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The Uses of Debt Conversion Mechanisms by Non-Governmental Organizations to Help Provide for the Capital Needs of Small Enterprises and Industrial Cooperatives

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I. Introduction

Since the debt crisis broke in the summer of 1982, non-governmental organizations NGO's, or private voluntary organizations PVO's as they are called in the United States, have become increasingly concerned about its impact on developing countries. There is a widespread consensus among NGO'S that the debt crisis is largely responsible for the prolonged economic recession in developing countries. The recession, combined with the burden of the debt, has most severely affected low-income people, the poor, landless and unemployed. NGO's tend to stress the impact of the crisis on these and other disadvantaged population groups because these populations constitute their main constituents.

The main features of the crisis are declining per capita income, rising and persistent unemployment and a continuing net transfer of resources to Northern countries. Between 1983 and 1988, the 17 most highly indebted countries paid out US$135 billion more in debt payments than they received in new money.(1) It is estimated that annual negative income flows amount to US$20 to 30 billion, or 4.5 percent of GNP of developing countries. Sustained economic growth and development in debt countries, NGO's contend, cannot take place in the face of negative resource transfers of this magnitude. While the situation of the developing countries continues to deteriorate, most banks have been able to improve their balance sheets and reduce their exposure.
While the crisis has spared few categories of populations, it has hit hardest the poor and disadvantaged population groups, including women and children, the landless, food-deficit farming households, the urban unemployed and those with jobs that allow enough for bare survival.(2) Many developing

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1. John Denham. Reducing South-North Resources Transfers: The Need for Bank Debt Cancellation". A background paper for the Meeting of European NGO's on Common Action on Commercial and Official Debt of Third World Countries, organized by FONDAD- Europe, Brussels, 30-31 August 1989.

2. Appendix III: Final Statement of the UN/NGO Workshop on "Debt, Adjustment and the Needs of the Poor", World Development, Vol. 15, supplement, 1987, pp. 255-261.

developing countries, as a condition for rescheduling loans or for receiving fresh credits, have agreed to adjustment programmes that push up interest rates, raise taxes, and lower subsidies on basic foods and services. They are obliged to service huge external debts in the face of declining export earnings, reduced foreign aid flows and limited access to credit from commercial banks. Because of the deflationary monetarist policies pursued by industrialized countries and international financial institutions, and the large net loss of resources, the developing countries have remained in the grip of a deep economic crisis.

Among the social consequences spawned by the economic crisis are rising infant mortality, decreasing access to food, increasing malnutrition, particularly among children and women, growing landlessness and unemployment, decline in real wages, and curtailment in education, health and other social services. In many sub-Saharan countries, the gains in health and education registered in the 1960's and 1970's are eroding under the impact of adjustment policies. In addition to these social and economic costs, the crisis has led to social instability in a number of developing countries and threatens democracy where it exists or is being built.

2. Response of NGO's to debt crisis

There has not been a uniform response by NGO's to the debt crisis. A number northern NGO's and their southern partners have argued that substantial reduction of the debt, which is estimated at US$1.3 trillion, or outright cancellation offer the only realistic solution to the debt crisis. Concern for the poor and disadvantaged populations of developing countries, these NGO's contend, must outweigh the needs of banks. Any strategy that does not allow for substantial debt reduction or cancellation, are mere palliatives and will not offer the needed relief.

2.1 Advocacy role

A number of northern NGO's, many located in Europe, and their southern partners, are of the view that the proper role for NGO's is to devote their energies to reversing the flow of resources from developing to developed countries through action at the international and national levels. Consistent with this approach, they would urge governments and commercial banks to consider measures to reduce the negative transfer of resources. At the national level, this would include write-offs of bilateral debt and support of the Nigel plan or similar initiatives for subsidizing interest payments or extending the period of loans repayment. Approaches would also be made to European banks that they take measures to reduce the flow of resources from developing countries. These include new lending and associated measures such as interest capitalisation, voluntary debt reduction or outright cancellation, interest relief "and selective action on certain illegitimate loans and on parts of capital flight".(3) This advocacy role should also be expanded by making representations to the Paris Club and international financial institutions on the impact of the debt crisis on the poor.

A number of NGO's in the United Kingdom, the Netherlands, France, the United States and other countries, acting in an individual or collective manner, have carried on such initiatives at the national, regional and international levels. Among these collective initiatives are the United Kingdom Debt Crisis Network, and the the Forum on Debt and Development (FONDAD). FONDAD is a Hague-based organization, initiated by the Dutch development NGO's Interchurch Coordinating Committee on Development Projects (ICCO), Netherlands Organization for International Development Cooperation (NOVIB) and the Catholic Organization for Joint Financing of Development Programmes (CEBEMO) which operate in conjunction with Third World partners.

2.2 Concern about legitimizing Third World debt

These and other NGO's subscribe to the view that debt should be reduced or cancelled because much of it was acquired by illegal means or for immoral purposes. Much of the debt was used for armaments or for projects that did not benefit the poor. In certain of the developing countries, it is argued, large portions of the debt were funneled into private bank accounts of dictators and their supporters. NGO's which purchase debt for development or for related purposes - no matter how small the amounts - "legitimize" it. The only acceptable role for NGO's, which must act solely on behalf of the people, is to seek the cancellation or reduction of the debt. This would be in line with the position taken at the 1988 Lima Conference of NGO's and mass organizations which

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3. John Denham. "Prospects of a European Bank Campaign". A background paper presented at the Meeting of European NGO's, organized by Forum on Debt and Development (FONDAD), The Hague, 21-22 March 1989, p.11.

took the position that the debt should not be repaid in its entirety.(4) A number of the NGO's favourable to this point of view would go along with debt for development purchases but on a case by case basis. The moral arguments - both for and against - will be presented below. (5)

3.0 NGO support of concept of debt as a development resource

In contrast to the NGO's which would have little or anything to do with debt for development projects, a considerable number do favour this approach. These NGO's while generally supportive of the idea of debt reduction or cancellation, tend to view these as unrealistic goals. Instead, they favour viewing debt as a potential resource by recycling it into worthwhile projects. Coalitions and networks have sprung up in the United Kingdom, the United States, France, the Philippines and elsewhere to promote direct action by NGO's in debt conversion arrangements. Among these is the Debt for Development Coalition, Inc., a Washington D.C.-based group established with funding from USAID in 1988 to help not-for- profit organizations find ways "to turn the international debts of countries into economic development opportunities". Following this, the coalition created the Debt-for Development Foundation to provide practical assistance to NGO's and PVO's in debt conversion transactions, particularly in arrangements that involve a number of such groups. In 1988, two international NGO's, the International Cooperative Alliance (ICA) and the World Council of Credit Unions (WOCCU) created the Debt for Cooperative Investment Service (DCIS) for the purpose of recycling developing country into investments in cooperative organizations. In France, a government commission involving concerned agencies and NGO's is involved with debt conversions. These and other actions of national and international non-governmental organizations in support of the concept and practice of debt for development are in line with the proposals put forward in the final statement of the UN/NGO Workshop on "Debt, Adjustment and the Needs of the Poor. The relevant proposal calls on NGO's to explore the possible advantages and disadvantages of "debt-for-development swaps and examine the conditions under which northern governments and NGO's can use such mechanisms to benefit the poor".(6)

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4. George Ann Potter, Dialogue on Debt. Alternative Analyses and Solutions, The Center for Concern, Washington, D.C., 1988, pp.64-67.

5. See pp. 14-16.

6. op. cit. Annex, p. 260.

3.1 Different forms of debt conversion schemes

There are different forms of debt conversions which are applied for different purposes. The latter include (a) debt for equity, (b) debt for development, (c) debt for trade, (d) debt for social services and (d) debt for debt. This list could be expanded to include other objectives. In most societies creditors are entitled to foreclose on bad loans and possess any collateral tied to these loans. By this scheme of things, a debt conversion results in a third party assuming responsibility over sovereign loans in exchange for the right to possess "collateral" in the indebted country. Hence the rationale for the above mentioned schemes whose limit is only set by the imagination.

3.2 Use of blocked currency accounts and debt donations

NGO's have been able to leverage their resources by means other than debt conversions. One way is to buy at a discount blocked currency accounts. The holders of these accounts, often a transnational corporation, is willing to sell non-convertible local currency below the official exchange rate in order to gain dollars or other hard currencies.

Debt donations is another way by which NGO's can acquire instruments of indebtedness of developing countries. Through this practice, commercial banks donate debt to a not-for-profit organization to undertake, after approval by the government, of a socially or economically desirable programme. Debt donation differs from swaps in that the NGO does not purchase the debt on the secondary market but receives it as a donation from a bank. Such an arrangement holds out certain benefits for a bank. It can save on expense and administrative costs relating to rescheduling and processing of arrears linked to small amounts of debt where payment prospects are slim. Although the amounts involved are small, donations could generate a good press, and a good image for the bank at home and in the developing country. Under a U.S. Internal Revenue Service ruling made in November 1987, such a donation made to an entity having 501 (c)3 status under the tax code is tax deductible. In a number of European countries, banks making donations of debt also receive tax breaks. An example of a debt donation for development is the Midland Bank's donation of Sudanese debt in the amount of US$800,000 to UNICEF. Under terms of the arrangement, UNICEF received an equivalent amount in Sudanese currency which are being invested in water, sanitation, reforestation and health education programmes.

3.1 Potential benefits of debt conversions

There is considerable agreement that debt conversions provide a potential source of local currencies to NGO's to further project development in developing countries. If successful, such a transaction can provide benefits to all parties concerned, namely banks developing countries and NGO's. Banks holding debt view conversions as an opportunity to convert a non-performing asset or potential loss into one that is performing, yields income and now or in the future will be partially or wholly repaid. Debtor countries view debt conversions as beneficial since it reduces their foreign debt and allows for local currency resources to be used for priority development programmes. Northern NGO's and their third world partners benefit by leveraging their resources to pursue agreed-upon programmes.

3.2 Mechanics of debt/equity swaps

The most common form of debt conversion is the debt/equity swap. A typical operation is the sale by a bank to an investor of non-performing debt in the secondary market. The investor then exchanges the obligation with the central bank of the debtor country for the face value of the loan, usually minus a fee or discount paid in local currency. In turn the investor makes an equity investment to capitalize a project. The effect of this transaction is to reduce the country's debt by the face value of the exchanged instruments of indebtedness.

Often, the retired external debt is exchanged for a local debt instrument redeemable in the domestic bond market. The interest paid on this local debt instrument generates a stream of income that is used to finance the operations of the investor or the NGO. A not untypical example of such an operation is the swap negotiated by CARE, the U.S. NGO of Ecuadorian debt to finance a soil conservation and land management programme. Under terms of the deal, CARE purchased US$3.5 of Ecuadorian debt at 16 cents on the dollar for US$580,000. After paying a fee, it received domestic bonds worth US$1.75 million in local currency. To protect CARE's investment against inflation, the bonds pay an indexed interest rate pegged to the average interest paid by a high quality instrument of indebtedness. Over the eight year life of the bond, CARE will receive the local currency equivalent of US$2 million to finance its programme.(7) Half the cost of the programme was funded by USAID, with additional financial support provided by the British Overseas Development Administration and the Dutch Government.

Debt/equity swaps make sense only in countries whose external debt is selling at a discount. The steeper the discount the greater the possibility for an NGO or investor to leverage its resources. The brightest prospects for success are in countries that have laws and regulations institutionalizing the process. Chile's position at the forefront of debt/equity swaps is partly explained by the unambiguous rules governing these transactions and the governments efforts to educate interested investors.

As a condition for participating in a debt/equity swap, the NGO or investor must adhere to conditions laid down by the government or its central bank. The programme to be implemented or the project to be financed must fall within the economic and social priorities of the government. The NGO/investor is required to provide information regarding the nature of the project, its scope and coverage, the financial means for implementation, including hard currency component, and disbursement schedule of local currency. As a rule, the project has to be carried out within a specified time frame. Failure to live up to these obligations could cause the authorities to revoke a pending deal and result in losses to the NGO/investor.

3.3 Financial steps involved in a typical debt/equity swap

Although conditions for debt/equity swaps vary from country to country, it is possible to identify the usual financial steps involved in a debt/equity swap:

a. The NGO applies for and receives approval for a project from the government agency (usually the ministry of finance or central bank) responsible for debt conversions. Processing of the application can be done by the U.S. financial intermediary or in some instances by the local partner or affiliate of the not-for-profit organization.(The financial intermediary can be a bank, brokerage house or the Foundation of the Debt for Development Coalition).

b. The NGO discusses the financial and relevant details of the project with the U.S. intermediary and, if agreement is reached, a letter of intent is signed.

c. The financial intermediary identifies a source (seller) that is willing to sell debt instruments. In the

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7. Interview with Thomas C. Gibson, Executive Vice-President, CARESBAC, March 13, 1990.

past, the financial intermediary, if it was a bank, would often draw on its own debt portfolio for such operations.

d. The financial intermediary verifies with the central bank that the particular debt is eligible for conversion.

e. The NGO transfers the required amount of funds to the financial intermediary, who, in turn, purchases the debt.

f. The financial intermediary informs the authorized government agency that the transaction is completed and requests it to transfer the local currency equivalent to the account of the NGO. Instead of local currency, interest-bearing domestic instruments of indebtedness may be credited to the NGO's account and will yield an annual income for the benfit of the project.

g. The proceeds of the transaction are available to the NGO or its local partner or affiliate.

3.4 If complications are to be avoided, the last three steps should be executed simultaneously. A central bank may decide, for whatever reasons, not to make payment. One possible reason is that the paper purchased may not be redeemed prior to its stated expiration date. Just such an experience befell an international NGO in Costa Rica when it tried to exchange the debt it acquired abroad for monetary stabilization bonds at the central bank. This could have been avoided by a simultaneous transaction at which time the NGO would have been apprised that the paper in question was not eligible for conversion.

4.0 Weighing the benefits and risks of a debt/equity swap

Before considering the advantages and disadvantages of debt/equity swaps for NGO's, it would be useful to identify the benefits and risks where an investor is the initiator of the transaction. Debt/equity swaps, on the face of it, secure benefits for all the participants. The investor acquires local currency at a discounted rate; the debtor country's external obligations are reduced by the face value of the purchased debt; and through the sale of the debt, the bank receives a portion of the debt it might have otherwise not received. These observations are valid up to a point. There are real and potential risks attendant on a debt/equity conversion that may show up soon or are likely to appear over time. A swap, it should be borne in mind, generally leads to an asymmetrical relationship between investments in the public and private sectors. Under its terms, the investment is made in the private sector while the debt is mostly public. A country's public debt is being sold at a discount to foreigners to enable them to invest in the private sector. These two sets of activities can only be evenly matched when the investors buy a privatized public asset.

4.1 Benefits to the banks

A debt/equity swap offers a bank the least expensive way of selling a non-performing asset of a developing country by allowing it to avoid the full market loss implicit in the secondary market, the discount being shared between the creditor and the debtor. By selling debt on the secondary market, a bank is able to realize some portion of the debt it might not otherwise receive for years - if at all. Swaps, it can be argued, only transfer debt ownership; what was once the country's external debt simply becomes a burden on the domestic budget, leaving commercial banks the primary benefactors of swaps. In the United States, the Federal Reserve Board has encouraged debt/equity swaps by amending Regulation K which governs the extent of equity participation allowed U.S. banks in foreign firms. The securitization of a country's external loans helps banks realign their foreign portfolios according to their risk preferences and corporate objectives. By and large, it is the larger banks that are most attracted to swaps because their affiliates provide them with a good understanding and close working relationship with the local economy.

4.2. Benefits to the debtor country

A debt/equity swap reduces the aggregate stock of external debt which a country is ordinarily expected to service. By properly regulating swaps, a country encourages investment in domestic industry and substitutes the foreign exchange outflow associated with contractual interest payments for the repatriation of earnings associated with equity capital. Debtor countries can better regulate the flow and timing of these transfers so that they are in tune with the state of the economy. Moreover, they are in a position to influence the kinds of benefits derived from debt capitalization schemes. By requiring investors to channel their investments into export or export substitution industries, debtor countries are in a position to improve industrial productivity and export capacity. Foreign capital negotiated through debt/equity swaps, alone or in combination with local capital, may be instrumental in helping develop those industries that are stagnating because of a lack of indigenous skilled labour and poor access to foreign markets. Foreign capital often carries with it access to external markets that local entrepreneurs are unable to penetrate. That debt/equity swaps are permitted is a signal to foreign investors of the debtor government's willingness to open the domestic market to foreign capital.

4.3 Benefits to investors

For investors, a debt/equity swap creates an opportunity to obtain vitally needed local currency at a favourable rate reflecting the discount at which the loan was bought. Using conventional methods of currency exchange, the investors would have received far less for their foreign exchange. They are now in a position to acquire on favourable terms new equity or expand existing equity, or to finance the local currency component of their investments at a lower cost. This serves to lower significantly the initial costs of investing and to give the investors a competitive edge over local rival producers. They are also well positioned to buy up cheaply business enterprizes, land and other national assets. Both possibilities could stir up nationalist sentiment over the ownership and control of these assets.

While some argue that a debt/equity conversion is a subsidy granted by the debtor country to the investor, others contend that the subsidy originates with the creditors who dispose of their debt instruments at a discount. Part of the subsidy may be recaptured, as is the practice in some countries, by levying a fee on the transaction. Debtor countries, moreover, can and usually do limit the size and scope of the investment by requiring it to fall within national priorities. Ecuador, for example, has placed an annual limit of US$50 million on the amount of its external debt that can be converted for development purposes. This right may be more apparent than real in some countries which may refrain from exercising it because of a compelling need to acquire foreign capital, technology and access to overseas markets.

5.0 Risks of debt/equity conversions

Where debt/equity conversions take place, the risks fall mainly on the debtor country. Neither creditor or investor bear immediate risks because, in selling a debt instrument and capitalizing a local asset, they are, presumably, acting in rational manner to maximize gains and minimize losses.The choice of the investment or a change in market conditions may ultimately cause the scheme to turn sour and result in a loss to the investor. This, however, is the risk of doing business, one which the investor understands. If the bank draws the debt instrument from its own portfolio and becomes the equity investor, it too, could incur losses on the investment. Here, again, this was a decision of its own making from which it stands to gain or lose.

5.1 Risks to the debtor government: inflation

Where debt/equity swaps take place at steep discounts, they provide an unambiguous sign of destabilized economies whose foreign exchange reserves are under pressure of debt service obligations. The effect of this could be to weaken investor confidence in the economy. Local business people who are not allowed access to debt conversion schemes could be particularly affected because they will be obliged to acquire local currency in credit markets where real interest rates invariably are high. Of more immediate concern are the potential inflationary pressures resulting from the need to monetize the converted debt into local currency. Since a common characteristic of heavily indebted countries is a high rate of inflation, the injection of fresh quantities of local currency into the money supply is likely to fuel inflationary pressures. This is particularly likely in countries where the government is apt to print more money or force up local interest rates when it borrows in domestic credit markets to put up local currency for the swaps.

There is evidence that the large volume of local currency generated by debt/equity swaps played an important role in bringing Brazil to the edge of hyperinflation, and may explain why the government scaled back the programme. Fears of escalating the already high rate of inflation was given by the fiscal authorities in turning down a debt conversion proposal by the Debt for Cooperative Investment Service in November 1989. Under the proposal, Polish debt held by a foreign bank would be converted into zlotys for investment in cooperatives. (8) The Central Bank of Costa Rica suspended debt/equity swaps in December 1986 because of their negative monetary impact and the increase in capital flight attributed to "roundtripping".

5.2 Containing inflationary potential of conversions

Inflation is not a necessary by-product of debt/equity conversions. There are strategies, rigorously applied, that could "sanitize" the impact of monetary expansion. One approach would be to limit the annual total volume of debt conversions. Another would be to invest part or all the local currency generated by the conversion into domestic stabilization bonds, the interest from which would be the source of income for the project. This practice has been used in a number of countries. When the World Council of Credit Unions (WOCCU) purchased US$1 million of Jamaican bonds at 50 cents on the dollar, the US$2 million in local currency generated by the transaction was invested in domestic instruments of indebtedness whose proceeds were used for strengthening the Jamaican credit union organizations.

Such a strategy to sterilize the money may not always prove

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8. The author of this study was a member of the two-man team that participated in this mission on behalf of the DCIS.

feasible in countries where real interest rates on domestic credit exceeds the real interest costs on foreign debt. A larger consideration is that since money and capital markets in indebted countries are typically thin and poorly developed, there is inadequate scope for the central bank to conduct the necessary sterilization operation to permit the conversion to take place in meaningful amounts. Widespread use of debt/equity swaps are therefore likely to have inflationary consequences.

5.3 Displacement of fresh capital

By converting existing debt and converting it into local currency, the investor is spared the need to make fresh capital available to the debtor country. To the extent this occurs, it deprives the country of much-needed foreign exchange by providing the investor with a way to increase his equity without adding new capital.

Debtor countries can resolve this problem by requiring that a certain percentage of a domestic conversion be financed in foreign currency or fresh domestic funds - a condition known as additionality. Both Argentina and Uruguay, for example, maintain additionality requirements. In Argentina, an investor may finance up to 70 percent of a project through a debt/equity conversion while in Uruguay the figure is 80 percent. In the Philippines, where a conversion fee is levied on the gross peso proceeds accruing from a swap transaction, the figure can vary depending on the amount of fresh capital made available by the investor. The smaller the percentage of fresh money, the higher the conversion fee. In a sense, the fee may be viewed as a means by which the Central Bank is able to recover part of the opportunity costs of forfeited foreign exchange earning resulting from the approval of the swap transaction. Jamaica has an additionality clause stipulating that money put up by an NGO cannot be a substitute for funding normally provided by a bi-lateral development agency.

5.4 Potential for illicit capital flight

Debt/equity deals may pose special problems to debtor countries that do not have effective administrative systems to control capital flight. This involves such abuses as "double discounting" by those who had "capital flighted" their funds out of country, can reinvest it at home with the added incentive of discount profits. Another abuse is the lucrative practice of "roundtripping" whereby business people, after exchanging newly acquired local currency, sell it at a discount for dollars, then remit the hard currency abroad. Not all central banks have the administrative machinery to monitor such unlawful flight of capital which is a drain on a country's capital resources.

6.0 NGO's and debt/equity conversions

The possibility of leveraging resources is what attracts NGO's to the idea of debt/equity swaps. By buying discounted debt on the secondary market, and exchanging it with central bank authorities at or near face value, the NGO can realize far greater value for its money than by exchanging it through conventional means. Debt purchased at 50 cents on the dollar and paid off at 100 percent will result in a doubling of resources; if paid off at 75 percent of face value, programme resources increase by 50 percent. This is no small consideration considering that contributions from government and public sources are not keeping pace with growing outlays and inflation. This multiplier effect can be very important for northern NGO's whose operations in developing countries entail substantial and continuous outlays of money. It permits them to maintain or expand programmes. And for certain kinds of NGO's, the leveraging of resources permit them to lend money to or invest in cooperatives, small enterprizes and organizations of poor people.

6.1 NGO disbursements for development

Total NGO monetary disbursements in development financing, though dwarfed by contributions from government sources, is far from insignificant. In the period between 1970 and 1985, this figure rose substantially due largely to increased Overseas Development Assistance (ODA) from DAC (Development Assistance Committee of OECD) governments. Over this 15 year period, NGO development financing rose from US$1 billion to US$4 billion. Of total DAC countries' "development disbursement" in 1985 (defined as net ODA transfers plus net private NGO grants), estimated in the amount of US$32.5 billion (of which US$19.6 billion was ODA proper and US$2.9 billion constituted "private NGO grants) total NGO disbursements of US$4 billion accounted for approximately 13 percent.(9)

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9. Hendrik Van Der Heijden, "The Reconciliation of NGO Autonomy, Program Integrity and Operational Effectiveness with Accountability to Donors", World Development, Vol. 15, supplement, 1987, pp.103-104. The US$4 billion is made up of private grants plus ODA contributions channeled through NGO's to developing countries.

6.2 Special character of NGO's affects its involvement in debt/equity conversions

Because of the special status of NGO's, the nature of their work and the source of much of their funding, NGO participation in debt conversion schemes cannot be pegged at the same level as that of a private investor. The latter is interested in debt/equity swaps solely out of profit motives and, as long he adheres to the conditions laid down by the central bank governing his investment, is not accountable to public authorities on the use of his money. The same is not the case for an NGO which has the status of a not-for-profit organization.(10) Because of this, the NGO has to report periodically on its activities to the government to show that it conforms to the terms of its charter. The business of NGO's takes the form not of "business" but of charity, humanitarian works and/or development in its various aspects. What further distinguishes NGO's from private enterprizes is that much of their funding comes from the public at large to which it is accountable. And as NGO's derive a growing proportion of their funds from official sources at the national, regional and international levels, they are more and more duty-bound to account to these bodies. Because of these factors, the involvement of NGO's in debt conversions raises certain issues and problems that are not associated with for-profit organizations.

6.3 Legitimacy of Third World debt

While many NGO's consider debt/equity swaps from the calculus of costs and benefits, others view it from a moral point of view and, on these grounds, find it objectionable. It should be stressed that those who consider the moral argument do not do so for religious reasons; among the largest practitioners of debt/equity swaps are Catholic and Mormon groups. The reasoning behind this thinking was presented in an earlier section of the paper (para. 2.2). NGO's that take up this position are more concerned with the overall debt problem and its impact on the poor. The efforts of FONDAD, the U.K. Debt Crisis Network, an informal group of British NGO's concerned with debt and development, and other groups of NGO's are given over to lobbying European governments and banks to reduce the debt of developing countries. It is their position that this approach can have a far greater impact in as much that a large part of the debt is owing to European governments and banks. By becoming involved in debt for development schemes, they argue, NGO's distract attention from the main issues of debt such as the negative net transfer of resources from developing to developed countries. The amounts of money that NGO's have at their disposal, they contend, are too small to make a dent on the amount of outstanding debt or contribute much to promoting development.

6.4 Attitude of southern NGO's

It is not possible to state with any degree of precision the number of NGO's that have principled objections to debt/equity swaps. In the United Kingdom, certain NGO's, notably OXFAM, Christian Aid, Save the Children, War on Want and the Catholic Fund for Overseas Development (CAFOD) have strong reservations to engaging in such arrangements. OXFAM's policy is not to consider purchase of debt unless requested by a local partner.(10) It would appear that OXFAM is prepared to consider debt swaps on a case by case basis and would respond favourably if its foreign partner were supportive of the deal. CAFOD, which also has moral reservations about debt conversion schemes, would consult with its local NGO partner before engaging in a debt swap.
It appears that the attitude of the local partner is an important, and at times, a determining factor before OXFAM and other NGO's harbouring moral reservations about swaps are prepared to go along with them. This speaks of a high degree of responsiveness on the part of these organizations to the wishes of their southern partners. The latter, it is understood, stand to lose most if their northern partners initiate a process which, however seemingly financially profitable, runs counter to their political interests or moral concerns.
Proponents of debt/equity swaps argue that participation by NGO'S in such deals does not imply that they legitimize the debt. Debt conversion can just as well be seen by an NGO as a simple pledge of a local currency to worthwhile projects; by the debtor government as a cancellation of debt; and by the creditor as a way to divest himself of a non-producing asset. Where a donation of debt is involvedd, the creditor will view it as a tax deductible charitable contribution.

In addressing the issue of debt legitimization, supporters of debt for development often take the legalistic position that the debt was entered into by governments of sovereign states. Until now, few if any of the them publicly favour cancellation or repudiation of the debt even if it could be demonstrated that portions of it were incurred for illegal or non-developmental purposes. If debt is tainted by corrupt practices, it is for the courts to deal with these matters. In the event, it is not for private organizations to pass on the validity of lawfully contracted obligations.(11)

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10. Interview with Steve Bridger, Deputy Campaign Officer, OXFAM, January 10, 1990. 11. Interview with John B. Ross, Executive Director, The Debt for Development Coalition, March 13, 1990.

6.5 The moral issue: a possible way out

It is possible that the concerns about debt legitimization can be allayed in specific circumstances to the satisfaction of all parties. Careful consideration would have to be given in striking a balance between principled objections to a particular debt conversion and the gains to be derived by the intended beneficiaries of the project.(12) Conditions could be worked out between the central banking authorities and participating NGO's to eliminate the need for administrative oversight for a particular project. Failing that, intermediaries could be used, or separate bank accounts set up to avoid government scrutiny of all the activities of the participating local partner. Northern NGO's might consider dealing only with countries whose oversight procedures are acceptable to their local partners.

6.6 Innovative role of NGO's

By participating in debt/equity deals or in debt donation schemes, NGO's have an opportunity to increase their influence over debtor country priorities. Conservation and environmental concerns have been heightened in many developing and developed countries by NGO participation in debt for nature swaps. Such swaps have been successfully arranged in Bolivia, Costa Rica, Ecuador, Madagascar and the Philippines. The amount of these swaps is about US$25 million which accounts a tiny fraction of the total debt of these countries. They are not to be seen, therefore, as a solution to the international debt crisis. What debt-for-nature swaps can and are doing in a not unimportant way is to focus attention on environmental problems and to make available resources that would not otherwise be available to deal with them. This is a role that is best served by international and local NGO's. International NGO's such as Conservation International and World Wildlife Fund perform multiple roles by providing the capital to purchase the debt and monitoring progress in programme implementation.

In the Madagascar operation, the World Wildlife Fund, in cooperation with the country's Central Bank, bought US$3 million of debt from four European banks at a discount of 55 percent to develop a three-year park and nature protection programme. The project became possible largely due

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12. UK Debt Crisis Network paper "Debt Development Conversions", (n.d.). 13. Betsy Cody. CRS Report for Congress. Debt-for-Nature Swaps In Developing Countries,(Congressional Research Service The Library of Congress, September 26, 1988, pp. 9-19.

to a grant of US$1 million from USAID. As the Congressional Research study showed, both international and local NGO's have important roles in realizing these debt-for-nature swaps. The local NGO is involved in initiating and implementing the project while the international body plays the role of facilitator and fund raiser. The involvement of the local NGO helps defuse the issue of foreign encroachment on national sovereignty. It also provides greater assurance that the project is likely to survive changes in administrations and policies.

6.7 Debt donation by banks

Non-governmental organizations, because of the tax-exempt status they widely enjoy, are likely to attract donations of debt. Banks are likely to donate debt when they are convinced it is unrecoverable, and particularly when small amounts are involved. By getting rid of such debt, it saves on administrative costs associated with rescheduling. A bank that donates debt also secures tax benefits. In the United States, legislation has been adopted clarifying the tax benefits banks are entitled to by donating debt to NGO's. Through the publicity surrounding debt donations to highly publicized projects, banks have gained much good will at relatively little cost. Until now, only a few banks have donated debt involving small amounts of money. Banks, as a rule, are loath to donate debt as this could have an adverse effect on the market value of other outstanding instruments of indebtedness of the same country.

7.0 Types of projects funded by NGO's through debt conversions

International NGO's promote, fund and sometimes implement projects that promote development. As in the instances noted above, environmental NGO's have resorted to debt/equity conversion schemes for specific conservation and ecological projects. A wide range of northern NGO's have leveraged their resources through debt conversion to promote social, economic and training projects in the fields of small enterprise development, cooperatives, housing and agri-businesses. Action international contre la faim (AICF), a French NGO, concluded a debt conversion programme in Madgascar in 1989 involving Medecins sans frontier (MSF) and the Comite catholique contre la faim et pour le developpment (CCFD). Under the programme, US$682,000 of debt was bought at about a 50 percent discount and, in cooperation with the Central Bank, converted at face value into Malagache francs. With local resouces doubled, the three NGO'S are expanding their field operations. MSF is increasing the scope of its vaccination project; CCFD is increasing its investment in small-scale enterprises; and AICF is promoting an integrated rural development project. Similar projects of a somewhat larger scale were under study in Chad, Sudan and Uganda. The World Council of Credit Unions (WOCCU), as previously noted, purchased US$1 million of Jamaican debt at 50 cents on the dollar and was in a position to lend 2 million in local currency to strengthen the country's cooperative credit union movement. A proposal having a similar purpose involving the use by WOCCU of $400,000 of a grant from USAID to purchase and convert twice the amount of Philippine debt had been approved in July 1989 by the Central Bank's Monetary Board. The Christian Children's Fund, (CCF) a U.S.-based NGO active in 27 developing countries, engages in debt conversion schemes on a regular basis as a way of maintaining expanded operations.(14) Debt conversion schemes are often resorted to by Catholic and Mormon groups in helping finance their development activities. The number of NGO's that at one time or other have taken part in debt conversion schemes is considerable; a complete list of the groups and the size of their operations has still not been compiled. Most of the transactions involving NGO's are handled by banks and a few brokerage houses in the United States and Western Europe.

7.1 Low participation of NGO's in debt/equity conversions

In spite of the real opportunities that debt conversion schemes offer to NGO's to leverage their resources for their development activities, not many take part in them. This is not for lack of knowledge. Information about them is available from NGO networks and in some countries, like the United States and France, from government sources. In part. the low level of participation may be attributed to the lack of expertise in financial management. Most NGO's are inexperienced in dealing in financial markets and lack the expertise to carry off debt conversion transactions. Operations of this sort require costly in-house expert staff. Most NGO'S are run on tight budgets which tends to foster a conservative attitude towards innovative approaches that initially may involve an outlay of money. Because of this, the great majority of them simply do not consider debt conversion as a viable option.

7.2 Doing a debt conversion transaction is expensive to a bank, involving as it does the services of lawyers, accountants and other senior staff. These financial institutions will, therefore, charge a substantial fee in order to cover costs and turn a profit. Normally, they will

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14. Interview with Paul McCleary, executive director, CCF, December 29, 1989.

not become invo'ved in a deal that involves less than US$0.5 million. Minimum transactions on secondary markets involve such an amount, with most falling between US$1-5 million.Most NGO's require on a regular basis far more modest sums than these. It is not to their interest to become involved in high cost brokerage operations

7.3 Pooling arrangements Through a pooling arrangement, entered into by two or more NGO's with a bank or brokerage house, it is possible for them to purchase debt equal to their combined needs. This lowers the cost to each of the participating NGO's. The Debt-for-Development Foundation, upon receiving tax-exempt status from the U.S. Government, under regulation 501 (C) (3) will arrange pooling agreements as part of its operations.

7.4 Threat of non-payment by central bank to NGO

As discussed in para 3.3, a major risk to NGO's in a debt/equity conversion is the unwillingness of the central bank to make payment of local currency. Normally, the NGO transfers funds to the broker who will purchase the debt on its behalf. The broker then arranges with the central bank to transfer the local currency equivalent into a designated local account. It is at this point that funds become available for the project. A central bank, however, may decide for various reason not to make payment.

7.5 Maintaining value of funds against inflation

Since a high rate of inflation is an almost constant characteristic of heavily indebted countries, converted funds are certain to depreciate in value before they can be spent.Ensuring that the nominal value of the currency keeps pace with the rate of inflation is a continuing problem to NGO's. Stabilization bonds whose interest rate is indexed to the cost of living offers one way of dealing with the problem. Another is through insurance that covers an NGO against value instability (as well as against a debtor government that does not honour its financial commitments). The Debt for Development Coalition has looked into the availability of such coverage for debt for development swaps and reports: "For any not-for-profit (organization) concerned with the maintenance of value and stability of its investment, political risk insurance coverage is available for debt swap transactions under certain conditions".(15)

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15. The Debt for Development Coalition, Inc. "Debt for Development, Recent Developments and Prospects for the Future", working draft, January 1990, p. 7 (mimeograph).

7.6 Impact of debt/equity conversions on agency priorities

The availability of larger than usual sums of money resulting from debt/equity conversion, normally an uncommon phenomenon, can have an adverse impact on agency priorities and operations. Large amounts of money, especially if they have to be disbursed over a short period of time, might prove a temptation to fund marginal projects. More is not necessarily better! New projects, while creating new opportunities, are not without their problems on the local NGO. Additional projects require more administrative and field staff. This can place a heavy burden on the agency which may not have the experience to coordinate and administer larger and more complex operations. While the local agency will be operating more projects, the quality of its services could be diluted.

Before new projects are undertaken, the local NGO should have a direct say in their design and implementation. Dialogue between the northern NGO and its local partner should begin before a debt conversion. This would send a strong message that the interests of the intended beneficiaries of the new projects are being taken into account. Project development, if it is to be successful, has to be based on local needs, views and knowledge. The local NGO, if it is to tailor the proposed new services to the needs of its constituents, has to have a clear idea of the amount of money it will receive, disbursement schedules and, if needed, the hard currency component. This way, it can gear up for the new projects by taking on staff at the headquarters and field levels. Local partners are more than conduits for northern NGO funds. These agencies are increasingly developing participatory relationships with their clients and have to take their views and interests into account before undertaking new activities.(16)

7.7 Government administrative oversight

An added burden is the reporting requirements placed on the local agency which is obliged to submit detailed accounts

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16. Doug Hellinger. "NGOs and the Large Aid Donors: Changing the Terms of the Engagement", World Development, Vol. 15 Supplement, 1987, pp. 138-141.

to its northern partner and to the government. This is to ensure that the additional funds are spent for the purposes that were intended. The central bank could insist upon access to the records of the implementing NGO as one of the conditions for approving the conversion. This could prove to be a serious problem in certain closed countries where antagonistic relations exist between the government and parts of the NGO community. Northern NGO's, in order not to complicate their relations with the debt government, might take projects away from local partners.(17) Such actions could rebound on the northern NGO and impair its working relationship with its local partner.

Debt conversion schemes could further complicate the administrative problems of local NGO's by indirectly subjecting them to regulations of foreign governments. This is becoming an increasingly likely prospect given the fact that in certain countries, notably the United States, official overseas development funds are being granted to NGO's for debt conversion purposes. In accepting such funds, northern NGO's should be satisfied that the interests of their local partners are taken into account. Any suggestion that these interests might be slighted in order to live up to conditions of the donor government could rebound on the northern NGO and create ill feelings in the developing country. Debt issues have become a focus for radical politics in a number of developing countries, particularly in Latin America. Unless they keep the interests of their southern partner uppermost, Northern NGO's, regardless of their motives, could be adversely affected by these sentiments.

7.8 Displacement of resources

Expanded NGO activity in a country could create a problem of fungibility. With additional NGO projects, the government could be freed from carrying out programmes to which it had already been committed. Relieved of the responsibility, the government might be tempted to spend the freed up funds on priorities different from those favoured by the local NGO. Debt conversions could have the perverse effect of letting a government off from its own responsibilities. This unintended consequence could be avoided through close consultations between the northern NGO, it local partner and the government.

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17. Ron Rote. Debt Conversions, A background paper for the FONADAD Conference on "Towards European Action on Debt",

21-22 March, 1989, The Hague.

8.0 NGO limitations to investing in industry

An NGO, because of its not-for-profit status, cannot invest or lend funds to an industrial enterprise. To do so would violate the terms under which it was established and almost certainly result in a revocation of its charter, along with its tax exempt status and other entitlements. Even if such constraints did not apply, NGO's lack the financial resources and skills to undertake investments in industrial or other forms of enterprizes. What many can do, however, is offer training and personnel services to enhance the operations of an enterprise. This could be through management courses and information for improving production, processing and marketing techniques to enhance enterprise efficiency and competitiveness. A number of NGO's offer such assistance as well as the services of senior executives to help run enterprizes or provide on-site training for local personnel. In this way, funds generated by NGO's through debt/equity swaps could be used to develop training and related programmes as a way of promoting industrial development. Agricultural Cooperative Development International, a Washington, D.C.-based NGO has wide experience in providing such forms of assistance to agribusiness and cooperatives through local currencies accrued through a U.S. food monetization project in Poland.

8.1 A more direct NGO involvement in small-scale enterprizes

Through imaginative approaches, it is possible for NGO's to play a more direct role in promoting small-scale industrial enterprizes. Such enterprizes often form the economic backbone of many small towns and villages in developing countries, and are found throughout medium and large urban centres. What is characteristic of many of these enterprizes, which usually employ anywhere from 5 to 50 workers, is that they often suffer from a lack of capital. Where this is the case, they cannot operate at full capacity for lack of skilled workers or inadequate access to domestic and foreign markets. These firms perform a useful role in the local economy because of the employment they provide to low income people. Much of their production utilizes local raw materials and their products generally involve a great deal of value-added in the form of labour and local technology. Capital invested in these firms can do much to promote employment among low-income workers, women and disabled persons. In terms of development, it can promote a more robust economy in the depressed regions of a country. Many of these firms engage in foreign export and this capacity could be enhanced through added capital.

8.2 The investment subsidiary as a vehicle for promoting NGO investment in small-scale enterprizes

By creating an investment subsidiary and helping finance its operations, an NGO can play an innovative and effective role in channeling resources to small-scale enterprizes. Such a subsidiary, which has an autonomous legal status, permits the NGO to promote investment activities that it may do by itself. An example of such an entity is the Societe d'Investissement pour le Developpement International (SIDI) which was created in 1983 by the Comite Catholic Contre la Faim (CCCF). Its sole purpose is to promote investments in small enterprizes. It purchased FF1 million (US$150,000) and which was used to capitalize an investment company (societe d'investissement). An equal amount of money was contributed to the fund by the French government.(18)

This money has been used to promote the development of small- scale enterprizes in Chile and Madagascar. In the latter, a Societe d'Investissement pour la Promotion de l'Entreprise Malgache (SIPEM) was created in 1989 and is currently studying some 20 different projects. In the previous year, FF1 million (US$150,000) was invested in the Banco del Desarollo in Chile to promote investments in small glass and toy manufacturing businesses and cooperatives in the Santiago region. The capital of the bank, which was established 20 years ago by the Catholic Church of Chile, is divided almost evenly between SIDI, the Chilien Cooperative Union and local NGO'S.

As of now, SIDI is using its own capital and that of its partners to promote investments in small enterprizes. It is, however, ready to resort to debt/equity conversions in the event this could prove useful. Debt/equity swaps have attracted little attention in France and there are only a handful of NGO's in France with sufficient resources to undertake a debt conversion arrangement.(19)

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18. Interview with Jacques LeCugy, Secretary-General, Commission cooperation-developpement, January 15, 1990.

19. Among the first 200 ranking NGO's in the world, only 2

are French.

8.3 CARESBAC: A CARED holding company to channel financial and technical assistance to small and medium-size businesses

Comparable in approach to SIDI is the not-for-profit subsidiary of CARE, the CARE Small Business Assistance Corporation (CARESBAC). Established in 1989 under a US$300,000 grant from USAID. CARESBAC has two separate but interrelated purposes. The first is to provide both technical assistance and equity capital to small and medium-size businesses (SMBs) in developing countries. Through such capital investment, these small firms can provide employment to unskilled and semi-skilled workers, and help promote economic development of developing countries. The second is to plough back CARESBAC's share of any profits generated by investments in SMB's, defined as employing from 50 to 150 workers, in CARE-managed or CARE-assisted projects in the countries where the investments were made. CARESBAC plans to establish in targeted countries local investment companies (LIC's). These LICs would identify interesting enterprizes, negotiate the terms for investment, monitor the investments and provide or arrange technical assistance to the investee. The latter would have to demonstrate an ability to sell abroad. Capital would be invested in the enterprise on condition the investee complies with the plan of action.(20)

Funding for CARESBAC investments would come from external, that is, non-CARE sources. A major source of funds is expected to be derived from debt/equity swaps and blocked local currency assets of multinational corporations (MNC's). CARESBAC, along with the creditor bank or MNC would capitalize the LIC and share in any profits derived from its investment. CARESBAC's share, less its operating expenses, would remain in the developing country to support projects in health, agriculture, environmental protection and micro-enterprise assistance or to be used for further investments in small and medium-size businesses.

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20. Interview with Thomas C. Gibson, Executive Vice-president, CARESBAC, March 13, 1990.

8.4 The NGO-owned subsidiary: prototype organization to channel resources to small and medium-size businesses

The research and development that preceded the organization of CARESBAC is completed and its organizational structure is in place. One locally incorporated LIC has already been established in Costa Rica and is conducting feasibility studies of several enterprizes manufacturing plastics, apparel and broom handles. It is still too early to say anything about the work of CARESBAC as the organization is clearly still in an embryonic state. The use by an NGO of a wholly-owned, not-for-profit subsidiary to channel resources to small and medium-size enterprizes appears to have promise. It permits an NGO to use some of its own resources, and most importantly, mobilize capital and technical assistance from the private sector and direct them to small and medium-size enterprizes that could use them in an efficient and profitable way. These firms, if they are to benefit from CARESBAC support have to operate in a business-like manner and return a profit to their investors. CARESBAC is a not- for-profit holding company which will invest its limited resources solely in for-profit companies. In important respects, the principles and purposes of CARESBAC are little different from those of the Societe d'Investissement pour le Developpement International (SIDI) that was established by its parent body, Comite Catholique Contre la Faim (CCCF).

9.0 Debt/Equity conversion for the benefit of cooperatives: The cooperative organizational network

Cooperatives constitute an important sector of the economies of most developing countries. It is in this sector where NGO potential for promoting debt conversions is greatest. In large measure this is due to the great number of cooperatives which have numerous representative unions and federations at the national and regional levels. There are, in addition, networks of support groups in both developed and developing countries which are generally known as Cooperative Development Organizations (CDO's).

According to a report prepared by the Committee for the Promotion of Assistance to Cooperatives (COPAC) in February 1987, the cooperative movements in 139 countries count 858,221 organizations with a total membership of 332,000,000 individuals. "Apex" organizations, representing the various economic sectors, notably agriculture, consumer services, credit and banking, fisheries, housing, * industrial development, insurance transport, etc. function in 66 of these countries. They serve the important function of representing the socio-economic interests of their constituent members. In 101 countries there are 2,146 national or regional cooperative federations which represent the interests of cooperators and their organizations in these various sectors.

There are, in addition, two international cooperative NGO's, the International Cooperative Alliance (ICA) and the World Council of Credit Unions (WOCCU), and their related organizations, which constitute a far-flung network reaching into 102 of the 139 developing countries. The ICA network includes (1) national cooperative organizations which are direct members, (2) national cooperative organizations affiliated through the four ICA regional offices and (3) and international cooperative organizations - including four regional organizations covering countries in South America, Central America, the Caribbean and North Africa/Near East. This ICA membership network includes cooperative organizations from 72 developing countries including 35 of the 48 countries having serious debt servicing problems.(21)

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* COPAC is a group representing cooperative interests of the UN, the International Labour Organization, the Food and Agricultural Organization and four international NGO's including ICA, WOCCU, the International Federation of Agricultural Producers and the International Federation of Plantation, Agricultural and Allied Workers.

21. Jack Shaffer. "Recycling Third World Debt for Cooperative Investment", December 13, 1988, p. 8, (mimeograph).

9.1 Financing cooperative development

Cooperatives, like any organization run along along business lines, require capital to finance the: operations. Unlike regular business enterprises, most industrial and agricultural cooperative organizations have traditionally had to raise funds from their members. While this may be adequate to help the cooperative get underway, it is often not sufficient to provide the capital needed for research and development and expansion into the costly and complex fields of food processing and industrial development. Ideally, cooperatives should mobilize capital from accumulated annual reserves. In practice, this is difficult to realize because they must deal with members at lowest possible costs rather than look for profits. New financial approaches are therefore needed to raise capital.(22)

9.2 NGO and CDO activity in support of debt conversion

There is growing recognition in the CDO community and among many NGO's that debt conversion holds out the promise for raising significant sums for capital-starved cooperatives in developing countries. The initiative and motive force for much of the action came from NGO's and CDO's in the United States. Unlike many of their European counterparts, NGO's in the United States are generally not held back by moral issues or whether debt conversion serves to "legitimize" Third World debt. Theirs has largely been a pragmatic approach inspired by the belief that through conversions, a portion of the debt could be converted into a resource for the benefit of cooperative and industrial development.

9.3 Organizing the NGO and CDO communities: The Debt for Development Coalition

The first concrete step taken by the NGO and CDO communities was to establish in mid-1988 The Debt for Development Coalition, Inc. whose offices are in Washington, D.C. Sitting on the Coalition's board are association or "umbrella groups" serving four communities: U.S. universities, cooperatives, private and voluntary organizations PVO's and international agricultural research institutes. The Coalition's main task is to educate organizations about the opportunities to use debt swaps while at the same time, it works to create such opportunities.

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22. Turto Turitianen and J.D. von Pischke, "The financing of agricultural co-operatives", Finance and Development, September 1982, p. 19.

Since its establishment, the Coalition has engaged in a range of activities to promote the concept and practice of debt/equity swaps. Specifically, the Coalition has:

a. worked with government officials in a number of Latin American and African countries with a view to sensitizing them about the the policy options and economic implications of debt conversion programmes;

b. educated the not-for-profit community about the opportunities for debt swaps. In line with this, it has organized workshops, led discussion groups and prepared a number of papers on debt conversion.

c. created (see para. 3.0) the Debt for Development Foundation to provide practical aid to to NGO's interested in undertaking debt conversion deals.

9.4 <u>USAID grant to Volunteers in Overseas Cooperative Assistance (VOCA)</u>

In early 1989, USAID provided Volunteers in Overseas Assistance (VOCA) a grant of $85,000 to carry out a project entitled "innovative Cooperative Finance" The project was designed to "...help develop financial systems for utilizing local currencies through public and private sources of financing for cooperatives in developing countries focusing on ... debt equity conversions". VOCA administered the grant on behalf of the Overseas Cooperative Development Committee (OCDC) which represents the U.S. cooperative development community. Other participating cooperative development organizations were Agricultural Cooperative Development International (ACDI), WOCCU, National Rural Electrification Cooperative Association (NRECA), Cooperative Housing Foundation (CHF) Land O'Lakes, Inc., Credit Union National Association (CUNA), National Cooperative Bank (NCB), CARE and the National Cooperative Business Association. Participation of these groups in the project reflected the growing interest of the U.S. cooperative movement in debt/equity swaps.

The three recommendations that came out of the project, and which have been since implemented, were: (a) convening a technical workshop on debt conversion; (b) production of a 'how-to' manual; and (c) despatch of prototype field project design missions to Costa Rica and Jamaica. Specifically:

a. A technical workshop was convened in Washington in December 1988 and attended by 47 people representing a broad spectrum of the cooperative and banking fields and officials of USAID;

b. A manual, entitled A Guide To Debt For Development: Making the International Debt Crisis Work for Development, was published in September 1989. The manual describes, inter alia, the nature of a debt conversion, different types pf debt conversion operations and practical steps to be taken to implementing them;

c. Each of the field missions submitted reports which presented examples of possible types of debt conversion projects. For Costa Rica, the mission suggested (1) a caffeine extraction project using a gas recirculation pyrolysis process with coffee wastes and (2) a private rural power electrification project. The Jamaican team presented as possibilities a project for (1) the capitalization of the central financing facility of the Jamaica Cooperative Credit Union League, the country's umbrella credit cooperative and (2) the establishment of a model dairy farm through a joint venture with a U.S. dairy cooperative. (23)

With the exception of the capitalization of the Jamaica Cooperative Credit Union League (see para. 5.2), the other projects wait to be implemented.

9.5 Joint ICA and WOCCU action to create the Debt for Cooperative Investment Service (DCIS)*

In response to the interest in debt conversion, ICA and WOCCU created a small unit to promote debt conversion schemes for cooperative development. The executive director of DCIS visited a number of countries in Africa and Asia to explain the nature of debt conversion to government officials and cooperators. Considerable attention was devoted to promoting debt conversion in the Philippines as a way of testing the concept. A mission was also undertaken to Poland to encourage cooperatives to take part in a debt conversion programme.

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23. See, letter from Joan K. Leavitt, Vice President, VOCA, to Harry Wing, Coordinator for Cooperative Development, October 26, 1989 and attached final report entitled Innovative Cooperative Finance.

* WOCCU and ICA have withdrawn their support for DCIS, although ICA still lends its name to the programme.

In promoting the concept and practice of debt conversion for cooperatives, the DCIS evolved three types of transactions.(24) One is the sale by a bank of all or part of its non-performing debt of a developing country and conversion of the proceeds into local currency which would be invested in or loaned to a cooperative organization. The money would be handled by an existing bank, a newly established financial intermediary created for the purpose by the creditor bank, or a cooperative institution established to handle the transaction. Another approach is for a cooperative bank or credit union to purchase a debt instrument on the secondary market and invest or lend the converted money into a cooperative. The third approach is for a bank to contribute non-performing assets to the DCIS which would be converted into local currency and be invested or lent to a cooperative enterprise.

10.0 Role of government in debt conversion programmes

The issues arising from debt conversion programmes involving NGO's are as much linked to public policy concerns as are such operations when conducted by private investors. Government policy in both developed and developing countries can serve to encourage, inhibit or discourage NGO participation in debt/equity swaps. In the United States, government policy is to support NGO activities in this field. In most other developed countries, the government policy ranges from limited support to neutrality. NGO's, according to those who espouse the latter approach, are organizations that are free to do as they wish as long as they conform to their charter obligations. In undertaking debt swaps, they do so at their own risk.

10.1 French government policy

French government policy is somewhat supportive by providing a matching grant that is nearly equal to the amount of debt purchased by the NGO. These grants are miniscule since debt conversion by NGO's are few in number and involve tiny sums of money. Support is also provided by the government through

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Jack Shaffer. op. cit.

an official consultative body, la Commission cooperation-developpement, or CO.CO.DEV.(25) The Commission, whose chairman is the Minister of Cooperation, is made up of an equal number of representatives of ministries involved in development, and delegates of NGO's. A working group has been organized within CO.CO.DEV. to study debt conversion issues. In March 1990, a round table was scheduled to be held to discuss ways of institutionalising debt conversion schemes. Representatives of concerned government ministries, banks and NGO's were invited to participate.

10.1 U.S. government policy

U.S government policy is undoubtedly the most supportive of debt/equity swaps and donations by banks of debt obligations of a developing country for development purposes. The position of the U.S. is grounded in the belief that the debt problem can only be resolved through a combination of traditional and innovative approaches. Certain of these measures could serve as a model to other governments wishing to favour debt/equity swaps by NGO's in their countries.

10.2 Specific U.S. measures

U.S.policy supporting debt/equity conversions has several components. They draw their inspiration from an overall government position that innovative approaches are needed to deal with the debt problem. This position was set forth by Secretary of Treasury Nicholas F. Brady in March 1989 in which he called for new ideas for creditor flexibility, including debt conversions. The Brady programme specifically embraces the concept of debt conversion for purposes of not-for-profit, people-to-people development purposes. The United States Congress has also given its backing to debt for development. In the appropriations bill for Foreign Assistance, the International Development and Finance Act of 1989 and the Support for Eastern Europe Democracy Act, the Congress urged greater use of this instrument.

Consistent with this policy, the following measures have been approved to encourage debt conversions by not-for-profit organizations:

1. Under a policy and guidelines issued February 15, 1989, USAID encourages debt for development transactions for a wide range of development activities undertaken by private

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25.Charles Condamines. L'Aide Humanitaire Entre La Politique Et Les Affaires, (Editions L'Harmattan, Paris, 1989), pp. 197-199.

U.S. not-for-profit organizations. The agency will finance all debt exchange transactions through intermediary organizations, such as private voluntary organizations and cooperatives. USAID will issue grants to such groups to purchase debt. Debt exchange programmes will be funded for a range of objectives, including "debt for nature" and "debt for education and health". Each activity of an NGO financed through a Debt for Development transaction must be approved by AID in accordance with standard Agency rules and procedures applicable to such organizations.

2. The U.S. Congress adopted legislation in November 1989, which establishes a policy that interest earned on USAID grants may be retained by grantees for use as programme resources and no longer be returned to the U.S. Treasury.

3. USAID has provided grants to NGO's to strengthen their capacity to participate in debt conversion programmes. The establishment of the Debt for Development Coalition was, in part, helped by a USAID grant. The Agency grant to VOCA was designed to help it and other CDO's to take part in debt conversion projects.

4. The U.S. Internal Revenue Service issued ruling 87-124 in November 1987, clarifying the tax consequences to a bank donating the debt of a developing country for development purposes. Commercial banks can claim, for tax purposes, a tax deductible charitable donation equal to the market value of a donated loan and the residual amount, if any, is considered a loan loss. Thus, if a bank holds a million dollar loan valued on the market at half that price, it is financially advantageous to sell the asset at that price and incur a half million dollar tax loss than to take a half million dollar charitable contribution and the same tax loss.

11.0 Conclusions

1.The crushing burden of debt has led to continued negative transfer of substantial resources from developing to developed countries. Under these circumstances, it is not possible for developing countries to promote sustained economic development that can benefit those most adversely affected by the recession.

2.Debt/equity conversions represent a potentially important source of capital for developing countries. Such conversions offer an opportunity to transform the debt into a resource for development. By properly regulating swaps, a developing country encourages investments in domestic industries and substitutes the foreign exchange outflow associated with contractual interest payments for the repatriation of earnings tied to equity capital.

3.Debt/equity swaps, though they can lead to substantial infusions of capital, are not without risk to the developing country. Foremost among these risks is inflation. Large amounts of local currency generated by debt/equity swaps can fuel inflation. The threat of inflation can be contained through strategies that "sanitize" injection of local currency. One way of containing inflation is to issue to NGO's or investors inflation-indexed stabilization bonds whose rate of interest is linked to the rate of inflation.

4.Debt/equity conversions is an attractive opportunity to NGO's to leverage their resources. It could permit them to maintain or expand programmes. And for certain kinds of NGO's, this multiplier effect can permit them to lend money to or invest in cooperatives, small industrial enterprizes and organizations of poor people. Through debt/equity swaps, such as "debt for nature", certain NGO's have played an innovative role in promoting development and protecting the environment.

5.In view of the relatively limited resources of NGO's, debt/equity swaps can prove highly useful to expand programmes in developing countries but can only have a negligible impact in reducing their debt.

6.Debt conversion, in the judgement of many northern and southern NGO's, should be avoided. As the advocates of the poor, who have been hardest hit by recession in developing countries, they believe that NGO's would best devote their efforts to urge banks and governments to scale down or cancel the debt. Through debt/equity swaps, they also "legitimize" the debt, much of which, it is contended, was acquired by illegal means to pursue immoral purposes.

7.In participating in debt/equity conversions, northern NGO's should be careful to take the interest of their southern partners into account. Through such consultations, it may be possible to reduce the salience of the "legitimacy" issue.

8.NGO's should seek to promote investment in small and medium-size businesses. The model used by CARESBAC in doing bears investigation by other NGO's or groups of NGO's.

9.Debt/equity conversions are a potentially important source of capital for cooperatives. Cooperative Development Organizations in the United States have accomplished much useful work in promoting the concept of debt/equity conversions where the local money proceeds would be used to capitalize industrial, food processing and other kinds of cooperatives.

10.Government should create a favourable climate for encouraging NGO's to take part in debt/equity conversions arrangements. It could do this by allowing foreign assistance funds to be used by NGO's to purchase debt of developing countries. Such debt exchange programmes should be used for a range of activities, including the promotion of small and medium-size industries.