Could debt swaps fund green growth?

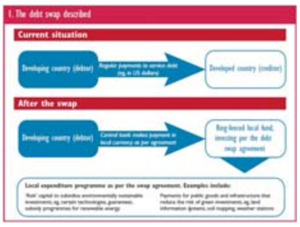
EMAIL

25 October 2012

Debt swaps to promote green growth could help stimulate climate finance, while easing the debt burden on developing countries vulnerable to climate change, say **Tanja Havemann** and **Fiona McKenzie**

Since the UN Framework Convention on Climate Change (UNFCCC) and its associated Kyoto Protocol entered into force, significant private and public funds have been committed to financing climate change mitigation and adaptation. Yet, while significant funding has been pledged, the consensus is that the disbursement of funds has been inadequate.

Despite good intentions, and the steps that many countries have taken to mitigate and adapt to climate change, efforts have largely been under-resourced. A further cause for concern is the overlap between countries that are highly vulnerable to climate change and those that are in debt distress. Meanwhile, investment in performance-based climate change mitigation and adaptation has been insufficient, further hindered by the high cost of capital in developing countries, the recent slowdown of the global economy, and uncertainty in the international carbon market.



Given the current bottleneck in disbursing climate funds, the burden of debt repayments on developing countries vulnerable to climate change, and the need for innovative climate financing, we at BeyondCarbon propose that a 'Green Growth Debt Swap' be considered.

This is a simple concept based on an old idea (debt swaps) with a new objective (green growth). Essentially, it means that sovereign debt is converted into a local fund for investment in activities promoting climate change-resilient, low-carbon economic growth.

The point of the Green Growth Debt Swap is not to establish a new framework, agreement, or even point of negotiation in the current international climate change talks. Instead, it would provide an alternative (and timely) source of finance, using money that already exists. It could finance low-carbon growth projects that would otherwise not be funded, such as: improving energy efficiency; reducing deforestation; increasing sustainable agricultural practices; providing guarantees for investments in renewable energy; and minimising atmospheric pollution.

In brief, a debt swap involves the voluntary exchange, by a creditor with its debtor, of debt for cash, another asset or a new obligation with different repayment terms. There are many variations to this model, including cases where the creditor is willing to accept less than the face value of debt. The terms debt swap, conversion and exchange are often used interchangeably, and the general concept is well accepted. For example, the Paris Club, an informal group of creditor nations that meets to provide debt relief to developing countries, introduced a debt swap clause in 1990, making bilateral debt eligible for swaps.

> ***A debt swap is not about creating 'easy' money. What it can be is 'timely' money***

The opportunity that a debt swap provides is that it can raise capital in low-income countries. Variations of the concept have been used to fund specific projects, including environment, infrastructure and community development projects. For example, a debt-for-environment swap involves an agreement that the debtor, rather than continuing to make external payments on outstanding loans in hard currency, instead makes payments in local currency to environmental projects in the country on terms agreed upon in advance with its creditors. The general concept is illustrated in figure 1.

Several 'debt-for-nature' and 'debt-for-development' swaps have been completed. Between 1985 – when Chile agreed the first debt swap – and 2000, an estimated $4.2 billion of official debt was swapped for local currency. Of this, $1.6 billion was for debt-for-environment swaps in approximately 30 countries. The Polish EcoFund is one of the best known success stories, raising more money for environmental projects than all other debt-for-environment swaps worldwide (see box). Other governments that have pursued swaps include Germany, France, Switzerland and the US.

A debt swap has three main steps: sourcing eligible debt; structuring a fund to hold the debt; and using the debt fund (ie, having a credible and effective expenditure programme). Different types of debt swaps are possible but the

Poland's EcoFund

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challenges and potential benefits vary considerably.
For example, in a bilateral debt swap, benefits to the creditor nation might include the tackling of international or regional environmental problems without having to raise additional aid budgets, or improved market conditions for environmental technologies. The benefits to the debtor nation might include keeping capital that was to be transferred out of the country for domestic investments and using monies to leverage greater private sector investment domestically.

Many aspects of a multilateral debt swap are similar to those of a bilateral swap, including getting agreement between parties and the administration requirements. The difference is that an intermediary, such as the Asian Development Bank or African Development Bank, would negotiate the swap with the debtor country. The intermediary would have several options to raise funds (which would still go into some form of ring-fenced facility or fund).

The benefits of a multilateral swap include the potential to aggregate numerous debts into a larger fund (the arranger could also source private sources of debt, for example). The challenges of such an arrangement include getting multiple actors to agree on the terms and conditions, including the value of debt and repayment terms.

It provides grants to public, non-governmental and private organisations for environmental projects in Poland, including the prevention of air pollution, greenhouse gas abatement, and biodiversity protection.

It was important in that it leveraged additional financing, created domestic environmental financing capabilities, provided a model for financing cost-effective environmental projects, set a benchmark for similar institutions in Poland, and helped to bridge the country's financing gap for environmental projects.

The fund is considered one of the most successful of its kind because of its:

- rigorous project cycle management procedures;
- close attention to achieving high cost/benefit ratios;
- strictly enforced procurement policies;
- political independence;
- stable, predictable, long-term revenues;
- strong leadership and highly qualified staff;
- objective, accountable and transparent decision-making; and
- competitive tendering processes including partial untying of donor aid.

The willingness of both creditors and debtors were key to its success. Creditor nations were attracted by: the opportunities for addressing global/regional environmental problems; business opportunities in Poland for the sale of environmental technologies; and an interest in supporting the development of local environmental financing capacity. EF

Sovereign debt may also be owed to private creditors. A private company, by definition, requires a return on its investment – ie, the debt. However, the form and the terms of repayment of this debt could be negotiated in the context of a debt swap. Instead of the sovereign debt, the creditor may accept payment in another form, such as a stream of tangible assets. In terms of benefits, such a swap may facilitate more professionalism as to how important assets are managed, and provide greater international scrutiny and accountability. Challenges would include ensuring that trade rules are observed and that national sovereignty over natural resources is protected. A debt swap involving private creditors would probably also need to involve a multilateral or a bilateral organisation as a 'go-between'.

Before getting too carried away, it is important to note that a debt swap is not about creating 'easy' money. What it can be is 'timely' money – so long as the steps that need to be taken in negotiating the swap are conducted efficiently. In all cases, while there are clear benefits, it is also important to acknowledge that there are some challenges to setting up a debt swap, not least getting agreement and buy-in from the creditor.

Agreement is required on how the new investment fund will be administered and the required controls and performance measures. This, in turn, requires monitoring and independent auditing of results. Figuring out what the money should be used for, who gets access, how it is to be administered and the metrics against which performance is judged need to be considered carefully from the very start. The more thorough the planning process and comprehensive the agreement between the two parties, the higher the likelihood of success.

The other important point is that a country needs to be diligent in figuring out how the money will be best used. Actions that are financed should be consistent with country priorities, and be guided by national or regional adaptation and mitigation strategies. A fund would need to have defined financial, social and environmental safeguards, with annual assessment and verification carried out by third parties. It should be focused and 'narrow' in scope. Examples already exist of national and regional funds that finance climate change mitigation and/or adaptation, including in Guyana (low-carbon growth), South Africa (wind energy) and Indonesia (geothermal power).

An expenditure programme could be linked to specific natural capital targets or the creation of green economy-enabling conditions, such as: appropriate regulatory frameworks, market-based instruments, training and education. Alternatively, a country may chose to invest in activities such as:

- provision of clean water and sanitation services;
- renewable energy and low-carbon technologies for fossil fuels;
- greening the water, fisheries and agricultural sectors;
- reducing waste and increasing efficiency in agricultural and food systems;
- recycling and energy recovery from waste;
- improving energy efficiency in the transport sector;
- adopting clean fuel; and
- shifting from private to public and non-motorised transport.

Once the proposed expenditure programme is designed, it could then be used to leverage additional finance from other sources. It should also be designed to catalyse private investments that are financially sustainable. Countries may also chose to develop a new expenditure programme that can complement and promote mitigation and adaptation actions based on existing strategies (such as the Clean Development Mechanism, Nationally Appropriate Mitigation Actions or Reduced Emissions from Deforestation and Forest Degradation). Either way, it should be debtor countries that initiate the swap and nominate the activities to be financed.

In summary, while there are considerable challenges, we believe there are adequate benefits for both the creditor and the debtor – and the environment – to develop and test this concept further. We invite governments, development institutions and private creditors to take up the challenge – to lead the way in locating and transforming a significant amount of suitable developing country debt into investment in results-based, low-carbon growth. EF

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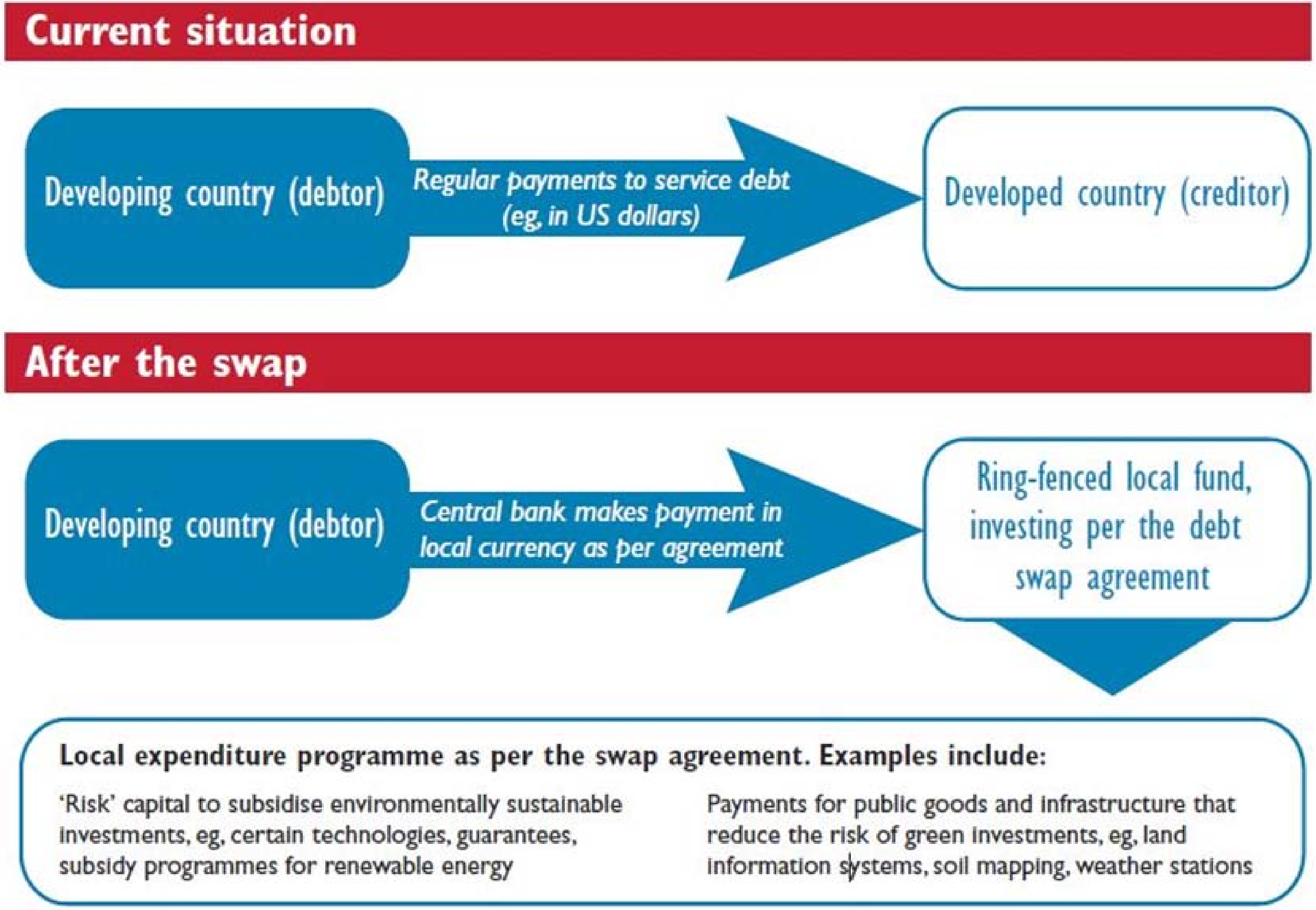
1. The debt swap described



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