap is given per country, although most of the countries listed have undertaken multiple swaps. The UNICEF swaps described in Box 1 are not listed (with the exception of Zambia's 1994 swap which includes UNICEF's transaction within the total).

<i>Swap</i>	<i>Face Value</i>	<i>Purchase price (PP)</i>		<i>Redemption price (RP)</i>		<i>Leverage (RP/PP)</i>
	<i>in US\$ of Debt</i>	<i>in US\$ on Secondary Market</i>	<i>(as % of face value)</i>	<i>in US\$-- Local Funds Generated</i>	<i>(as % of face value)</i>	
Madagascar 1990 <sup>a</sup>	919,000	446,000	49%	919,000	100%	2.1
Guinea 1990 <sup>b</sup>	1,000,000	500,000	50%	1,000,000	100%	2
Niger 1990 <sup>b</sup>	1,000,000	500,000	50%	1,000,000	100%	2
Ghana 1991 <sup>c</sup>	1,000,000	250,000	25%	1,000,000	100%	4
Nigeria 1993 <sup>d</sup>	1,000,000	400,000	40%	500,000	50%	1.3
Tanzania 1994-95 <sup>e</sup>	2,100,000	750,000	36%	1,850,000	88%	2.4
Zambia 1994 <sup>f</sup>	92,300,000	10,200,000	11%	15,300,000	16.5%	1.5

- a. undertaken by the World Wide Fund for Nature for environmental projects.
- b. undertaken by the International Foundation for Education and Self Help for 'self-help' projects.
- c. undertaken by Conservation International, with the assistance of the Debt-for-Development Coalition, for environmental projects.
- d. undertaken by the River Blindness Foundation for vaccination programs.
- e. four swaps undertaken by the Aga Khan Fund for Economic Development and the International Finance Corporation, with the assistance of the Debt-for-Development Coalition, for eco-tourism projects.
- f. undertaken by a number of NGOs, including UNICEF, CARE, Habitat for Humanity and World Vision, with the assistance of the Debt-for-Development Coalition, for a range of projects in the social sectors.

towards the provision of basic education, although, when we examine the standard practices of donor financing this is not surprising. At basic educational levels most spending is in local currency—principally on salaries (accounting for over 80% of many African basic education budgets)—while only small amounts are spent in foreign exchange. Many development and donor agencies have statutes that preclude the use of their funds for supporting local currency expenditures. Indeed, some agencies finance exclusively the foreign exchange costs of an education project, leaving all the local currency costs to be born by the government. Furthermore, almost all agencies have limitations on the use of such funds for supporting salaries of national civil servants. Hence, there is a mismatch between the type of funds needed for basic education (mainly local currency) and the funds available from external agencies (almost always foreign exchange). These donor financing restrictions run contrary to basic education needs and agencies find their budgets skewed away from supporting a sustainable education system and toward providing technical assistance and overseas scholarships (where the mismatch is less glaring). One of the real attractions of a debt-for-education swap is that the problem of mismatched funds is overcome, while at the same time donors help to build the basis for a comprehensive system of basic education.

## 5. THE POTENTIAL CONCERNS OF DEBT SWAPS

5.1 If debt swaps appear to benefit everyone, why have they not been used more extensively? There are five potential concerns associated with swaps that deserve mention.

5.2 The first concern of debt swaps deals with inflation. In theory, inflation in the beneficiary country is a concern associated with swaps, for if the government provides the local project funds by printing new money, this will increase the money supply and have an inflationary impact. In practice, however, concerns about inflation are greatly overrated. A number of the countries most suited to debt swaps are those classified by the World Bank as IDA-only (International Development Association, i.e. the lowest income countries). Most of these countries are following International Monetary Fund macroeconomic packages that place strict limits on government spending, government borrowing and the growth of the money supply. If the country wishes to participate in a debt swap, therefore, it cannot simply pay for the project by increasing spending through printing new money or borrowing. Instead, the country must incorporate the new spending into the national budget and reallocate resources from other areas to support the project. Such an operation has no impact on the money supply or total spending and therefore will have no inflationary impact.<sup>2</sup>

5.3 The above discussion points to an important point, specifi-

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<sup>2</sup>In the past, countries participating in debt swaps issued local bonds (instead of currency) in order to avoid fueling inflation. To support the project costs, the implementation agency would then either receive quarterly interest payments on the bonds, or they would sell the bonds on the open market, generating an immediate lump-sum of cash. Since selling bonds to the public does not require the central bank to print more money, this approach allows the agency to obtain cash immediately, without fuelling inflation. The practice of issuing bonds, however, is now rarely used. This is in part because selling bonds on the open market requires sophisticated domestic capital markets, and in part because this approach was found to be too complicated, time consuming and unreliable.

cally, that debt swaps are not a cost-free exercise for the recipient government. Before the debt swap, the government was holding a low-cost foreign debt (low-cost because if the government is already in arrears the debt is unlikely to be fully repaid). However, after the swap the government is holding what is essentially a high-cost domestic debt (that must be repaid to finance the agreed development project). Swaps turn debt into a source of development funding—however it must not be forgotten that the government is responsible for providing those new funds.

5.4 The second concern of debt swaps involves two *transaction risks* for the external development agency: the diminishing value of the investment and non-payment. The first of these risks—the diminishing value of the investment—relates to the fact that with a debt swap, the external agency typically “converts” all of its foreign currency into local funds at once. If the project is scheduled to last over a number of years, however, NGOs run the risk that their initial leverage will be diminished or lost, through currency devaluation or hyper-inflation. This risk can be overcome, however, by leaving the proceeds from the debt swap in an escrow dollar account with the central bank. With such an account, the development agency maintains its investment in dollars and converts the proceeds into local currency (at the prevailing exchange rate) only when needed.

5.5 The second transaction risk involves non-payment. Debt swaps rely upon the government providing the local project funding, although this raises concerns such as whether a new regime will respect the commitments of its predecessor. Non-payment was a real concern in the early days of swapping debt, when, after having handed over a debt note, some NGOs did not receive the full payments they were expecting. There are two answers to this problem: first, if projects are chosen carefully with a *clear national constituency* for the project, then difficulties of national commitment can be avoided; and, second, instead of tendering debt notes in their entirety at the beginning of the project, they can be tendered progressively and converted as needed. Nonetheless, if the political or macroeconomic environments are unstable, NGOs with long-term projects may find it wiser to convert foreign exchange conventionally and gradually over

the life of the project.

5.6 The third major concern of debt swaps is that the leverage created by secondary debt markets works mainly in the NGO's favor. If the NGO can generate close to 100% of the debt's face value in local funds then the developing country does not benefit from the debt's discounted price. Rather, developing countries end up *subsidizing* the value of the NGO's leverage. Therefore, governments must ensure that the projects being supported are national priorities linked to long-term development goals.

5.7 The fourth concern that has arisen out of previous debt swaps is the issue of "additionality", or the amount of new resources that come to the country as a result of the debt swap. When an international NGO participates in a debt swap, the additional funds that are gained through leverage may allow the organization to actually reduce the level of hard currency resources they devote to that country. Thus, the funds generated by debt relief may be used to replace existing spending and savings can be spent on projects in other countries. Furthermore, in countries where international NGOs are an important source of hard currency, the government may find that its foreign exchange reserves have deteriorated. Governments can overcome this concern during the preparation stage of the swap by screening and approving only projects that represent additional spending. It is worth noting, however, that international NGOs, with their limited resources, are often looking for projects that will give them the highest yield on their investment. Therefore, a number of NGOs participate in debt swaps in order to gain the highest possible return and if the debt swap did not exist, they would not be involved in the project. In other words, the whole debate around "additionality" does not always reflect the way in which NGOs actually operate.

5.8 The fifth concern of debt swaps is "round tripping". Round tripping occurs when the local funds produced through the debt swap are spent overseas. In some cases, countries may use the debt swap proceeds to buy specific imports, although these overseas purchases should be infrequent and of a high priority to the project. However, in most cases, round tripping essentially defeats the purpose of the

swap—the development funds do not directly benefit the country and the low-cost foreign debt which was swapped into a high-cost domestic debt draws down foreign exchange reserves (in other words, as if it were a high-cost foreign debt). Round tripping has also occurred in the past when debt swaps have been used to generate scholarship programs for nationals in foreign universities<sup>3</sup>. Governments must decide if providing overseas scholarships is of sufficient importance to justify the negative impacts associated with round tripping.

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<sup>3</sup>An example of this occurred in 1990 when Harvard University and the government of Ecuador agreed to use a debt swap to finance scholarships at the university for 20 Ecuadorian students over 10 years. Harvard bought \$5 million of debt paper for \$775,000. In exchange, the Ecuadorian central bank provided local funds worth \$2.5 million, which after a year were mostly converted into dollars and invested in US money markets to finance the scholarships. A small percentage of the local funds (15%) remained in Ecuador to finance a research fund for visiting Harvard faculty and students. The benefits of this program to Harvard are clear—they gain a scholarship program and a research fund at a greatly reduced price. The government of Ecuador retires a (non-performing) debt note and allows for a handful of students to be educated overseas. However, this requires new government spending (which draws down foreign exchange reserves). Furthermore, because not all of those students will necessarily return to Ecuador afterwards, the impact on national development of the scholarships is limited. Given the questionable value of this type of transaction, it is rarely done now.

## 6. THE PREREQUISITES FOR A SUCCESSFUL SWAP

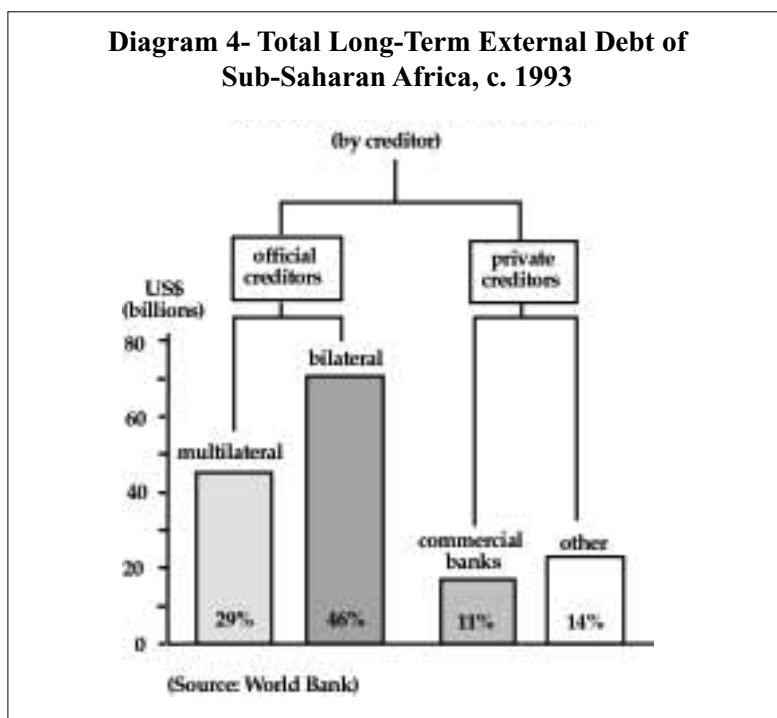
6.1 Based upon the pros and cons of swapping described above, it is clear that debt swaps, if carefully planned and fully thought through, can work in everyone's interest. Nonetheless, before a debt swap can be used there are certain criteria that need to be fulfilled. Five of the major prerequisites for debt swaps are described below.

6.2 The first prerequisite for a swap to take place is that the debtor country is considered "severely indebted" with little or no prospect of being able to pay off its debt and the accumulated arrears. It may seem obvious that debt relief is only given to countries that need it, although it does mean that, for example, a number of countries in southern Africa would be unsuitable for debt swaps (see **Diagram 2** for the level of indebtedness of African countries).

6.3 The second prerequisite is that the country must have sufficient levels of *appropriate* debt. Swaps have mostly involved debt that is owed to commercial banks, yet in sub-Saharan Africa three-quarters of all long-term debt is owed to official multilateral and bilateral creditors. As illustrated in **Diagram 4**, only 11% of sub-Saharan African debt is owed to private commercial banks, while 29% is owed to multilateral lending organizations and 46% is owed bilaterally (the remaining 14% is owed to other private creditors). Thus there is relatively little African commercial debt available, compounded by the fact that European banks (which hold many of the debt notes) often do not have the same tax incentives as do their American counterparts to write off bad debt. This means that the secondary market for Africa debt and the scope for swapping is limited.

6.4 The third prerequisite deals with sector-specific considerations. Debt swaps begin with donor and recipient agreeing on the details of a suitable project, but the fact that donor and government will be able to reach agreement cannot be taken for granted. With

**Diagram 4- Total Long-Term External Debt of Sub-Saharan Africa, c. 1993**



regards to education, is there a coherent national policy in place that can serve as the basis for agreement between the government and foreign investor? If not, then there will be limits on the number of education projects that can be agreed upon and supported through debt swaps. In addition, we must ask what are the existing levels of state spending on education. There are a limited number of countries in Africa where education spending is at high levels, and hence, debt swaps that further increase spending levels on the education sector may be unnecessary or undesirable. This is the case in a minority of African states, but it is important to stress that debt swaps are not an appropriate mechanism for all situations.

6.5 The fourth prerequisite—a sound macroeconomic environment—addresses the long-term sustainability of the program funded through the debt swap. It must be remembered that a debt swap is a means of *temporarily* producing counterpart funds for

projects—the funds from a debt swap may last for three or four years. But what happens when the funds generated by the swap have been consumed? Debt swaps could be used to temporarily increase spending on education, while at the same time reducing the burden of debt service and allowing macroeconomic growth to occur. When the local project funds generated through the debt swap run out, national funds generated through macroeconomic growth should take over and sustain the increased education spending. This obviously assumes that the rest of the economy has performed sufficiently well to support increased educational spending. Nevertheless, given that spending on basic education is mostly in the form of salaries, these expenditures are reasonably difficult to compress and therefore have a certain degree of built-in sustainability.

6.6 The fifth prerequisite deals with the management capacity of the recipient state. It is important that the central bank and treasury have experience with other types of swaps, such as debt-for-equity, for a debt-for-development swap to work smoothly. This is becoming less of an issue as more African states—including Madagascar, Zambia, Guinea, Niger, Ghana, Nigeria, Senegal, Sudan and Tanzania—use the debt swap mechanism. However, in the late 1980s when debt swaps were beginning to take hold, the issue of management capacity contributed to NGOs using this new technique almost exclusively in Latin America. NGOs had confidence that Latin American states would be able to successfully undertake a swap and this is certainly one reason why over two-thirds of all debt-for-development swaps have taken place in that region.

6.7 Countries that fulfil these prerequisites are suited for undertaking swaps. For countries to participate in swaps, there are four possible approaches that can be used. First, a limited number of countries (notably Mexico and the Philippines) have set up permanent debt-for-development swap mechanisms (known as debt-for-development funds). With these funds in place, NGOs can approach the government with a proposed project. The government will have previously set up a structure for swapping debt. This structure will have in place a mechanism for approving potential projects, determining a redemption price and identifying sources of debt. Govern-

ment directed debt-for-development funds, which make debt swaps into a routine operation, are described in greater detail in paragraph 8.3. Second, a debt swap can take place in conjunction with an IDA Debt Reduction Facility package. The World Bank has set up a debt reduction program for the lowest income countries that provides a grant essentially allowing the government to buy back commercial debt on the secondary market at a highly-discounted price. IDA debt reductions have begun to incorporate debt-for-development swaps as an option, and in the technical annex, the use of this technique in Zambia is described. The third possible approach for a debt swap is for the development agency to undertake a transaction on a one-off basis in a country that has undertaken a debt swap before. The capacity to undertake a swap will exist within the appropriate ministries, although development agencies would be advised to use professional expertise to structure the swap. The fourth possible approach is for a development agency to undertake a swap in a country that is interested but has no previous experience. This approach will likely require a degree of capacity building, with the assistance of debt swap specialists, within the beneficiary government to ensure that the appropriate skills exist in the treasury, central bank and relevant sectorial ministries. Governments may have a certain ambivalence and hesitancy about participating in a debt swap for the first time—due to fears that swapping debt will set a precedence against outright debt forgiveness. These sorts of strategic calculations are inevitable, although an evaluation of the pros and cons should make it clear that swaps can work in everyone’s long-term interests.

## **7. EXPANDING THE SCOPE OF DEBT-FOR-DEVELOPMENT SWAPS—THE ROLE OF OFFICIAL DEVELOPMENT AGENCIES**

7.1 Historically, debt swaps have mostly involved NGOs buying commercial bank debt. This has meant, however, that the impact of debt swaps in reducing overall debt levels has been marginal as the amount of resources NGOs can mobilize is limited and because commercial bank debt represents only one element of total foreign debt. In sub-Saharan Africa, 75% of all long-term foreign debt is owed to multilateral and bilateral creditors. There are trends towards greater acceptance of the concept of debt swaps among official creditors.

7.2 Bilateral development agencies have begun to recognize that debt swaps can be considered as one of the available instruments for financing *official development assistance programs*. This slightly alters the scenario described in Section 3 in that, when bilateral official development assistance (ODA) debt notes are used, the “development agency” and the “creditor” are the same organization. Nonetheless, the basic nature of a debt swap does not change and the development agency and beneficiary government must negotiate the amount of local financing that will be provided for the amount of debt relief (in essence, determining the purchase and redemption prices).

7.3 Specific examples of bilateral agencies using debt swaps can be cited. The Canadian government announced a swap program at the 1992 United Nations Conference on Environment and Development that has converted US\$80 million of its ODA debt owed by El Salvador, Honduras, Nicaragua and Colombia into their local currencies and used to finance sustainable development projects. Likewise, the United States set up the «Enterprise of the Americas Initiative» related to U.S. government concessionary debt owed by certain Latin American and Caribbean countries. The debt of each participating country is reduced and restructured, and then interest is paid back in local currency that is deposited directly into environmental

funds. To date, roughly \$150 million has been generated through the Initiative. In addition, Sweden, France and Germany have initiated debt-for-development swaps with their outstanding ODA debt notes.

7.4 From the perspective of official bilateral donor agencies, swaps present an appealing option. Virtually all development organizations accept the argument that sustainable development in many countries requires meaningful debt reduction. Therefore, bilateral agencies have been forgiving official debt as part of their overall development strategy. However, debt swaps are a form of debt forgiveness with the *added payoff of generating local project funds*. Therefore, official creditors will find that swapping some of that debt—and channelling the debt relief into specific projects—will help to fulfill their overall development objectives to a greater extent than will straight debt forgiveness. Furthermore, as official development agencies deal with shrinking budgets, debt swaps represent one way for them to do “more with less”.

7.5 Bilateral agencies should also consider debt swaps as an instrument of official policy for the issue of “local ownership”. We know that swaps retire debt and create local project funds, but this is not all that swaps do. In addition, there is a less obvious advantage to swapping debt: namely, the encouragement of greater local participation in development projects. When externally-funded development projects fail—no matter how well planned or potentially beneficial they are—the donor agency asks “what went wrong?” Recent experience has shown that projects often do not succeed when they are externally-driven and when local actors are not involved. Local stakeholders must feel a sense of meaningful participation and ownership in a process of change that implicates them. However, genuine local involvement is often weak in externally-funded projects. Typically, the external lending agency meets the foreign exchange requirements of a project, while leaving the local costs of the project to the recipient government. But national governments often have economic difficulties and, hence, their financial participation is limited or does not materialize. This jeopardizes the project, in part, because essential financing is missing, but equally so because the project lacks real local commitment. Since local resources are

not being used, there will be only a limited concern about failure. So how can the external agency improve the sense of local participation and ownership, and also ensure that local funds are available? This is where debt-for-development swaps fit into the equation.

7.6 All bilateral development agencies hold debt notes, some of which may not be repaid. Unlike commercial debt, very little of the official bilateral debt will be traded on the secondary market. How then can this bilateral debt be swapped for project funding? Instead of using the traditional approach to funding development projects, an agency could offer, along with new project money, a swap of some outstanding debt for local development project funds. The new money is used for the project's foreign exchange requirements, while the debt swap is used to create local currency that is specifically earmarked as counterpart funding for the project. Debt swaps require the national government to provide local currency for the agreed project at the moment of the swap, thereby safeguarding the local financing requirements from the start. Of equal importance, however, *the debt swap guarantees that there will be a sense of local commitment to the project.* When national resources are used, there will be a substantial degree of local responsibility for management. In turn, responsibility for management creates a sense of "ownership" and a concern for success that is often missing from externally-driven projects. Therefore, agencies should find that debt swaps help to improve the success rate of project implementation.

7.7 The discussion above has focused on ODA debt, although many of these ideas could work equally well for official bilateral agencies using non-ODA debt. It is important to emphasize that ODA debt represents only a small share of the total debt owed to official bilateral creditors. Most bilateral debt is held by other government agencies, most notably the export credit boards. Although export credit boards are essentially run on a commercial basis, they are still quasi-governmental agencies and, subsequently, do not have the freedom of commercial banks in writing off bad debts. For many export credit boards, writing off bad debt would require the creditor government to make a budget allocation against the debt note, and this could come at the expense of new aid flows. This presents an

opportunity for debt swaps: official development agencies could use their funds to write off the debt owed to other government agencies, while having the local currency generated through the swap assure that the total aid volume does not suffer.

7.8 The renegotiation of non-ODA official creditor debt relief is undertaken within the framework of the “Paris Club”. The Paris Club is the regular meetings of debtor countries with their official bilateral and multilateral creditors (the name comes from the fact that the French Ministry of Finance hosts the meetings and provides a secretariat). The Paris Club has come up with proposals for dealing with developing country debt that includes a provision for swapping debt. The most severely indebted, low-income countries have been able to choose from a menu of options called the “enhanced-Toronto terms”, and most recently the “Naples terms”. With respect to debt-for-development swaps, these terms allow countries, when rescheduling or reducing their debt stock, to use up to 10% of all eligible debt owed to bilateral creditors towards swap programs.<sup>4</sup>

7.9 Multilateral development agencies have assisted countries in reducing their stock of outstanding commercial debt through buy-backs and swaps, although these agencies have not used their own stocks of debt for this purpose.<sup>5</sup> Multilateral lending organizations have strict institutional rules stating that their debt must be repaid in full. The World Bank’s position is that writing off some of its own debt stock would have negative repercussions on its credit worthiness, which in turn would increase the cost of borrowing from the Bank by all developing countries. Therefore, to protect their status as the “lenders of last resort”, multilateral agencies have not reduced

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<sup>4</sup>The full menu of options available under the enhanced-Toronto and Naples terms is described in the World Bank’s *World Debt Tables, 1994-1995* (Washington: World Bank, 1994). The Naples terms offer up to 67% reduction in the debt stock or debt servicing of the “eligible debt” of the lowest income countries. Eligible debt refers to debt that was issued before a certain cut-off date, in order to protect and ensure new capital flows, which typically corresponds to the date of the country’s first Paris Club meeting. Since some African countries went to the Paris Club in the early 1980s, their cut-off dates are from that time (except in those cases where the date has been renegotiated). Hence, the terms of Paris Club debt reductions are not always as generous as they first appear.

their own debt stocks. Nonetheless, multilateral agencies—which hold fully one-third of long-term debt in sub-Saharan Africa—recognize that *exceptional measures* are needed to achieve meaningful debt reduction. One such measure is the “Fifth Dimension” supplement, through which the World Bank provides IDA resources to the lowest income countries for the purpose of paying the interest charges on outstanding IBRD debt. Multilateral agencies may find debt swaps to be another appropriate exceptional measure which succeeds in paying off the debt (as local development funds) and wiping the debt note off the creditor’s books. Swaps could be an acceptable compromise to the strict rules on repayment—particularly when the “repayment” is used for human resource development—while allowing multilateral agencies to deal with the debt overhang.

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<sup>5</sup>The World Bank’s International Development Association (IDA) Debt Reduction Facility has provided grants to the poorest countries to allow them to reduce their commercial bank debt. Based upon an endowment from the International Bank for Reconstruction and Development (IBRD) and additional support from bilateral agencies, seven countries—Bolivia, Guyana, Mozambique, Niger, São Tomé and Príncipe, Uganda and Zambia—have used the facility to eliminate \$814.1 million of commercial bank debt. A study of the Zambian case, which involved an extensive debt-for-development swap, is described in the Technical Annex. Likewise, the Inter-American Development Bank initiated a \$400 million fund in 1990 to provide foreign exchange for member countries to buy back their commercial debt on the secondary market at a discount, providing the debt was converted into local currency and deposited in an environmental fund.

## 8. EXPANDING THE SCOPE OF DEBT-FOR DEVELOPMENT SWAPS—THE ROLE OF AFRICAN GOVERNMENTS

8.1 As illustrated in **Diagram 3**, the initiative for undertaking a debt-for-development swap has historically come from an external development agency. Underlying this paper, however, is the proposition that responsibility for educational development rests with national governments. When considering debt-for-development swaps, therefore, we would advocate *country leadership* in establishing swaps and negotiating the terms of those swaps.

8.2 Within the framework of an overall debt reduction strategy, governments can approach creditors and development agencies with a proposal for a debt-for-development swap to support specific activities. Government should define as extensively as possible the exact mechanics of the swap—how this would fit in to the larger debt reduction strategy, what reasonable purchase and redemption prices would be, what specific debt notes could be used and what types of projects would be supported with the local currency proceeds.

8.3 To encourage swaps, governments can establish permanent debt-for-development swap mechanisms (commonly known as debt-for-development funds). Mexico and the Philippines have both established such funds. NGOs submit potential projects to be funded through a debt swap and if government approves the project, then the NGO is advised of appropriate debt notes that can be purchased and at what rate they will be redeemed in local currency. Countries that wish to set up debt-for-development funds must determine responsibility for leadership, which rests typically with the ministry of finance, in consultation with other sectorial ministries. It is essential when setting up a fund that a process is established for reviewing the suitability of potential projects for swaps. The debt-for-development fund must prepare a questionnaire for interested NGOs that asks for the following information: a description of the project, clearly indi-

cating how it represents additional spending; a summary description of the agency funding the debt purchase and the agency implementing the project; and, a detailed budget for the project, indicating local and international costs. Based upon this questionnaire, governments can choose suitable projects, and since government will be subsidizing the NGO's leverage, it is essential that the projects chosen reflect national priorities. Governments can favor certain priority issues over others by offering a higher redemption price for projects in favored sectors. There is a limit to the total volume of projects that can be supported and, based upon the national absorptive capacity for swapping, this limit must be determined beforehand. Finally, it is worth mentioning that debt-for-development funds can be used as a tool for encouraging creditors to donate their debt note. Creditors can be offered a range of development projects that can be supported through a swap.

8.4 Those countries that are eligible to participate in the IDA Debt Reduction Facility can also encourage swaps as part of the debt reduction program. As described in the **Technical Annex**, Zambia retired \$200 million of outstanding debt through the IDA Facility in 1994, roughly half of which occurred as a debt-for-development swap. Those countries that are presently negotiating debt reductions through the IDA Facility—including Sierra Leone, Ethiopia, Guinea, Mauritania, Senegal and Tanzania—could greatly benefit from incorporating a swap along the lines of the Zambian model.

8.5 Government can use debt-for-development swaps as an opportunity to build the capacity of local NGOs and institutions. When determining the agency that will implement the project, the government can insist that local NGOs be used in partnership with foreign NGOs. Using local NGOs to implement projects is particularly relevant to education, given the growth in the 1980s of community schools in Africa outside the public sector. A number of governments have found that they are unable to build new schools at a pace sufficient to keep up with demographic growth, although self-financing community-based school initiatives have helped to fill the gap. Using the proceeds of a debt swap to support community-based school initiatives would see them flourish, and since government is involved in financing, this would give the state greater scope for

monitoring and inspecting these schools.

## 9. CONCLUSION

9.1 The purpose of this paper has been to increase awareness of debt-for-development swaps among governments and development agencies. Debt swaps represent an opportunity for some countries to deal with their debt overhang, while simultaneously channelling more resources into social sectors. They are an innovative tool with tremendous potential, although they are complex and will often require professional support in design and implementation. Swaps will not work in all developing countries, nor can all types of outstanding debt be used. Nevertheless, there is a window of opportunity for donors and governments to use debt swaps to advantage. It is difficult to determine how long this window will remain open, however, given the changing nature of secondary markets and the progress being made in resolving developing country debt overhang.

9.2 The use of debt swaps will continue to be hampered by the strategic calculations of creditors (of being repaid) and debtors (of having the debt forgiven). Debt swaps send signals from one party to the other. When a creditor agrees to a swap, the debtor interprets this as realization on the part of the creditor that the debt will not be fully repaid. Therefore, the debtor may choose to postpone until the creditor agrees to full outright forgiveness. Likewise, from the perspective of a creditor, the very fact that governments or NGOs are discussing a swap may push the secondary debt market price up beyond reach. These game-theory calculations will continue to deter swaps from being used more widely.

9.3 Given the constraints that an environment of adjustment and austerity imposes upon spending in the social sectors, it can be argued that health and education deserve special consideration for funding through a debt swap mechanism. A number of governments in Africa are unable to provide universal basic health and education systems, let alone to provide systems that keep up with the growth in population. Yet, governments and donors alike have placed a

renewed emphasis on investing in human capital as a cornerstone of development. The potential use of debt swaps in channelling resources into the health and education sectors is extensive and needs to be closely considered by the development community.

## **TECHNICAL ANNEX— THE 1994 ZAMBIAN DEBT-FOR-DEVELOPMENT SWAP WITHIN THE IDA DEBT REDUCTION FACILITY**

1. In a two-tranche operation in July and September 1994, Zambia undertook an extensive program to reduce much of its outstanding commercial debt. This operation took place within the framework of the World Bank's IDA Debt Reduction Facility and included both cash buy-back and debt-for-development swap options. In total, \$200 million of debt was retired.

2. This debt reduction program began with negotiations between the government of Zambia and the World Bank to include Zambia as one of the countries eligible to participate in the IDA Debt Reduction Facility program.<sup>6</sup> Zambia fulfilled the three requirements of the program, ie. it was classified as low income, it had a World Bank approved medium-term economic plan in place, and it had a comprehensive debt management strategy. Therefore, Zambia was eligible to receive a grant from IDA funds to buy-back outstanding commercial debt at a heavily-discounted price. Once Zambia's participation in the IDA Debt Reduction Facility was agreed in principle, the government of Zambia (represented by the Zambian Bank and the Ministry of Finance), in accordance with the World Bank, decided that Zambia's commercial creditors would be offered three possible options: first, they could receive cash for the debt directly from the government (a straight buy-back); second, they could sell or donate their debt note to an NGO, who would use it for a debt-for-

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<sup>6</sup>The Debt Reduction Facility is open to IDA-only countries (those classified as low income—GNP per capita less than \$695). The Facility was endowed with \$100 million in 1989 and replenished with a further \$100 million in 1993 from the IBRD to provide grants to eligible countries to reduce their commercial debt through buy-backs at discounted prices. Bilateral donors have contributed additional funds on a case-by-case basis. To date, \$814.1 million of commercial bank debt has been retired through the IDA Facility in Niger, Mozambique, Guyana, Uganda, São Tomé and Príncipe, Bolivia and Zambia. Similar transactions in Sierra Leone, Albania, Ethiopia, Guinea, Mauritania, Senegal and Tanzania are under preparation.

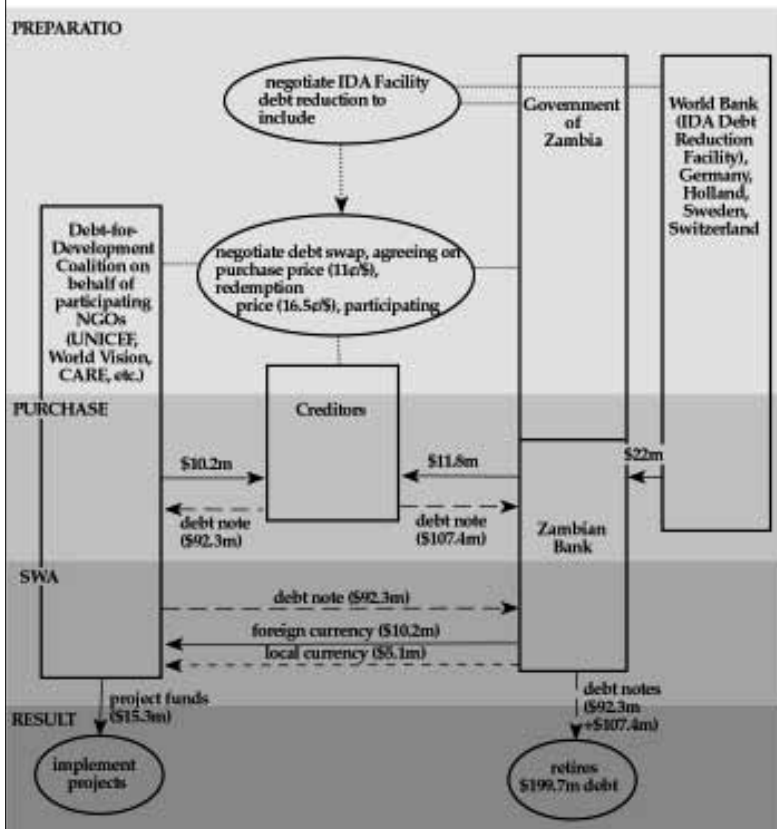
development swap; or, third, they could exchange the debt note for long-term bonds redeemable at a premium in privatizations for equity (although no creditors chose the bond option, and therefore, it will not be discussed further). The World Bank agreed to provide an IDA grant, in addition to resources from bilateral donors, to pay for the purchase of debt. For the debt-for-development swap option, it was agreed that NGOs would purchase eligible debt from creditors at the same price offered by the government. NGOs would then redeem the debt with the Zambian Bank in kwacha at a 50% premium to finance development projects in-country. This was the first IDA Debt Reduction Facility operation to fully incorporate a debt-for-development swap. The complete operation, which is illustrated in **Diagram 5**, is described below.

3. Once the structure of the debt reduction had been agreed, the *preparation phase* of the debt reduction operation began. Four bilateral donors—Germany, Holland, Sweden and Switzerland—agreed to add their own resources to those of the IDA Facility, pledging a total commitment of up to \$45 million. Of this amount, \$22 million was eventually used for debt retirement. The government of Zambia received a further \$3 million technical grant to cover legal and financial advisory fees and other administrative expenses.

4. The Government of Zambia, acting through the Ministry of Finance, contracted the Debt-For-Development Coalition to structure, coordinate and implement the swap. The Coalition advised the government on the structure of the questionnaire that potential NGOs would submit for approval of participation in the debt-for-development swap option.

5. The government of Zambia, through its legal and financial agents (Arnold and Porter, and S.G. Warburg respectively), negotiated with the creditors a purchase price of 11¢ on the dollar. The parties agreed that this purchase price would apply to eligible debt, defined as debt owed to commercial creditors and guaranteed by the government of Zambia and that had been in continuous arrears since 1 January 1992. Once a purchase price had been fixed, the government of Zambia sent out a global offering to all its commercial

**Diagram 5- The Debt-for-Development Swap Within the IDA Debt Reduction Facility, Zambia 1994**



creditors to sell their debt, choosing from the possible options (cash or debt-for-development).

6. In parallel, the Debt-For-Development Coalition marketed the debt swap to potential NGO participants. A number of NGOs, acting through the Coalition, submitted project applications for government approval. The government of Zambia had previously identi-

fied the areas of water and sanitation, health, primary education, vocational training and education infrastructure and the social safety net as its priority issues to be supported through the swap. Based upon these priorities, approximately 50 NGOs had their projects approved for participation in the swap.

7. The Debt-For-Development Coalition then matched participating NGOs with creditors willing to participate in the swap option. Only 14 of the approximately 50 NGOs had funds available for the purchase of debt. As only two creditors chose to donate debt, the remaining NGOs were unable to participate further. The Debt-For-Development Coalition then negotiated debt purchase agreements on behalf of the 14 NGOs with creditors willing to sell their claims. The NGOs—UNICEF, CARE International, World Vision, Christian Reformed World Relief Committee, Catholic Relief Services, Harvest Help, Habitat for Humanity International, Africare, Population Services International, the International Executive Service Corps, the International Union for the Conservation of Nature, the International Planned Parenthood Federation, the Christian Council for Zambia and the Program Against Malnutrition—made cash deposits into an escrow account to guarantee that they had the \$10.2 million required to buy the debt notes.

8. The Ministry of Finance, in order to fulfil government obligations of providing a 50% kwacha premium to NGOs, made a kwacha allocation in the national budget equivalent to \$5.1 million to support this spending. The final step in the preparation phase was for the creditor banks to respond to the global offering, by choosing the option—cash or debt-for-development—of their choice. Once a creditor had accepted the offer to participate in the debt reduction program, it was legally bound to not withdraw from the program at a later date.

9. Following the preparatory phase, the operation entered the *purchase phase*. The World Bank and bilateral donors provided the Zambian government with a grant of \$22 million. The Ministry of Finance handed \$11.8 million of this over to the commercial banks against debt notes worth \$107.4 million. At the same time, the \$10.2

million that NGOs had deposited was transferred over to commercial banks against debt claims of \$92.3 million. In total, \$199.7 million of Zambia's commercial debt was purchased.

10. Immediately following the purchase, the operation entered the *swap phase*. The NGOs handed over the debt notes worth \$92.3 million to the government and in exchange, the remaining \$10.2 million from the IDA grant was put into an escrow account for the participating NGOs.<sup>7</sup> The Zambian Bank committed a further \$5.1 million to the account. NGOs were required to take the \$5.1 million as local currency for spending on the project. The \$10.2 million was made available for project spending as either foreign currency—to purchase any necessary imports—or as local currency.

11. In a traditional debt swap, it is usually forbidden for project funds to be spent on imports. Spending on overseas goods creates the problem of “round tripping” (described in paragraph 5.8) that largely eliminates the advantages of a swap. Round tripping did not occur with this swap, however, because two-thirds of the local project funds were provided for out of the IDA grant (in foreign currency). Therefore, NGOs could be reimbursed for their initial investment in hard currency if they wished. The remaining one-third of project funds (equivalent to the 50% premium) came out of national resources, and therefore, had to be spent in kwacha. Providing the funds in both local and foreign currency was only made possible through the large initial grant from the World Bank and bilateral donors and this would not be an option for standard debt-for-development swaps where all local project funds come out of national resources.

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<sup>7</sup>In reality, the purchase and swap phases occurred simultaneously and there was no physical exchange of paper. Prior to the closing date, \$11.8 million from IDA and bilateral sources and \$10.2 million from NGOs was placed in one escrow account (earmarked for purchasing the debt from the creditors). The remaining IDA funds of \$10.2 million were placed in another escrow account, into which the government placed a further \$5.1 million (earmarked as the project funds created through the swap). On the closing date, \$22 million was transferred to creditors, while the \$15.1 million escrow account was turned over to the NGOs. The actual debt paper was retired, according to the agreed contract, by the simple act of transferring the funds to creditors.

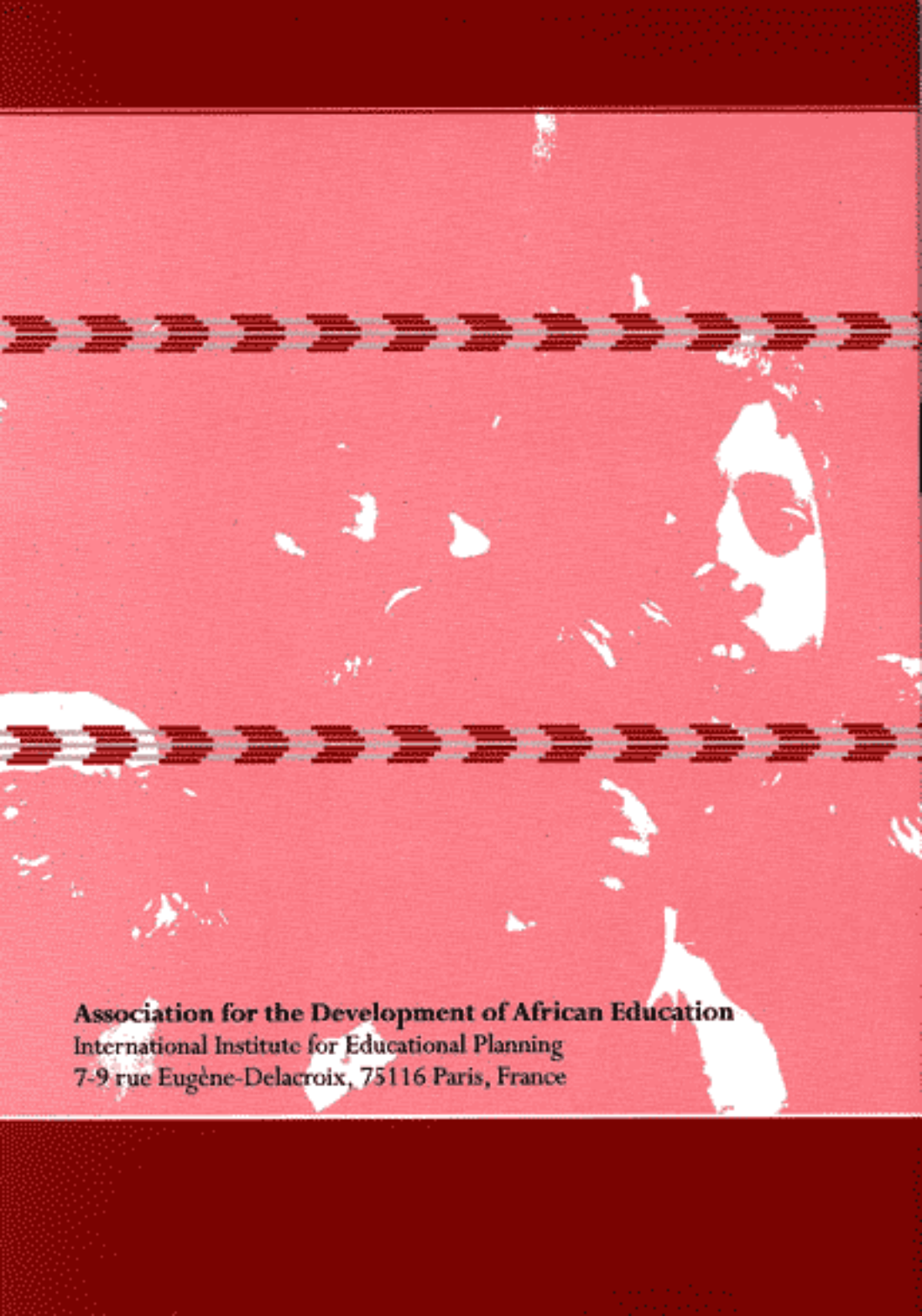
12. Although it is unusual for debt swaps to provide project funding in foreign exchange, there was a strong argument supporting this course of action. In the preparatory phase, it was determined that all projects by the swap would be new activities, representing “additional” resources into the economy. Therefore, for every 50¢ of local currency that government would put into the social sectors, an additional \$1 (in foreign currency) would enter. This had two positive effects for government: first, it was able to see its own funds levered; and second, since the additional spending entered the economy as foreign exchange, this freed up government’s import spending. In other words, the debt swap acted as an *incentive* program to encourage the government to allocate more of its existing spending into the social sectors.

13. With the swap phase completed, the operation proceeded to the *results phase*. Two actions took place. First, the Zambian Bank retired commercial debt worth \$199.7 million, \$92.3 million through the debt-for-development option and \$107.4 million through the cash option. Prior to the swap, Zambia’s commercial debt stood at \$440 million, of which \$240 million was considered eligible for the debt reduction program. Hence 83% of eligible debt, or 45% of total commercial debt, was extinguished through the program. Second, the NGOs undertook the projects, including work in virtually all social sectors—education, health, agriculture, AIDS awareness campaigns, housing projects, family planning, stockpiling of emergency food reserves and business management consultants.

14. It is worth noting that the \$15.3 million of project funding was not all disbursed to NGOs immediately. Rather, the money was kept in an interest-bearing dollar account for each NGO and only disbursed on a pre-arranged date (typically quarterly). In order to protect the value of the investment against devaluation, the amount of local currency paid out was calculated based upon the prevailing exchange rate.

15. Not all of Zambia’s creditors chose to participate in this debt reduction program. There is fully \$40 million of eligible debt still outstanding. When this is coupled with the fact that less than

half of all approved NGOs were able to participate in the swap, opportunities for a third tranche open up. Such a third tranche could be offered to those creditors that hold eligible debt notes as a final opportunity to recover some of the outstanding payments, with the understanding that these debt notes after a third operation would be worthless.



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