Economic and Social Commission for Western Asia (ESCWA)

Debt Swap for Climate and SDGs Finance in the Arab Region

ESCWA Discussion Paper

Final Draft

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### Abbreviations and Acronyms

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<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>AF</td>
<td>Adaptation Fund</td>
</tr>
<tr>
<td>AfDB</td>
<td>African Development Bank</td>
</tr>
<tr>
<td>AsDB</td>
<td>Asian Development Bank</td>
</tr>
<tr>
<td>CDR</td>
<td>Caribbean Development Round Table, ECLAC</td>
</tr>
<tr>
<td>CHF</td>
<td>Swiss Franc</td>
</tr>
<tr>
<td>CIRRs</td>
<td>Commercial Interest Reference Rates, OECD</td>
</tr>
<tr>
<td>COP</td>
<td>Conference of the Parties, UNFCCC</td>
</tr>
<tr>
<td>COVID-19</td>
<td>Coronavirus disease</td>
</tr>
<tr>
<td>CRF</td>
<td>Caribbean Resilience Fund</td>
</tr>
<tr>
<td>DAC</td>
<td>Development Assistance Committee of the OECD</td>
</tr>
<tr>
<td>ECLAC</td>
<td>United Nations Economic Commission for Latin America and the Caribbean</td>
</tr>
<tr>
<td>EGP</td>
<td>Egyptian Pound</td>
</tr>
<tr>
<td>EUR</td>
<td>Euro</td>
</tr>
<tr>
<td>ESCWA</td>
<td>United Nations Economic and Social Commission for Western Asia</td>
</tr>
<tr>
<td>FRF</td>
<td>French Franc, before the implementation of EUR</td>
</tr>
<tr>
<td>GCC</td>
<td>Gulf Cooperation Council</td>
</tr>
<tr>
<td>GCF</td>
<td>Green Climate Fund</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
</tr>
<tr>
<td>GEF</td>
<td>Global Environment Facility</td>
</tr>
<tr>
<td>HIPC</td>
<td>Heavily Indebted Poor Countries</td>
</tr>
<tr>
<td>IFIs</td>
<td>International Financial Institutions</td>
</tr>
<tr>
<td>KfW</td>
<td>Kreditanstalt für Wiederaufbau, the German development bank</td>
</tr>
<tr>
<td>LDCs</td>
<td>Least Developed Countries</td>
</tr>
<tr>
<td>LDCF</td>
<td>Least Developed Countries Fund</td>
</tr>
<tr>
<td>LBP</td>
<td>Lebanese Pound</td>
</tr>
<tr>
<td>MDB</td>
<td>Multilateral Development Bank</td>
</tr>
<tr>
<td>MDGs</td>
<td>Millennium Development Goals</td>
</tr>
<tr>
<td>MDRI</td>
<td>Multilateral Debt Relief Initiative</td>
</tr>
<tr>
<td>MICs</td>
<td>Middle-income countries</td>
</tr>
<tr>
<td>NGO</td>
<td>Non-Governmental Organisation</td>
</tr>
<tr>
<td>ODA</td>
<td>Official Development Assistance</td>
</tr>
<tr>
<td>OECD</td>
<td>Organisation for Economic Cooperation and Development</td>
</tr>
<tr>
<td>PRSP</td>
<td>Poverty Reduction Strategy Paper</td>
</tr>
<tr>
<td>SDGs</td>
<td>Sustainable Development Goals</td>
</tr>
<tr>
<td>SIDS</td>
<td>Small Islands Developing States</td>
</tr>
<tr>
<td>SCCF</td>
<td>Special Climate Change Fund</td>
</tr>
<tr>
<td>UN</td>
<td>United Nations</td>
</tr>
<tr>
<td>UNEP</td>
<td>United Nations Environmental Programme</td>
</tr>
<tr>
<td>UNCTAD</td>
<td>United Nations Conference on Trade and Development</td>
</tr>
<tr>
<td>UNFCCC</td>
<td>United Nations Framework Convention on Climate Change</td>
</tr>
<tr>
<td>UNESCO</td>
<td>United Nations Educational, Scientific and Cultural Organisation</td>
</tr>
<tr>
<td>UNHCR</td>
<td>United Nations High Commissioner for Refugees</td>
</tr>
<tr>
<td>USD</td>
<td>United States Dollar ($)</td>
</tr>
<tr>
<td>WB</td>
<td>The World Bank</td>
</tr>
</tbody>
</table>
1. **INTRODUCTION**

The accumulation of debt and rising debt service obligations are very high for low- and middle-income countries in the Arab region. Increasing costs of borrowing and declining concessional loans have contributed to worsening the situation and constraining budgets for development expenditure, including for climate-related investments. Loss of growth and revenues due to the recent global economic slowdown, conflicts and crises in parts of the Arab region, weak public finance management and the adverse economic impact of the COVID-19 pandemic have contracted the fiscal space in most countries in the region at a time when demand for financing climate actions and the Sustainable Development Goals (SDGs) is high.¹

Member States across the world have called for the provision of debt relief for low- and middle-income countries to support the recovery efforts of these countries from the adverse consequences of COVID-19. The 2020 United Nations High-level Meeting on Financing for Development set out several options for consideration by Heads of State and Government, including the use of debt swaps, particularly to assist countries that are highly indebted but do not necessarily have unsustainable debt burdens.² A recent ESCWA policy brief on fiscal space has advocated for debt swaps as one of the important mechanisms to free up fiscal space for meeting essential expenditures and to mitigate the impact of the COVID-19 pandemic.³ These debt swaps have the twin objective of reducing debt burdens and improving resources for social and environmental expenditures, which can help accelerating implementation of the SDGs and Paris Agreement.

This draft paper provides an overview of debt swap concepts, methodologies and lessons learned, and discusses potential opportunities of debt swap as an effective and valuable tool for debt relief and resource mobilization to advance climate action and sustainable development in the Arab region. The following section contributes to make a case for debt swap for climate finance through examining the challenges of high and rising debt and the inadequate climate finance flows to the region. The third section discusses debt swap concepts and particularities. The fourth section discusses historical examples and lessons learned from past experiences undertaking debt swaps, including from the debt for nature swaps. The fifth section proposes a practical Debt Swap Mechanism (DSM) that can support formulating and implementing debt swaps with the objective of financing SDGs and climate action. This draft DSM will be reviewed and discussed during an expert consultative meeting to better understand the socio-economic consequences, potential challenges and their mitigation, and implementation arrangements of debt swaps from the perspective of creditors, debtors and donors. The outcomes of the expert consultation will contribute to finalising this draft.

2. **THE CASE FOR DEBT SWAP TO IMPROVE CLIMATE FINANCE AND TO REDUCE DEBT BURDEN**

2.1. **External Public Debt and Debt Vulnerabilities in the Arab Region**

The Arab region is home to high income countries of the Gulf Cooperation Council (GCC), high and low middle-income countries (MICs) and Least Developed Countries (LDCs). The

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¹ ESCWA, 2020b; ESCWA, 2019a; ESCWA, 2019b; Sarangi, 2020.
² UN, 2020.
³ UN, 2020; ESCWA, 2020a.
fiscal space for spending or absorbing a debt swap thus varies widely. The GCC countries are relatively better off in terms of their fiscal space, although they are increasingly using debt-financing as a strategy to finance their expenditure needs due to low oil revenues since 2015. Fiscal stress is high for most MICs that are suffering from high debt burdens and for the LDCs that rely heavily on aid and external debt finance. The public debt to GDP ratio was 92 percent in 2018, as an average for the five middle-income countries in the region, namely Egypt, Jordan, Lebanon, Morocco and Tunisia. Debt to GDP in Lebanon was the highest at 151 percent in 2018. Among the LDCs, the debt to GDP ratio in Sudan was the highest at 212 percent in 2018.\(^4\)

External public debt, measured by public and publicly guaranteed debt,\(^5\) of the MICs amounts to $184 billion out of total $300 billion external debt in 2018 (Figure 1A). The share of public debt in total external debt\(^6\) shows a steady decline in the past three decades since 1990. In the past ten years, the share has declined marginally from 65 percent in 2008 to 61 percent in 2018. During the same period, private non-guaranteed debt increased from $27 billion to $55 billion. In addition, the short-term external debt increased from $22 billion to $45 billion between 2008 and 2018. This recent pattern suggests higher risks associated with external debt servicing either due to exchange rate shocks or due to any negative shock to trade balance.

**Figure 1: Size and composition of external public debt, MICs**

The decomposition of external public debt of MICs shows that there has been a steady decline in the share of official creditors in the total external public debt of the MICs over the past three

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\(^4\) ESCWA, 2019b.

\(^5\) External debt, public and publicly guaranteed, refers to long-term external obligations of public debtors, including the national government, political subdivisions (or an agency of either), and autonomous public bodies, and external obligations of private debtors that are guaranteed for repayment by a public entity.

\(^6\) External debt total refers to debt owed to non-residents repayable in currency, goods, or services. Total external debt is the sum of public, publicly guaranteed, and private nonguaranteed long-term debt, use of IMF credit, and short-term debt.
decades. In the last decade, the share of official debt in total external public debt of MICs has declined from 68 percent in 2008 to 56 percent in 2018.\(^7\) During this past decade, issuance of bonds and commercial banks have increasingly become the source of external borrowing for the MICs, which is usually associated with a higher cost of borrowing than that from official creditors. Most notably, the debts raised through bonds increased from about $24 billion in 2008 to $68 billion in 2018 (Figure 1B).

While the MICs are struggling with high debt and persistent current account deficits since 2008,\(^8\) COVID-19 and its adverse consequences on the economy have increased debt risks mainly from external sources. For meeting emergency needs to address the adverse impact of COVID-19, Egypt, Jordan and Tunisia taken together have borrowed over $10 billion under IMF’s short- and medium-term lending mechanisms (Table 1).\(^9\) These loans are non-concessional by their definition, thus increasing the debt servicing burden of these MICs in the upcoming period.

**Table 1: Emergency Financing from IMF to Arab Countries (MICs) during COVID-19**

<table>
<thead>
<tr>
<th>Country</th>
<th>Type of Emergency Financing</th>
<th>Amount Approved (SDR million)</th>
<th>Amount Approved (US$ million)</th>
<th>Date of Approval</th>
</tr>
</thead>
<tbody>
<tr>
<td>Egypt</td>
<td>Rapid Financing Instrument (RFI)</td>
<td>2,037.1</td>
<td>$2,772</td>
<td>11 May 2020</td>
</tr>
<tr>
<td></td>
<td>Stand-By Arrangement (SBA)</td>
<td>3,763.64</td>
<td>$5,200.00</td>
<td>26 June 2020</td>
</tr>
<tr>
<td>Jordan</td>
<td>Rapid Financing Instrument (RFI)</td>
<td>291.55</td>
<td>$396</td>
<td>20 May 2020</td>
</tr>
<tr>
<td></td>
<td>Extended Fund Facility (EFF)</td>
<td>926.37</td>
<td>$1,300.00</td>
<td>26 March 2020</td>
</tr>
<tr>
<td>Tunisia</td>
<td>Rapid Financing Instrument (RFI)</td>
<td>545.2</td>
<td>$745</td>
<td>10 April 2020</td>
</tr>
</tbody>
</table>

*Source: IMF, 2020a.*

External public debt of the LDCs, taken together, was $23.7 billion\(^{10}\) in 2018 out of total external debt of $33 billion (Figure 2A). More than 70 percent of total external debt is public debt and official creditors account for 80 percent of sovereign debt in 2018. In 2008, official creditors accounted for 86 percent of total external public debt in the LDCs. External public debt of LDCs reported a steady increase from commercial banks and other private creditors from a 2.5 billion in 2008 to 4.6 billion in 2018 (Figure 2B).

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\(^7\) There are contrasts among the MICs. Lebanon’s external public debt was about $33 billion in 2018 out of which the official creditors accounted for only nearly $2 billion. Therefore, majority of the external debt stock belong to private creditors mainly bond holders (a little less than $31 billion), commercial banks ($135 million) and other private creditors ($29 million).

\(^8\) See Sarangi, 2020 (forthcoming).

\(^9\) IMF financial assistance for emerging and advanced market economies are: Stand-By Arrangements (SBAs) to address short-term or potential balance of payments problems; Extended Fund Facility (EFF) as medium-term support to countries facing protracted balance of payments problems because of structural weaknesses that require time to address; Rapid Financing Instrument (RFI) to provide rapid assistance to countries with urgent balance of payments need to cope with shocks. (See [https://www.imf.org/en/About/Factsheets/IMF-Lending](https://www.imf.org/en/About/Factsheets/IMF-Lending))

\(^{10}\) It may be noted that using $55 billion external public debt for Sudan, the total external public debt (PPG) of the five LDCs will be about $63.7 billion in 2018 as against $23.7 billion as per the IDS debt statistics.
Several LDCs remain at risk of debt distress according to the Joint Bank-Fund Debt Sustainability Framework for Low Income Countries (LIC-DSF). According to the assessment, Somalia is in debt distress, whereas Comoros, Djibouti and Mauritania are at moderate to high risk of debt distress (Table 2). Sudan and Yemen are also in high fiscal stress. These countries are experiencing steep output contractions at the same time that COVID-19 relief and recovery efforts are demanding a massive increase in expenditures.

Table 2: DSSI participants and their potential savings based on amounts owed to creditors

<table>
<thead>
<tr>
<th>Country</th>
<th>DSSI Participation</th>
<th>Risk of external debt distress</th>
<th>Risk of overall debt distress</th>
<th>Date of DSA Publication</th>
<th>Potential DSSI Savings (US$ million)</th>
<th>Potential DSSI Savings (% of 2019 GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Comoros</td>
<td>Yes</td>
<td>Moderate</td>
<td>Moderate</td>
<td>Apr-20</td>
<td>2.3</td>
<td>0.2%</td>
</tr>
<tr>
<td>Djibouti</td>
<td>Yes</td>
<td>High</td>
<td>High</td>
<td>May-20</td>
<td>59.2</td>
<td>1.6%</td>
</tr>
<tr>
<td>Mauritania</td>
<td>Yes</td>
<td>High</td>
<td>High</td>
<td>Apr-20</td>
<td>90.0</td>
<td>1.2%</td>
</tr>
<tr>
<td>Somalia</td>
<td>No</td>
<td>In distress</td>
<td>In distress</td>
<td>Mar-20</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>Yemen</td>
<td>Yes</td>
<td>…</td>
<td>…</td>
<td>..</td>
<td>142.7</td>
<td>0.5%</td>
</tr>
</tbody>
</table>

Note: Potential DSSI savings are estimated debt service payments owed, based on monthly projections for May-December 2020, based on end-2018 public and publicly guaranteed debt outstanding and disbursed.

In the LDCs, most of the debt is from official creditors. Comoros, Djibouti, Mauritania and Yemen have only official external debt. Mauritania obtained substantial debt relief through the HIPC Initiative, which makes it unlikely for its debt to be eligible for a debt swap. Sudan has been dragging on debts for decades, and some of it is in the hands of private creditors such as “vulture funds” that were bought between 7 and 12 percent in the 1990s. These private creditors could be interested in a debt swap. From the official creditors, Sudan may be granted maximum cancellation of its debt under the HIPC Initiative, but the country has not yet met all the requirements to qualify for HIPC debt relief. There is need to speed up the process of debt relief in these countries. Further information on private creditors and secondary market information of debt is required to better understand the possibilities of working out commercial debt swap proposals.

Most of the middle-income countries in the region (Egypt, Jordan, Lebanon, Morocco and Tunisia) have accumulated high external public debts (Table 3). The major share of debt in most of these countries is from bilateral and multilateral creditors, except for Lebanon. Their debt service burden is high, with the highest being in Lebanon where, on average during 2016 to 2018, nearly 42 percent of public revenues were spent in debt servicing. Tunisia spent nearly 20 percent of its revenues in debt servicing during the same period. Egypt, Jordan and Morocco had spent more than 10 percent of their revenues in debt servicing.

Table 3: Debt burden of countries in the Arab region (average 2016 through 2018)

<table>
<thead>
<tr>
<th>Country</th>
<th>Government gross debt/GDP (%)</th>
<th>External debt (PPG)/GDP (%)</th>
<th>Bilateral debt/External debt (PPG) (%)</th>
<th>Multilateral debt/External debt (PPG) (%)</th>
<th>Private creditors/External debt (PPG) (%)</th>
<th>External debt service (PPG)/GDP (%)</th>
<th>External debt service (PPG)/Total revenues (%)</th>
<th>External debt service (PPG)/Exports (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Egypt</td>
<td>97.5</td>
<td>27.5</td>
<td>51.9</td>
<td>27.8</td>
<td>18.1</td>
<td>2.7</td>
<td>13.1</td>
<td>16.3</td>
</tr>
<tr>
<td>Jordan</td>
<td>94.2</td>
<td>36.1</td>
<td>21.3</td>
<td>23.8</td>
<td>54.8</td>
<td>3.1</td>
<td>12.0</td>
<td>8.8</td>
</tr>
<tr>
<td>Lebanon</td>
<td>150.7</td>
<td>56.3</td>
<td>2.2</td>
<td>4.1</td>
<td>93.7</td>
<td>8.6</td>
<td>42.0</td>
<td>35.6</td>
</tr>
<tr>
<td>Morocco</td>
<td>64.7</td>
<td>28.9</td>
<td>24.2</td>
<td>46.8</td>
<td>28.9</td>
<td>2.7</td>
<td>10.4</td>
<td>7.4</td>
</tr>
<tr>
<td>Tunisia</td>
<td>67.6</td>
<td>51.0</td>
<td>18.9</td>
<td>49.5</td>
<td>31.5</td>
<td>4.7</td>
<td>19.1</td>
<td>10.6</td>
</tr>
<tr>
<td>Comoros</td>
<td>18.7</td>
<td>13.3</td>
<td>62.1</td>
<td>37.6</td>
<td>..</td>
<td>0.1</td>
<td>0.9</td>
<td>1.1</td>
</tr>
<tr>
<td>Djibouti</td>
<td>47.2</td>
<td>66.9</td>
<td>71.1</td>
<td>28.6</td>
<td>0.2</td>
<td>4.1</td>
<td>17.3</td>
<td>18.0</td>
</tr>
<tr>
<td>Mauritania</td>
<td>78.7</td>
<td>79.7</td>
<td>41.8</td>
<td>58.2</td>
<td>..</td>
<td>6.1</td>
<td>21.2</td>
<td>14.6</td>
</tr>
<tr>
<td>Sudan</td>
<td>163.0</td>
<td>17.6</td>
<td>48.8</td>
<td>22.1</td>
<td>29.1</td>
<td>0.3</td>
<td>3.7</td>
<td>3.1</td>
</tr>
<tr>
<td>Yemen</td>
<td>75.7</td>
<td>13.5</td>
<td>51.4</td>
<td>48.6</td>
<td>..</td>
<td>0.2</td>
<td>4.1</td>
<td>19.8</td>
</tr>
<tr>
<td>Algeria</td>
<td>27.8</td>
<td>1.0</td>
<td>34.9</td>
<td>62.5</td>
<td>1.8</td>
<td>0.1</td>
<td>0.3</td>
<td>0.4</td>
</tr>
</tbody>
</table>

*Source: ESCWA staff calculations, based on World Bank, 2020b.*

12 Even at a higher price, it could still be interesting for a nature-focused NGO, if, for example, the fund sells at 25 and the country reimburses 40 in local currency.

13 However, this would imply a payment for the information.
While increasing revenues mobilization remains a challenge for most countries in the region, the high share of revenues being spent on debt servicing limits fiscal expenditures for development needs, especially for climate actions. Therefore, there is an urgent need to establish debt relief mechanisms\(^\text{14}\). Debt swaps provide a unique way to reduce the debt service burden and generate fiscal space to finance efforts to advance the SDGs and climate actions, especially if the debt swap involves a large share of debt. The potential benefits are high for most of the middle-income countries that have a large share of debt from the bilateral creditors. The importance of this distinction is that bilateral debt swaps can be relatively easier to implement through consultation between the debtor and the creditor, than the implementation of commercial debt swaps, which require the involvement of market intermediaries and complex price negotiations to make a debt swap commercially viable to the debtor and the creditor. These debt swap concepts and particularities are further discussed in Chapter 3.

The mechanism of debt swap for debt owned by private creditors requires commercial negotiations. As noted in Table 3, private creditors hold a significant share of external public debt in the middle-income countries of the region, such as Egypt, Jordan, Lebanon, Morocco and Tunisia. In the case of Lebanon, private creditors hold about 94 percent of external public debt. Bilateral creditors hold about 2 percent of total external public debt. Any debt swap for Lebanon’s public debt would thus need to focus on private creditors.\(^\text{15}\) For other MICs, bilateral debt swaps could potentially bring significant debt relief.

International action to support debt relief is imperative for most Arab States, especially to build back better from the adverse impacts of COVID-19. The G20 Debt Service Suspension Initiative (DSSI) to defer bilateral debt service payments until end 2020, which was extended through mid-2021, is helpful for some LDCs, but it is not enough given that the DSSI does not cover all LDCs, nor does it cover MICs. The opportunities of getting access to concessional funding is also limited for the MICs. Indeed, the share of concessional loans to MICs has been declining over the past decade.\(^\text{16}\) The MICs hold the majority of their debt stock in the Arab region and they reserve over 10 percent of their revenues, on average, for external debt servicing.\(^\text{17}\) Most of their debt is held by official bilateral and multilateral creditors. Therefore, the implementation of debt swaps can be a good opportunity for MICs to mobilize urgent financing needs to mitigate the impact of the COVID-19, and also to finance climate actions and SDGs in the longer term. Egypt called for debt swaps for SDGs at the High-level Meeting on Financing for Development in the Era of COVID-19 and Beyond.\(^\text{18}\) Debt swaps can bring a direct resource effects, as measured by the economic value of debt relief, which is discussed in Chapter 3.

There are also some positive net indirect effects as well that can lead to higher net aggregate flows from private and public sources.\(^\text{19}\) Debt relief can provide some negotiating power in the

\(^{14}\) Debt relief corresponds to any form of debt reorganisation which relieves the overall burden of debt by altering the amount or repayment terms of outstanding debt. It includes rescheduling, refinancing, debt forgiveness, conversion and buybacks – within or outside the framework of the Paris Club.

\(^{15}\) In case of Lebanon, there is the urgency to restructure its Eurobonds, following default of coupon payments of Eurobonds due in March 2020 (See Arnold & Perry, 2020).

\(^{16}\) ESCWA, 2020b (forthcoming); Akhtar et al, 2020.

\(^{17}\) Sarangi, 2020.

\(^{18}\) UN, 2020.

\(^{19}\) See discussion in Cassimon & Vaessen, 2007.
hands of countries needing external finance in their choice of projects, as the need for ‘defensive lending’ abates.\textsuperscript{20} Evidence also suggest that aid flows may increase to the countries that have received debt relief.\textsuperscript{21} For the debtor countries working out external debt reduction mechanisms, this is imperative. From the perspective of bilateral and multilateral creditors, supporting debt reduction mechanisms through various instruments, including debt swaps for climate finance or development finance, is crucial to support financing for the SDGs and to recover better from the adverse impacts of the COVID-19.\textsuperscript{22} Even private creditors need to show solidarity and participate in the debt relief efforts. Debt swaps for climate and development finance provides a unique opportunity to show solidarity and advance actions on development cooperation.

2.2. **Inadequate Climate Finance Flows to the Arab Region**

The region faces a dual challenge in climate finance flows: the quantity and the quality (composition) of climate finance support received does not meet the region’s needs and priorities. Existing support is also unequally distributed among Arab countries.\textsuperscript{23}

Arab States defined their commitments under the Paris Agreement to implement national priority climate actions in their first Nationally Determined Contributions (NDCs) to the UNFCCC, most of which were submitted in 2015 and 2016. Eleven Arab States estimated at least some of the costs of NDC implementation, although most have not systematically costed all their NDC targets. Considering all the reports submitted to the UNFCCC (NDCs, national adaptation plans, among others), thirteen of 21 Arab States have identified some of the financial costs of climate action.\textsuperscript{24} The sum total of these estimated costs is $478 billion. While an incomplete figure, the estimated costs for NDC implementation totals $378 billion, of which $344 billion is required to implement NDC targets that are conditional on receiving international support.\textsuperscript{25} The majority of this finance is needed within the next 10 years.

In contrast, based on the most recent reporting, total public international climate finance flows to the Arab region from developed countries through bilateral and multilateral channels have remained around $4 billion, measured in constant 2017 USD (Figure 3). Thus, the quantity of flows is well below the need.

Furthermore, these flows are not well matched to the need, which is a quality problem. Specifically, from 2014 to 2018, adaptation finance (as opposed to mitigation finance) has consistently remained less than 20 percent of total flows even though the Arab region prioritizes adaptation over mitigation.\textsuperscript{26} Grants have not exceeded 9 percent of support over

\begin{flushleft}
\textsuperscript{20} In case of a country facing liquidity problem for servicing debt, new interventions are often funded to allow the country to stay current on debt service payments, rather than for selective development purposes. This is denoted as ‘defensive lending’ (Birdsall et al, 2003).
\textsuperscript{21} Burnside & Dollar, 2000.
\textsuperscript{22} Akhtar et al, 2020.
\textsuperscript{23} See ESCWA, 2019a.
\textsuperscript{24} This includes NDCs, Biennial Update Reports, National Adaptation Plans, Technology Needs Assessment, and Technology Action Plans.
\textsuperscript{25} UNFCCC, LAS, and ESCWA, forthcoming.
\textsuperscript{26} Unless otherwise noted, information on climate finance flows is calculated by ESCWA, based on OECD, 2020. Public international climate finance includes bilateral and multilateral climate finance flows to the Arab region based on reporting to the OECD. It includes bilateral flows with climate marked as a “principle” objective (Rio Tag) and “climate components” reported by multilateral development banks. Bilateral flows with climate marked as a “significant” objective (Rio Tag) are not included. GCF finance is not included.
\end{flushleft}
this period, while the share of non-concessional debt finance has increased significantly, despite the lack of fiscal space to finance climate action. There is no sign to indicate that climate finance flows to the Arab region are improving in the aftermath of the 2015 Paris Agreement.

**Figure 3: Annual Public International Climate Finance Flows to the Arab Region from Developed Countries between 2013 and 2018 by Purpose and Type**

The pattern of flows to the region also shows uneven distribution across countries. Over 92 percent of the flows from 2013 through 2018 have gone to just six Arab states: Egypt, Iraq, Jordan, Lebanon, Morocco and Tunisia, with roughly 60 percent to Egypt and Morocco alone (13.2 billion). Meanwhile, the six Arab LDCs (Comoros, Djibouti, Mauritania, Somalia, Sudan and Yemen) received just 4.3 percent ($922 million) of the climate finance support provided to the region (Figure 4). Notably, the Arab States that have received climate finance at greater scale have done so through debt instruments, particularly non-concessional debt, while Arab States that rely primarily on grants have failed to access climate finance at scale.
Figure 4: Total Public International Climate Finance Flows to Arab States (2013-2018) by Purpose and Type

Note: This chart evaluates bilateral and multilateral climate finance flows to the Arab region based on reporting to the OECD. It includes bilateral flows with climate marked as a “principle” objective (Rio Tag) and “climate components” reported by multilateral development banks. Bilateral flows with climate marked as a “significant” objective (Rio Tag) are not included.


While five dedicated multilateral climate funds serve the Paris Agreement (Green Climate Fund, Global Environment Facility, Adaptation Fund, Least Developed Countries Fund, and Special Climate Change Fund), they only account for roughly 1 to 2 percent of public international climate finance flows to the region. Most negotiations for public international climate finance is undertaken bilaterally or with multilateral development banks.
Multilateral development banks (MBDs) have become the dominant source of climate finance overall, but bilateral sources remain the most important source of grant finance, with more than half of grant finance to Arab States provided bilaterally by OECD Development Assistance Committee (DAC) member countries (Figure 5). Non-DAC bilateral flows have a very high share of grant finance (although these flows have declined in recent years). Non-MDB multilateral sources, including the Green Climate Fund and Global Environment Facility, remain important sources of grant finance. In contrast, MDBs provide almost exclusively debt, the vast majority in the form of non-concessional debt.

**Figure 5: Total Public International Climate Finance Flows to the Arab Region (2013-2018) by Source, Purpose, and Type**

**A. Flows by Type and Source (2013-2018)**

![Bar chart showing flows by type and source](chart)


![Bar chart showing flows by purpose and source](chart)

*Note: This chart evaluates bilateral and multilateral climate finance flows to the Arab region based on reporting to the OECD. It includes bilateral flows with climate marked as a “principle” objective (Rio Tag) and “climate components” reported by multilateral development banks. Bilateral flows with climate marked as a “significant” objective (Rio Tag) are not included.*

*Source: ESCWA staff calculations, based on OECD, 2020.*

In addition to public international sources, the green bond and green sukuk market is emerging rapidly in the Arab region as an alternative source of public finance, and may provide an important opportunity to mobilize resources for project finance and other needs that are suited to debt finance. However, an important gap remains in mobilizing grant finance for climate action.
Box 1: Challenges in climate finance flows

The Quantity of financial flows is insufficient

- Ten Arab States estimate $344 billion in support is needed to implement NDC targets that are conditional on public international financial support. This is likely an incomplete estimate;
- In contrast, the 22 Arab States have received approximately $4 billion in annual climate finance since 2014;
- Total flows in 2018 were only 7 percent higher than in 2014;
- On average, just two of the 22 Arab States received GCF funding for a national project in a given year. Most Arab LDCs have not yet received GCF funding for any national projects.

The Quality of financial flows is not matched with the need

- *Grant and concessional finance needs are not being met.* Loans exceed grants by roughly 10 to 1, even though many Arab states already face high debt burdens and limited fiscal space; Non-concessional debt increased from 45 percent of debt finance in 2014 to 74 percent in 2018;
- *Adaptation needs are not being met.* Adaptation is the regional priority, but mitigation finance exceeds adaptation finance by roughly 4 to 1;
- *Distribution is geographically uneven and not needs-based:* less than 5 percent of flows have gone to the region’s six LDCs. The lack of predictable flows complicates long term planning, including efforts to transition to climate resilient economies;
- *Climate action in water and agriculture is underfunded:* Despite presenting high vulnerability to the impacts of climate change in the region, the water and agriculture sectors received just 13 percent and 10 percent, respectively, of bilateral international climate finance support from 2013 to 2018; in contrast, 53 percent went to more easily bankable sectors including energy, transport, industry, finance and banking.

Sources: ESCWA, 2021, forthcoming; ESCWA, 2019a; and UNFCCC, LAS & ESCWA, forthcoming.

Quite clearly, climate finance mobilization is more difficult for the countries that are facing high fiscal stress and require greater concessionality and grant finance, such as the LDCs and middle income countries suffering from high debt burdens.\(^{27}\) For these countries, climate actions may not always be prioritized given the political economy context as other expenditure needs becomes more pressing in the near term. It is quite understandable that the NDCs of Arab countries therefore include many targets that are conditional upon external support, and without which the achievement of NDC targets and national priorities are not possible. Two critical risks that adversely impact the progress of achieving the NDC targets include:

- **Ensuring predictability of climate finance.** Given limited fiscal space, climate finance is often donor driven and *ad hoc*, complicating efforts to budget for climate expenditures. Finance flows to the region present significant year-over-year variation in commitments by country, highlighting the unpredictable nature of public international climate finance at the macroeconomic level; and

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\(^{27}\) This paragraph draws on the findings presented by Sarangi et al, 2018. Overview of Financing Sustainable Development in the Arab Region, in Saab and Sadik (eds.), 2018.
Ensuring co-finance requirements and other mobilization efforts support national priorities on climate actions. While MDBs play a catalytic role in mobilizing climate finance, most finance mobilized comes from public sources (e.g., recipient government co-financing) and goes towards mitigation actions, with a minority of co-finance coming from private sources. The sector breakdown is also highly unbalanced, with climate finance mobilized for the energy sector exceeding climate finance mobilized for the agriculture sector and for the water and sanitation sector by a factor of three and four, respectively. This is a strong indication that high co-finance requirements may risk efforts to channel finance toward climate actions that rely more heavily on grant and concessional finance, including water and agriculture.

Therefore, scaling up of concessional public international climate finance and innovative sources of finance is necessary to support Arab States to implement existing conditional NDC targets. The need for additional resources is greater if the objective is to further scale ambition of climate action by Arab States, particularly for adaptation. To do so, a significant increase in grant finance is needed in the water and agriculture sectors as well as for nature-based solutions and ecosystems.

The trend in grant finance is not encouraging. Scaling up grant finance in near term is a challenge especially when the COVID-19 has adversely affected all economies in the world, including those of the donor countries. Debt swaps provide a potentially a good option that can help debtor countries to release part of their foreign currency debt service obligations to finance strategic climate actions that help the climate and their economies recover better from the pandemic, while also providing creditor countries to use part of their debt holdings to meet their climate finance pledges as called for under the Paris Agreement. In this context, the following chapters elaborate on debt swaps and lessons learned from their application.

3. DEBT SWAP: CONCEPTS AND PARTICULARITIES

3.1. Sovereign External Debt Swaps for Domestic Liabilities

Countries might enter a debt conversion process called a “debt swap” through a market-based or collaborative arrangement between the debtor and the creditor. In this process, a “debt swap” constitutes the legal and financial transformation of a country’s external debt instrument into a different—often innovative—instrument, which is not necessarily debt. The arrangement could waive all or part of the entire stock of the outstanding debt obligations and interest claims for new obligations or conditionalities. The nature of the new obligations can be very broad: cash (buy-backs), exit bonds (debt-for-debt in foreign currency), debt for equity swaps, debt for development swaps, debt for nature swaps, debt swaps for climate adaptation and/or mitigation actions, debt swaps for sustainable development, etc.

In general, debt swaps could be a good exit strategy for the debt vulnerabilities of countries when external debt is swapped into a domestic asset or investment. Such arrangements provides the debtor country with financial resources for domestic expenditures and reduces the

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28 ESCWA, forthcoming.
29 Debt conversion is an exchange of debt – typically at a substantial discount – for equity, or counterpart domestic currency funds to be used to finance a particular project or policy. Debt for equity and debt for development swaps are all examples of debt conversion.
external debt burden, thus allowing governments to devote available resources to boost climate-
resilient investments, create more jobs, and promote inclusive and sustainable development.

The actors involved in undertaking debt swaps can be very wide, in can include the debtors
themselves, creditor governments, multilateral financial institutions, NGOs or other
intermediaries. Debt swaps often involve various intermediaries especially when the creditors
feel the risk of debt repayment and the debt is selling in the secondary market at a deep discount
rate. These types are called commercial external debt swaps in which the external creditor
agrees to a swap with the debtor country and often through a broker.

Figure 6 shows the sequential steps for a typical commercial Foreign Debt/Domestic
Investment Swap, where transactions in foreign currency are in red and domestic currency in
blue. The sequence is as follows:

1. The foreign investor puts the necessary resources with a broker for the latter to buy the
required amount of debt.
2. The broker buys from the debt owner the foreign debt at a discount. The broker keeps
a percentage of the amount of the sale as a commission.
3. The creditor passes the debt to the broker. Note that the debt is purchased at a discount
to the nominal value.
4. The broker sells the foreign debt to the debtor country, normally to the national treasury
or the central bank. This transaction is also at a discount.
5. The broker is paid in domestic currency at a discount, normally smaller than the
operation in foreign currency.
6. The broker puts the proceeds of the sale, in domestic currency, in the foreign
investor’s hands.
7. The latter invests these resources in the agreed activity in the debtor’s country economy.

Figure 6: An Example of Commercial Debt Swap

As in the example of commercial debt swap, a broker is often necessary for the commercial
swap operations for two reasons. First, a broker knows the market and can operate swiftly and
efficiently. Second, the broker can operate more discretely than an investor or a government,
thus without having a significant influence, if any, on the debtor country’s debt price in the
secondary market. In consequence, the commission paid to the broker tends to be smaller than
the cost that an inexperienced buyer might incur if approaching the market without the necessary technical experience and background.

Once the swap made, the domestic currency can be used for many purposes: domestic debt, equity, direct investment or other types of expenditures like social and human development or climate change. We bear in mind that the swap mechanism, which is a purely financial operation, is independent of the utilisation of the proceedings that will result from it.

The recording of a swap of this type is equivalent to a buyback—paid in domestic currency at a discount—of the foreign debt, i.e., the foreign debt is paid off through this mechanism. The foreign debt reduction accounted for is the nominal value of the debt bought by the broker to the owner of the debt in the secondary market. The resources used by the broker to buy back the debt may come from different sources, including bilateral or multilateral donors, either private or public. A grant can be used to buy back external debt.

Official bilateral debt-for-development-swaps are relatively easy to implement, and it can be without specialized intermediary, when the bilateral creditor and debtor government agrees to swap certain amount of external debt in exchange for commitments on investments in domestic currency by the debtor country (Figure 7). Generally, there is no need of market intermediaries in bilateral debt swaps when the debt is not trading in the market or purchased by an investor from the market. The negotiation is mainly between the debtor and creditor to use the debt conversion part into domestic investments toward achieving common socio-economic outcomes. It may contain a grant component as part of aid finance from the creditor as well. However, such a mechanism is not usual in commercial debt swap since it involves market operators. Leverage plays an important role in successful implementation of a commercial debt swap, which is discussed below.

**Figure 7: Example of a Bilateral Debt for Development Swap**

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30 The equity investment promotion arms of governments in debtor countries can use their own account or the investment agency can act as a trustee in a debt conversion programme. See Griffith-Jones, 1993. It can also be through a specific debt conversion account, opened at the Central Bank or at the Treasury (UNESCO, 2011).
3.2. Leverage of an External Debt/Domestic Investment Swap

The leverage of a commercial debt swap is a “measure” for the foreign investor to gauge the “profitability” of the swap. To understand the utility of this notion, the following numerical example is provided:

An investor wishes to invest $15 million in a country through a debt swap mechanism. Let us assume that the debt instruments of the debtor country in which the investor wishes to invest worth 60 cents per dollar in the secondary market, and that the debtor country’s Government is willing to redeem the debt at 80 percent of the face value.

Making abstraction of the costs in which the investor may incur, Table 4 shows how to organise the calculations.

The leverage, or multiplier, is calculated as the ratio of the price redeemable by the Government divided by the debt price paid by the investor in the secondary market:

Table 4: Calculating the Leverage of a Swap

<table>
<thead>
<tr>
<th>Debt price paid in the secondary market (cents per $1)</th>
<th>0.60</th>
</tr>
</thead>
<tbody>
<tr>
<td>The amount required for buying back ($ million)</td>
<td>15</td>
</tr>
<tr>
<td>Price redeemable by Gov. (cents per $1)</td>
<td>0.80</td>
</tr>
<tr>
<td>Domestic currency pay-out ($ million)</td>
<td>20</td>
</tr>
<tr>
<td>Leverage</td>
<td>1.33</td>
</tr>
</tbody>
</table>

We calculate the leverage of the swap as:

\[
Leverage = \frac{\text{Government price}}{\text{Secondary Market price}} = \frac{0.80}{0.60} = 1.33
\]

The leverage is an index to calculate the pay-out that the investor obtains in the local currency, expressed in foreign currency, USD ($) in our example, from the initial amount required for buying back the debt:

\[15 \times 1.33 = 19.95 \approx 20\]

The utility of this approach is that the investor or the debtor country can make iterative calculations to determine what redeemable price or what secondary market selling price, or what combination of both, are convenient to obtain a desired domestic currency pay-out. A review of historical swaps suggests that some investors would not be ready to undertake the swap operation with leverage levels smaller than 1.3 to 1.5.

The notion of leverage calculated in Table 4 is extremely important and useful, as it represents the cost of external debt in the secondary market and the total redeemable amount in domestic currency by the government’s debtor country. The lower the debt price in the secondary market, the higher the willingness of the creditor to sell the debt instrument at a substantial discount from the face value. For the debtor, the investor charges a higher redemption cost in
domestic currency than that the investor pays in foreign currency in the secondary market. However, it should be still economically beneficial to the debtor in the sense of providing debt relief as against the full amount of debt service that the debtor would have paid.

3.3. The Economic Benefits of Debt Swaps

Debt swaps are one kind of debt relief or debt reduction mechanism. Debt relief should free up resources in the debtor country that can be channelled to other spending or to reduce the fiscal deficit. In this respect, debt relief operations may be equivalent to a new money inflow or savings to support budget expenditures. However, this similarity would be valid to the extent that, in the absence of debt relief, the debt would have been fully repaid.

Therefore, real direct resources savings of debt relief is equal to the share of debt service transferred in the absence of debt relief. The Economic Value at date zero \((EV_0)\) is defined as:

\[
EV_0 = (1 - \delta) \sum_{t=0}^{\infty} DS_t (1 + i)^{-t}
\]

Where \(DS_t\) is the debt service (principal plus interest) falling due in date \(t\); \(i\) is the rate of interest of the particular loan we are dealing with; and \(\delta\) the percentage of debt service that cannot be honoured in each year.

Before interpreting the meaning of formula (1), which is a familiar expression in debt rescheduling analysis, we need to explain some concepts that will give this formula a slightly different meaning than the one used, for instance, by the HIPC Initiative.

In the HIPC Initiative, the rate of interest used in formula (1) was an ad hoc rate chosen in function of the debt currency agreed among the different creditors and defined by the OEDC-DAC, in line with Commercial Interest Reference Rates (CIRRs). The objective of the donors using these rates was to calculate the opportunity cost of their concessional loans in order to reach an equitable and fair debt rescheduling burden sharing among them.

There is no burden sharing among creditors in calculation of a commercial debt swap. The loans are owned by market participants and they take the risk for their decisions. Therefore, to calculate the present value of debt service in (1) we will apply the contractual interest rate of each individual loan, which means that the sum in (2) is simply the Face Value of the loan at date zero:

\[
FV_0 = \sum_{t=0}^{n} DS_t (1 + i)^{-t}
\]


There is no evidence that this point would be valid for a Paris Club member for the member countries swap programmes because the main negotiation during a Paris Club meeting is to establish a fair rescheduling burden sharing among creditors applying the CIRRs. The feedback to the debtor country’s request is based, first, on the creditor’s agreement on their burden sharing, and second on the demand that the debtor country puts forward.
Subtracting the percentage of debt service that cannot be honoured from one, we have the percentage of the debt service that can be honoured: \( \alpha = (1 - \delta) \); replacing this concept and (2) into (1), we find the Economic Value of the loan at date zero:\(^{33}\)

\[
(3) \quad EV_0 = \alpha FV_0
\]

We can interpret the Economic Value in (3) as the valuation of the loan in the secondary market at date zero considering the percentage of the loan that the debtor is unable to pay.\(^{34}\)

Therefore, even if the debtor country can obtain a 100 percent debt relief of \( EV_0 \) in (3), the additional budgetary resources that the debtor country will obtain, are smaller than the Face Value of the loan. Even more, the larger \( \delta \) in respect to \( \alpha \), the smaller the additional budgetary resources that the debtor country obtains through the debt relief operation. One example of the above paradigm was the latest steps of the HIPIC Initiative, which was a swap of debt for poverty alleviation. The swap had little additionality of resources, and despite the goodwill of creditors, poverty reduction efforts in debtor countries were not highly effective.

The Economic Value in (3) is expressed in foreign currency, and the final investment in the debtor’s economy is in domestic currency converted at a given date, let us say date zero in respect of formulae (2) and (3). In the case of a purchase of the debtor’s debt by a third party—such as foreign investor—the debt would be paid at the current market value of the debt \( \alpha FV_0 \). The creditor accepts a payment of \( \alpha FV_0 \) instead of nothing.

When the debtor pays the investor, the foreign currency amount is exchanged into domestic currency, normally at the market exchange rate of the operation date. For sake of simplicity, we assume is date zero.

Denoting \( e_{fc/dc} \) the amount that one unit of foreign currency buys in domestic currency at date zero, the Economic Value (3) in domestic currency at that date is:

\[
(4) \quad EV_{0}^{dc} = e_{fc/dc} \alpha FV_0
\]

However, the debtor country, in order to make the operation palatable for the foreign investor, adds a premium in domestic currency in percentage that we denote \( \beta \). Therefore, the amount to be paid to the foreign investor by the debtor country will be:

\[
(5) \quad EV_{0}^{*} = e_{fc/dc} \alpha FV_0 (1 + \beta)
\]

\(^{33}\) The Face Value calculated with the original interest rate is, in general, larger than the present value calculated with the CIRRs, as the rates of the former are in general larger than the letter. The Paris Club calls this “net present value,” which is a mistake. This misunderstanding comes from the fact that the Excel function that can calculate a present value of unequal amounts is the “Net Present Value” function, used for investment decisions, i.e., series with positive (income) and negative (expenditures) values. However, if all the values have the same sign the function gives a simple “Present Value” not a “Net Present value.”

\(^{34}\) We must bear in mind that the price value of a debt in the secondary market is not an exact mathematical expectation, but rather a market subjective perception of the debtor’s economic capacity to honour its debts.
Where $EV_0^*$ denotes the Economic Value plus the premium in domestic currency. Referring to the concept of the swap leverage explained in Table 4, as $\alpha$ is given by the market, the debtor must calculate a $\beta$ such that:

\[
1.3 \leq \frac{\beta}{\alpha} \leq 1.5
\]

The value of $\beta$ in equation (6) is a negotiation bargaining process between the debtor and the foreign investor.

The economic value in this example presents a direct resource effect of a commercial debt swap. As noted, a well-designed commercial debt swap has also other economic benefits to the debtor country such as fostering investment, creating jobs, boosting future growth and economic transformation. Alternately, debt swaps may not be effective due to shortness of additional resources, unwelcome conditionalities, high opportunity costs that imply the possibility of additional grants forgone and/or adverse impact on debtor’s ratings resulting in net indirect financial effects in present value.\(^{36}\) These are discussed in more detail in chapter 6 of the paper.

Applying equation (5) to an official bilateral debt swap, the economic benefits of the debtor stem from the fact that the debtor pays the amount in domestic currency to itself towards the new obligation agreed under the terms of the swap, such as poverty alleviation or climate action. The value of $\alpha$ is 100 percent of debt service since the debtor is committed to payback external debt if there is no debt swap. Therefore, debt swap for climate and SDGs finance allows governments to improve financing climate-resilient investments, while reducing their external debt burden. It can be particularly helpful to countries that are suffering from fiscal stress due to high indebtedness, such as in the Arab region.

4. **DEBT SWAP FOR CLIMATE AND DEVELOPMENT FINANCE: HISTORICAL EXAMPLES**

Debt swaps have a relative long history. The first debt swap was a consequence of the 1980s debt crisis and introduced by Argentina in 1984, with the aim of swapping external debt for equity in the domestic economy. The idea was to reduce external debt by increasing investment in domestic capital.\(^{37}\) Argentina was followed by Chile in 1985, the Philippines and Mexico in 1986,\(^{38}\) Ecuador and Venezuela in 1987. In the late 1980s and early 1990s, debt for nature

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35 The boundaries in inequality (6) are indicative, the upper or lower bounds could be negotiable as well.

36 For the complete presentation of this point see Cassimon & Vaessen, (2007). They propose a measure of the relative economic benefit of debt relief, which is equal to the Economic Value of the debt relief, minus the opportunity cost of debt relief—which includes, among other, development aid foregone—and the net indirect financial effects of debt relief in present value, e.g., the financial effects of the improvement of the debtor’s rating in present value. These two last concepts are important for the theoretical analysis of debt relief, but of difficult measurement in a practical and concrete case. Therefore, in this paper we limit the analysis to the Economic Value of debt relief.

37 Some of the examples of this Section are drawn from Cosío, 2005.

38 In respect to Mexico, see Buchheit, Chabert, de Long, & Zettelmeyer (2019), Box 4 Case Study: Mexico 1987. In 1987, Mexico secured the consent of its Bank Advisory Committee to include in the country’s debt restructuring agreements a seemingly innocuous clause permitting qualified debt-for-debt exchanges. As drafted, this clause permitted the debtor to exchange any bank’s interest in the restructured loan for a new debt instrument, if the average weighted life of the new instrument was greater than the average weighted life of the debt it was replacing. Importantly, the clause was explicit in severing the sharing clause and negative pledge clause links between the new instrument and the old restructuring agreement.
swaps (DfN) were undertaken by Costa Rica and Bolivia.³⁹ In the early 1990s, debt for development swaps were implemented in some African countries like Tanzania. The participants to these swaps have included a large range of investors, from private investors to international organisations such as UNICEF and WWF, to governments including Belgium, Canada, France, Germany, Switzerland and the United States of America. The amount of official debt converted under these programs can be roughly estimated at $2.0 to 2.5 billion.

The official creditors (bilateral and multilateral creditors) can voluntarily engage in debt swaps, including of debt for nature, debt for aid or other local currency debt swaps, backed by the Paris Club agreement.⁴⁰ There are no restrictions regarding debt swaps on ODA claims.⁴¹ However, the adoption of the Paris Club debt conversion clause in 1991 imposes some constraints on the implementation of debt swaps.⁴² Some bilateral creditors have their own specific guidelines for debt swaps as well. Germany, for instance, has more stringent rules for debt swaps than the general Paris Club guidelines. In case of debt of the middle-income countries from Germany, the only debts eligible for debt swaps are those that have already been restructured with a degree of concessional within the Paris Club framework. In those cases, debt swaps are often not an attractive solution for middle-income countries with high debt burdens, as these countries tend to prefer new rescheduling within the Paris Club framework.

In the Arab region, there are several examples of bilateral debt swap, mainly the Paris Club debt swap, that are largely debt for development swap. These are broader in scope than a dedicated DfN swaps, but they earmark a portion of proceeds for environmental objectives. There is no specific example of a DfN swap in the Arab region. Many DfN swaps would qualify as debt for climate finance swaps. Given this context, we discuss some examples of the Paris Club debt swaps in the region and also some examples of DfN swaps from other regions of the world as useful references below.

4.1 Bilateral Debt-for-Development Swaps: Selected Examples from Egypt

As mentioned earlier in this paper, bilateral debt swaps are relatively simple mechanisms that involve agreement between debtor and creditor governments to swap a certain amount of external debt in exchange for commitments on investments toward achieving development goals by the debtor countries in domestic currency. These often do not require the involvement of any broker or other intermediaries. It is like a part of the foreign currency debt or debt service is written off by the external creditor in exchange for the debtor country to invest an equivalent (or agreed upon) domestic currency for purposes of social or economic or environmental development. Such arrangements may contain a grant component as part of aid finance from the creditor. Egypt has benefitted from several bilateral debt swaps, including from creditors such as Germany, Italy, Switzerland and France.⁴³ These are discussed below.

Egypt and Germany

³⁹ For a detailed survey on debt for nature swaps, see: https://www.undp.org/content/dam/sdfinance/doc/Debt%20for%20Nature%20Swaps%20%20UNDP.pdf.
⁴¹ Debt swaps amount for non-ODA claims are capped at a certain percentage of each individual Paris Club creditor’s stock for claims. Certain countries, like Germany, that only consider ODA loans eligible for swaps. See Berensmann, 2007.
⁴³ Early this year Egypt announced that the government is bringing in the British company Actis to help to attract investment. See Emerging Market Sovereign NEWS Number 4, 2020, p.21.
On 15 November 2001, Egypt signed an agreement with Germany to exchange an amount of EUR 204.5 million, which represents part of the debt service charges owed to Germany for the period 1 January 2002 to 1 January 2016. The agreement consisted on allocating 50 percent of the amount to finance projects on the areas of poverty reduction through financing public works programme, improving water and sanitation infrastructure in low-income areas, improving basic education, and environmental protection and the other 50 percent to support of the state budget. The operation covered eight stages from the beginning to the end of the dates, allowing for verification that Egypt was fulfilling its obligations before each stage of the swap was executed.

Egypt and Italy
Two agreements were signed between Egypt and Italy swapping part of the premiums and interest owed to Italy. The first debt swap agreement was signed on 19 February 2001 whereby $149.09 million were swapped. The second debt swap agreement was signed on 3 June 2007 whereby $100 million were swapped for financing development projects. The third debt swap agreement was signed on 10 May 2012, whereby $100 million were exchanged.

According to the swap agreements, a special account for each instalment was to be opened at the due date to be used for projects approved by a committee in accordance with the following priorities: environmental, health, food security, rural development, poverty reduction and support to NGOs abroad and in Egypt. Under the first tranche, 54 projects were funded in more than 23 governorates. In the second swap being implemented, it was agreed to finance 26 projects in the amount of EGP 494,427 million.

Egypt and Switzerland
On 25 May 1995, an agreement was signed between Egypt and Switzerland to swap debts amounting to CHF 150 million, which represented part of the debt burden owed by Egypt to Switzerland. 40 percent was allocated to budget support, and 60 percent to the establishment of the Egyptian Swiss Fund for Development, which is in charge of financing development projects that could create jobs and increase of income, and improve the environmental and social situation through public health, especially maternity and childhood. The projects were selected and monitored by the Fund and implemented by NGOs through deposits in commercial banks.

The original amount allocated to the Egyptian Swiss Fund for Development totalled EGP 265 million. The amount was deposited with the Commercial International Bank (CIB) with interest and capital accrued to EGP 668,105 million. Until the Fund closed on 30 April 2010, the remaining balance was applied to support projects successfully implemented through NGOs by ensuring their sustainability in the areas of water, sanitation and microcredit.

Egypt and France
On 30 March 1994, an agreement was signed between Egypt and France to swap debts amounting to 58 million FRF 58 million, which was part of the debt owed to France by Egypt for the period 1 April 1994 to 1 January 1998. This period covered the time during which Egypt was exempted from paying instalments, provided that the Social Fund for Development of Egypt received the equivalent of the payments due in EGP. The resources were used to implement development projects in Egypt, including qualification for job opportunities and revival of heritage handicrafts. Concerning debt-for-investment, the French company Inoivo
expressed its interest to invest in Egypt and bought EUR 1.250 million of the Egyptian debt owed to France.\footnote{Early this year Egypt announced that the government is bringing in the British company Actis to help to attract investment. See Emerging Market Sovereign NEWS Number 4, 2020, p.21.}

These bilateral debt swaps of Egypt with Paris Club creditors show the amount of debt that is exchanged over a multi-year period and channelled to finance many development projects aimed at achieving development outcomes, including poverty reduction and environmental protection. Given the nature of information available, it is not conclusive to quantify the effectiveness of the debt swaps of Egypt. However, it may be noted that these are relatively small transactions as compared to Egypt’s external debt burden. However, the multiple debt swaps of Egypt with the Paris Club creditors show the potential of debt swaps as an instrument to be considered for larger projects and interventions to support climate and sustainable development finance that can in parallel reduce debt in middle-income countries of the region. The advantage of these swaps is their simple implementation mechanisms as compared to complex procedures and high transaction costs that are incurred in commercial debt swaps.

### 4.2 Debt for Nature (DfN) Swaps

Debt for nature (DfN) swaps were first implemented in the 1980s. The typical DfN swap in the 1980s and 1990s involved several intermediaries, such as an international donor who provided funds to buy the external debt at a discount, an international NGO who bought debt and negotiated with the debtor countries to sell the debt in domestic currency for commitments on in support of the environment, a local NGO that executed investment decisions, in addition to agreements between debtors, creditors and an international NGO. Bilateral DfN swaps often involved an international NGO working on nature conservation. Although the implementation of DfN swaps are complex, these swaps have a clear objective that is linked to conservation actions. There was a high volume of transactions under the DfN in the 1990s, which subsequently declined, although the potential application of debt for climate initiatives have led to renewed interest on such swaps after 2010.\footnote{UNDP, 2017.} Canada, France, Germany, the United States, among other bilateral creditors, have formal DfN initiatives and eligibility criteria in place.

According to a UNDP report, $1.2 billion in proceeds from DfN swaps went towards nature conservation between 1985 and 2015, mostly in the 1990s.\footnote{UNDP, 2017.} Poland generated over 500 million in proceeds, which represented roughly half of all DfN proceeds globally due to its successful application of DfN during its negotiations with the Paris Club in 1990.\footnote{OECD, 2007.} The United States has generated over $500 million in DfN proceeds accounting for more one third (36%) of proceeds for conservation;\footnote{It is not clear whether this refers to the value of swap proceeds or to the face value of retired debt. Source: UNDP, 2017.} the next largest are Switzerland (16%) and Germany (13%). DfN swap proceeds are often managed by conservation trust funds, which can help to ensure the long run commitment of the debtor country to the agreed objectives while also helping to mobilize additional finance for the conservation action. Two recent examples of DfN swaps are presenteded below, namely the bilateral DfN swap between Ecuador and Italy implemented through a UNDP-administered trust fund and the multi-party DfN swap between South Africa,
the Seychelles and The Nature Conservancy with a trust fund promoting public-private partnership.

**Ecuador – Italy 2012 Debt Swap for Rainforest Conservation**

The Government of Ecuador agreed to a debt swap for nature with the Government of Italy in 2012, whereby Italy forgave EURO 35 million of sovereign debt in exchange for a commitment by Ecuador to contribute this amount in dollars to a UNDP-administered trust fund for the conservation of Yasuni National Park in the Ecuadorian Amazon. The trust fund was proposed by the Government of Ecuador in exchange for a commitment not to allow oil extraction in three oil blocks in the Park, provided it could raise 50 percent of the foregone value of bringing the blocks into production. The initiative to leave the oil in the ground received a high degree of support globally, including support from OPEC. The Italian debt swap was one of multiple contributions to the trust fund.

The conditionalities associated with the swap highlights the clear objective of the swap, agreed upon by the debtor and creditors at the time of signing, although the approach was ultimately abandoned by Ecuador in 2013 when it failed to reach its target of mobilizing 50 percent of the foregone value of bringing the blocks into oil production. Contributions were refunded by UNDP as the administrator of the trust fund, including roughly $3.9 million in Italian contributions that had been made to that date through the debt swap. As designed, the benefits of the swap were principally in its ability to align the financial incentives of debtor countries with conservation objectives while reducing the fungibility of the additional resources. Compared to grants, these benefits likely included the ability of the swap to serve as a commitment mechanism by the Government of Ecuador, aligning financial incentives well with conservation commitments, and with a relatively easy financial recourse for the donor in case these conservation commitments were not met. This likely minimized the need for complex monitoring, evaluation, and results verification by the donor, which may have been otherwise viewed to increase the complexity from the perspective of the donor.

**South Africa – Seychelles – TNC Swap**

The Nature Conservancy (TNC) describes this multi-party swap, through which Seychelles swapped $29.6 million in sovereign debt to South Africa for $27.3 million in debt to a national public private partnership established as part of the swap design. The restructured debt extended the repayment term from 8 to 20 years, reducing annual payments by $2 million dollars, while extending the financial incentive for the Seychelles to fulfil conservation commitments. Furthermore, while a portion of the repayment is to be used to repay the $23 million in impact capital loans, another portion will be paid to a trust fund established to manage a new marine protected area, generating at total of $13 million, 70 percent of which is payable in local currency, to “fund nature based solutions for climate change.” TNC highlights that this innovative approach will help crowd-in private impact investment in the

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49 The current Executive Director of the Green Climate Fund, Mr. Yannick Glemarec, was the executive coordinator of the UNDP Multi-Partner Trust Fund Office at this time. Source: UNDP, Multi-Partner Trust Fund Office, No Date.
50 Government of Ecuador, Ministry of Foreign Affairs and Human Mobility, No Date. Press Release No. 1079.
51 Larrea, 2009.
52 UNDP MPTFO, 2014.
53 The information on this swap is based on: The Nature Conservancy Africa, 2016.
future to finance climate adaptation, specifically nature-based solutions, which are often not perceived as bankable.

This approach was agreeable to TNC even though the discount provided by South Africa was minimal. Rather than leverage, TNC’s focus in this swap was on the speed with which it can recover resources to deploy elsewhere.\textsuperscript{55} Thus, the efficiency of the swap can perhaps be interpreted in terms of speed of impact and scale of private capital mobilized to fund nature based solutions, rather than the underlying financial leverage of the swap.

Both the examples of DfN swaps indicate that they have been useful in generating additional resources for climate adaptation or mitigation actions, and in some cases they have also led to mobilizing private finance to fund needs that are not (or not easily) bankable, including nature-based solutions and other adaption and mitigation efforts. Establishing a trust fund was a central component in both the examples, while the implementation mechanisms and stakeholder engagements varied depending on the complexity of the debt swap.

While these DfN swaps aimed to raise resources for the environment, and effectively unlock project finance through some degree of financial engineering to align incentives and correct what may otherwise be market failures or inefficiencies, the amount of debt for nature swaps has historically been much too small for any significant debt reduction. An example of a large debt for environment swap, involving the conversion of bilateral debt of over half a billion USD, was undertaken by Poland. The Polish EcoFund was established to manage the proceeds of the swap and went on to be an award-winning organization for the quality of its expenditure management practice and which, as a result, allowed Poland to raise additional grants from several donors and leveraged resources from public and private sources, in addition to the swap proceeds. The fund also helped to build national capacity in project preparation.\textsuperscript{56}

Therefore, if debt swaps are implemented at scale by establishing facilities that rely on quality expenditure management practices, the swaps could mobilize larger volumes of finance that make them effective not only to support the climate or SDGs, but also to have a more significant impact on debt reduction. The recent proposals to use debt swap for climate finance by establishing a regional facility, as proposed by ECLAC, falls under the category of large swaps that can have a significant impact on debt reduction while in parallel mobilising resources for climate action. This scale of action is discussed in more detail in the next section.

### 4.3 A Critical Assessment of Debt Swaps

The debt swap operations in the 1980s and 1990s under the Paris Club bilateral debt swaps as well as debt swaps using discounted debt bought at the secondary market, either by the debtor countries themselves or by third parties, were not efficient enough to significantly reduce debt in the debtor countries. The transactions involved in debt swaps were small, and were mainly for specific micro-development projects, as compared to the total country’s debt.\textsuperscript{57} When the economic value (EV) of debt swap is small, the indirect effects are also small because a smaller amount of debt relief is often not adequate to change the economic behavior of the debtor or creditor governments. Additionally, most of these debt swaps are at high transaction costs

\textsuperscript{55} The Nature Conservancy Africa, 2016.
\textsuperscript{56} OECD, 2007.
\textsuperscript{57} See Cassimon & Vaesen, 2007.
because of their complex legal nature and the number of intermediaries involved in it. A meaningful debt swap should therefore be large enough to make a difference, yet simple enough to eliminate transaction costs.

A naïve view is that a swap is a transaction that simultaneously cancels external debt and generates capital inflow. This is a misleading picture on both sides: the external liability has not been cancelled through a debt swap; rather, it has been exchanged against a different liability. Moreover, as the new liability is in domestic currency, there is no capital inflow: any investment by the foreign agent making the swap is in effect being financed by the country’s domestic savings, and not by external supplied resources. However, if the purchase of the external liability is made at a discount, there is a reduction in the external debt stock of the debt, on the one hand, and on the other hand, there could be an additionality for national budget expenditures.58

From the point of view of balance of payments, a debt-equity swap is also misleading because the current account takes the interest payments abroad exactly as the profit remittances abroad. Nevertheless, it is possible, although not certain, that if the present value of the profit remittances flow from the direct investment financed by a debt-equity swap, it would be less than the interest payments on the original debt. Accordingly, if the profit remittances are deferred in respect to interest payments on the original loan, the country may find its short- or medium-term foreign liquidity improved. However, there should be no general presumption that debt-equity swaps, simply by transforming the nature of the liability, would reduce the debtor country’s net liabilities to the rest of the world.59 It appears that the argument that debt-equity swaps lead to short- or medium-term liquidity gains may be more defensible, but two problems may offset such liquidity gains, namely round-tripping and lack of additionality.

Round-tripping occurs when an investor that engages in a debt-equity swap finds a way to disinvest out of the debtor country an equivalent amount of money in foreign currency. In that case the debt swap becomes a cash buy-back financed by the debtor, probably in less favourable terms than a straightforward buy-back transaction. Lack of additionality is when a debt-equity swap finances an investment that would have been made in any case by the foreign investor. Again, the swap becomes a cash buy-back financed by the debtor.60

Additionality happens when a swap has the immediate effect of increasing liquidity domestically, i.e., when additional resources can alleviate the public sector short-term monetary and fiscal pressures. This may have undesired inflationary effects increasing the domestic money demand. This effect occurs when the new liquidity has not been properly budgeted, and the swap increases public expenditures in an undesired and unforeseen amount. To avoid this, the resources stemming from the swap proceedings must be planned and included in the budget as resources for future spending within the budget’s agreed limits. There is also important, that the national authorities do not “pay” in a single down payment the swap

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58 See Sub-section 2.3 above, that in addition to this draw back, points out to the possibility of cancellation of new money, grants or loans, due to the country risk that the debt rescheduling operations represent.
59 However, the swaps can generate employment and increase the exports potential of a country. For instance, in Mexico, cars manufacturers like VW, Nissan, Ford, and GM invested in the country through swaps, generating employment and exports potential.
proceeds to the investor, but in tranches as the project makes progress. This policy will limit
the possibility of round-tripping.

It has been argued—very often in a way showing more passion and dogmatism than scientific
analysis—the “evilness” of swaps regarding their inflationary consequences. The proceeds of a
swap are not different in this regard to the proceeds of a foreign loan converted into domestic
currency or the proceeds stemming from the sale of a donation in kind in domestic currency.
All these kinds of external resources—once converted into domestic currency—must be properly
budgeted for spending in the corresponding fiscal year budget, respecting the budget-
established ceilings. If the budgeting of these proceeds is not properly done, then the spending
of the swap proceeds will be as inflationary as any other extra-budgetary expenditure.

However, poorly managed debt swaps might accelerate inflation. If the central bank of a
country increases the money supply to pay the debt in local currency without the swap
resources properly budgeted, there can be an upward pressure on the inflation rate depending
on the size of the debt involved as well as the redemption price. Issuing central bank bonds or
treasury bonds instead of cash can remove the immediate risk of inflation. A study by the
Government of Costa Rica revealed that an annual volume of $50 million converted into local
bonds would increase inflation only by 0.5 percent.61

Another undesired effect that a swap could bear is of strategically political order, which occurs
when the swap proceedings are used to buy shares or to invest in strategically economic sectors
that eventually could weaken the sovereignty of the debtor country. In order to avoid this, the
recipient country must carefully issue rules and regulations on the utilisation of the swap
proceedings that will avoid this situation.

If the goal of the swap is not a commercial activity, for instance if it is intended for human and
social development, nature, environment, climate change, etc., then the leverage to raise the
resources needed for purchasing the debt in the secondary market will depend very much on
the credibility of the operation. It must be borne in mind that the absorption capacity in social
and human development over one fiscal year may be relatively little. Thus, a well-planned
activity on human and social development should stretch over several fiscal years in order to
be credible. For this reason, in most of the cases of swaps for human and social development,
nature, environment, climate change, etc., the beneficiary government guarantees the value of
the exchange rate at the date when the swap was made.

There are also certain limitations of DfN swaps based on past experience, which arise for
various reasons, including their limited effectiveness in improving development outcomes,62
sensitivities associated with influence of environmental interest groups on the selection of
projects and partners, and enforcement challenges.63 For instance, in case of the swap
agreement between Bolivia and Conservation International in the 1980s, citizens in Bolivia
perceived that the government had relinquished its sovereignty to the international
environmental group, which created controversy around this agreement.64 Selection of
environmental protection projects that are sensitive to certain population groups or lack clear

63 Occhiolini, 1990.
64 Occhiolini, 1990.
enforcement mechanisms are other challenges that adversely affect the achievement of the objective outlined in the swap.

### 4.4 Recent Proposals on Debt Swap for Climate and Development Finance

Recently, debt swaps have widened the domestic field of application, such as debt swap to finance refugee camps, education, microfinance, climate action, and considerations for using debt swap for the SDGs, as discussed by the member States during the United Nations High Level Meeting on Financing for Development in 2020.\(^{65}\) Given the rising external debt burden in many developing countries, and their liquidity constraints of external finance, debt swaps are emerging as an important instrument to finance development activities. The United Nations High Commissioner for Refugees (UNHCR) created debt-for-humanitarian activities in several countries around the world.\(^{66}\) The International Labour Organisation (ILO) previously proposed debt-for-jobs swaps through increasing microfinance and microcredit activities in developing countries.\(^{67}\)

Two recent examples are a debt swap for education proposed by UNESCO, and a debt swap for climate finance proposed by ECLAC. These two initiatives have different operational mechanisms while they mainly target official debt for the swap, and link these swaps to clear development objectives associated with accelerating action on the SDGs and climate.\(^{68}\) We discuss these two proposals in brief below given their relevance for the proposed debt swap mechanisms being put forth by ESCWA.

**Debt swap for education, UNESCO’s call for creation of a Debt Conversion Account (DCA) at national level**

UNESCO launched an interesting initiative to pursue a debt swap for education, which proposes identifying new source of domestic finance for the swap. The proposal suggests that domestic savings of developing countries themselves are potentially the most substantial and sustainable sources of additional funding for development. This includes, for instance, assets held by pension funds and insurance companies that need to be invested on a long-term basis. There are more than $3 trillion in assets held by such institutional investors in developing countries, and those assets are growing rapidly.\(^{69}\) Therefore, domestic savings can be mobilised for social and economic development needs by issuing long-term bonds, as most developing countries are already doing, within limits determined by their capacity to repay the debt.

The proposal is to structure these bonds in the following way: one or more bilateral creditors agree to forgive specific debts in exchange for a commitment from the debtor country’s government to periodically deposit in a special account the debt service payment saved from not having to make principal and interest payments on the external debt to the creditor.\(^{70}\) The special account would be held at the debtor’s central bank or treasury as a fund that UNESCO calls a Debt Conversion Account (DCA). The payments into the DCA are in local currency,

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\(^{65}\) UN, 2020.

\(^{66}\) The HCR swaps were used to finance expenditures for camps of refugees in different parts of the world.

\(^{67}\) See Cassimon & Vaessen, 2006, *op. cit.*

\(^{68}\) The ECLAC proposal also considers a debt buy-back scheme and debt for equity swaps for countries with high debt from private creditors.


\(^{70}\) However, we have seen in Sub-chapter 2.3, that if the Market Value of the loan is relatively low, the budget additionality is small.
that apply the exchange rate at the date of the conversion agreement with each creditor. The proposal argues that such borrowing would not add to the fiscal burden of debtor governments, since the funds for the future debt service would come from not having to make future payments on the converted external debt.\textsuperscript{71}

\textit{Debt swap for climate finance, ECLAC’s call for creation of a Caribbean Resilience Fund (CRF) at regional level}

ECLAC’s proposal for the Caribbean islands stems from the recognition that while Caribbean countries are among the most highly indebted countries in the world, the high accumulation of debt is not driven by policy missteps, but rather is closely linked to increased expenditures to address the impact of extreme events and climate change, compounded by the inherent structural weaknesses and vulnerabilities confronting Caribbean SIDS that have limited capacity to respond. ECLAC thus concludes that “Any remedy for this low growth-high debt dilemma facing the Caribbean has to be not only development-centered but also triadic, in that it must simultaneously address high debt, build economic resilience and finance climate adaptation.”\textsuperscript{72}

Given this background, ECLAC’s debt for climate adaptation swap proposal calls for donors to use pledged resources from the Green Climate Fund (GCF) to finance a gradual write-down of 100 percent of the multilateral debt stock of Caribbean SIDS that are held by various multilateral institutions, as well as the bilateral debt stock of member States.\textsuperscript{73} The initiative also seeks to establish a Caribbean Resilience Fund (CRF) to which the debtors should agree to make annual payment of an amount equal to the discounted debt service payments. ECLAC has highlighted that this CRF is needed to fund broad-based and systemic investments in climate resilience projects and thus should be capitalized from all possible sources, including swaps and contributions from donors and development partners.

\textit{Take away points from the two proposals}

Both UNESCO and ECLAC proposals have mainly targeted official debt to swap for three reasons: (a) commercial debt swaps have historically been too small for any significant impact on debt reduction and development outcomes and their implementation requires complex procedures and intermediaries; (b) debtor countries may not accept commercial debt swap for potential adverse signals of credit worthiness of financial market; and (c) in non-HIPC low- and middle-income countries, mainly bilateral debt is available for debt swaps and is relatively easy to operationalize. In addition, bilateral debt swaps serve a common objective for the debtor and the creditor that both aim at accelerating the achievement of the SDGs and climate action.

The UNESCO debt swap proposal relies on the mobilization of funds for debt conversion through issuing domestic long-term bonds. The positive aspect of this mechanism is that the resources for the swap stay out of public budgets, and by channelling domestic savings to investments on education within the country, it helps reducing capital flight from the country. It also provides opportunity for significant debt relief from external debt service if the amount of the bonds issued meet the expected debt conversion as per the swap agreement. However, the mechanism of raising resources has potential risk of inadequacy of meeting resources

\textsuperscript{71} See UNESCO, 2011, \textit{op. cit.}, p. 4-5.
\textsuperscript{72} McLean et al, 2020.
\textsuperscript{73} ECLAC, 2016.
equivalent to debt conversion (in case of undersubscribe of the bonds). It also has the potential risk of impacting the domestic debt burden in case of increased cost of debt service in the future (linked to exchange rate appreciation). These factors complicate the calculation of the present value of the bonds issue and the future debt service obligations.

The ECLAC debt swap mechanism calls for donors’ contributions to purchase the Caribbean debt at a discount from bilateral and multilateral creditors. It also emphasises on the establishment of a CRF to support climate-resilient investments in the Caribbean, which will be capitalized through contributions from donors and discounted debt repayments from debtor countries in local currency.\(^74\) This mechanism relies heavily on significant haircuts by the creditors and contributions from donors for effectiveness of the swap. Another complexity of the mechanism could be managing multiple currencies when the debtor countries pay swap payments in local currency to the regional fund, CRF. The mechanism does not suit well when the debtor countries have diverse currencies and follow different exchange rate regimes.

While these swaps provide important lessons, the effectiveness of any debt swap mechanism needs to consider diverse macroeconomic contexts of countries including the composition of debt and creditors’ profiles, opportunities for climate-resilient investments as per their national development plans, and governance arrangements structuring the implementation of the debt swap. Taking these issues into consideration, ESCWA presents a proposal for a debt swap mechanism to support Arab States that is presented for discussion in the following chapter.

5. **Debt Swap Mechanism for Climate and SDGs Finance in the Arab Region**

ESCWA is launching a Climate/SDGs Debt Swap Mechanism (DSM) initiative that is relatively simple to operate, practical to operationalize, and offers high potential for reducing debt burdens and improving resources for climate and SDG finance.\(^75\) The DSM presents an opportunity to creditors and donors to support the efforts of developing countries in the Arab region to accelerate action towards achieving SDG and Paris Agreement commitments, and to advance North-South and triangular cooperation. The main components of establishing and operationalising the DSM are proposed below.

5.1 **Design of Climate/SDGs Debt Swap Mechanism (DSM)**

The mechanism will be operationalized through coordination and implementation by the United Nations Economic and Social Commission for Western Asia (ESCWA), as follows:

(a) ESCWA holds dialogues with member States facing significant debt serving payments to identify a portfolio of climate-resilient investment projects that are aligned with national plans and are of potential interest to sovereign creditors. The projects identified would have clear deliverables and measurable results detailed in a long-term results-based programme framework that can accelerate progress toward the achievement of the SDGs by 2030 and Paris Agreement commitments;

(b) ESCWA initiates consultation with a debtor country in the Arab region and a bilateral creditor for a possible debt swap to support one or more climate-resilient projects;

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\(^74\) The mechanism says that the CRF will also be capitalized from the haircut values negotiated through the swap. However, it is not clear how the creditors’ “haircut value” represent additional resources for the CRF, unless it is requesting matching funds from other donors to the CRF. See the Information Flyer “Debt for Climate Adaptation-Swap initiative for Caribbean SIDS” specifically the schema of the “Post ECLAC Debt Swap initiative.”

\(^75\) The objective here is to draft an idea and assess its opportunities and challenges in the expert group meeting.
A bilateral creditor agrees to a debt swap. It agrees to write down interest payments on external debt starting 2021 to 2030 in return for a commitment by the debtor country to deposit the equivalent amount in domestic currency in a dedicated debt conversion account (DCA) to finance climate-resilient projects. The creditor entrusts ESCWA to play an important role in monitoring the debt swap arrangement and to ensure that the converted funds are used to implement the climate-resilient projects in line with the swap agreement. The creditors may involve other actors, including multilateral financial institutions and themselves, in this process.

The debtor agrees with the creditor on the debt swap arrangement, including the conditionalities and remedies, and continues consultation with ESCWA on monitoring and implementation arrangements.

ESWA plays a valuable role in helping negotiate between the debtor and donors to mobilize matching finance to scale up the swap investment through earmarked climate-resilient projects or programmes. To ensure transparent monitoring and management of the projects, the donor agrees to provide an operational grant to the debt swap mechanism (DSM), managed by ESCWA.

The DCA in the debtor country releases funds to support the climate-resilient projects based on coordination and approval of ESCWA DSM. In parallel, ESCWA DSM releases donor earmarked grants in support of project implementation.

The illustration shows the channels of the DSM (Figure 8).

**Figure 8: An illustration of a debt swap between bilateral creditor and debtor country**

### 5.2 Identification of Main Actors in the DSM

The exchange rate date can be determined through the agreement. The DCA can be at the Central Bank or at the Ministry of Finance or can be at the equity investment promotion arms of governments, as decided by the debtor country. However, its operation is coordinated jointly between the national entity and ESCWA.
The main actors in the DMS as defined in the proposal are as follows:

**Debtor:** The DSM mainly targets low and middle-income countries in the Arab region that face external liquidity challenges, suffer high debt burdens, and spend a significant share of their revenues on interest payments/debt servicing in external currency. They are not countries at risk of default. Among the countries in the region with high debt burdens, Egypt has called for debt swaps to help meet financing needs to mitigate the impact of the COVID-19 pandemic, and to finance long-term projects that can positively impact progress towards the SDGs, which could include climate-related activities. Jordan, Morocco and Tunisia are also candidates for debt swaps, as they are facing increasing debt service burdens that put their recovery from the pandemic at risk.

**Creditor:** The proposed DSM mainly calls upon bilateral creditors, since they hold a large share of public debt in several Arab middle-income countries, as mentioned earlier in the Table 3, and since ODA disbursements to developing countries in aggregate are less than the commitment of several bilateral creditors. Scaling up ODA or climate finance pledges in the immediate and near term can pose a challenge for these countries, especially given the adverse economic consequences of COVID-19 and constraints affecting bilateral cooperation. Several DAC countries that are large creditors to the Arab region could thus use this window offered by debt swap to enhance their ODA disbursements and climate finance pledges toward accelerating SDGs and climate action.

**Donor:** International donor organizations operating at the global and regional levels, which can scale up the debt swap by financing climate-resilient projects at scale, for the mutual benefit of achieving the SDGs and the Paris Agreement. Such organizations include the Green Climate Fund, Global Environment Facility, the Adaptation Fund, multilateral development banks, and bilateral donors.

**ESCWA:** The role of ESCWA includes hosting the DSM and ensuring the effective development and implementation of the debt swap, including through monitoring and supervision. ESCWA is a United Nations regional economic commission that is mandated to provide technical assistance to member States to advance and accelerate progress towards the SDGs and climate action. Its standard operating procedures are applied in accordance with United Nations rules and regulations, which establish ESCWA as a credible institution that the debtor, creditor and donor can trust to monitor and implement the swap funds in a transparent and accountable manner. ESCWA has the mandate and convening power to liaise with national governments to advance the SDGs and climate-resilient investments, in accordance member State priorities, national development plans and their NDCs. Setting up clear and transparent conditionalities, remedial measures, monitoring and implementation mechanism would ensure that domestic investments are channelled to the desired climate/green projects. In addition, ESCWA can liaise with donors to contribute matching finance (that is external or part of the swap) through the DSM, and to scale up investments in earmarked climate-resilient projects in multiple Arab countries to achieve better results at the national and regional levels.

### 5.3 Assessment of Mutual Benefits of the DSM

Climate/SDGs debt swaps can be an effective financial instrument providing win-win results for debtor and creditor countries. It provides a unique opportunity for creditors and donors to show solidarity in assisting developing countries to recover better from the COVID-19 pandemic.
pandemic and demonstrate their commitment to strengthening development cooperation to accelerate the achievement of the SDGs and Paris Agreement commitments.

As explained in the initial section of the paper, the economic benefits of the debtor stems from the fact that the debtor pays the amount in domestic currency to itself towards the new obligation agreed under the terms of the swap. The direct resource effect is 100 percent of interest payments on external debt since the debtor was committed to not to default if there is no debt swap. In addition, it has positive net indirect effects when such investments lead to higher net aggregate flows from donors, and from private and public sources, to climate-resilient projects. Other important socioeconomic benefits include job creation, advancing local community development, and promoting women’s empowerment that all contribute to bridging inequality gaps.

Debt swaps are also beneficial for bilateral creditors, donors and development partners, since the amount of the debt swap allocated for climate-resilient projects increases ODA disbursements/climate finance pledges that accelerate the achievement of the SDGs and Paris Agreement commitments without adding extra burdens on their budgets. Furthermore, long-term climate-resilient projects will likely boost economic transformation and future economic growth of debtor countries and crowd in complementary grants and investments, which in turn facilitate the repayment of outstanding debt stocks.

5.4 Assessment of Potential challenges of the DSM and their mitigation

There may be several challenges in implementation of a bilateral debt swap even though they are not negotiated through market-based actors. ESCWA’s role would be to assess these challenges and support the debtor and creditor countries with evidence-based tools to help them arrive at common grounds. Some of these challenges and their mitigation include the following:

➢ Creditors and debtors must agree to terms, which can take time and resources. This is the first step in progressing in operationalizing the debt swap mechanism. ESCWA can play the role of a facilitator and uses its technical capacities and engagement with member States through intergovernmental mechanisms to expedite negotiations.
  o ESCWA can support in preparing a term sheet to facilitate negotiation, which will be grounded in evidence-based research, outcomes of parallel consultations with debtors and creditors, assessment of mutual benefits, as well as risk logs and remedial measures so that the term sheet can facilitate the negotiation process to find common ground.

➢ A potential risk is that debt swaps could undermine country ownership and autonomy if the creditors push for restrictive conditionalities. In this case, the challenge is to ensure that the use of swap funds should be aligned with national development plans including national SDG targets and climate action commitments articulated in NDCs prepared under the Paris Agreement. At the same time, it takes into consideration remedial measures for potential fungibility concerns.
  o ESCWA as a facilitator of the debt swap can engage with the creditors and debtors in parallel to ensure that the term sheet for negotiation provides guidance on sensitive issues regarding use of swap funds aligned to national priorities and economic incentives to debtors while it clearly articulates remedies in case of fungibility concerns.
➢ For the debtor, long term *earmarking funds* from the conversion of debt to climate-resilient investment programme is a commitment, which can be a challenge financially, and it can be sensitive to public sentiment due to lack of proper sensitization of public regarding the commitments and their proper utilization. Since the debtor that enters into the DSM is not a defaulter, it makes credible efforts in its budget to set aside resources for debt conversion (as agreed according to the debt swap agreement). Mobilizing this domestic resource is part of treasury resources even without a debt swap. Improving transparency in monitoring and evaluation and through a clear communication strategy regarding the utilization of these resources, including financial and non-financial returns of the programme and projects, can sensitize different stakeholders and minimize potential sensitivities. Therefore, putting up a proper long-term programme monitoring and evaluation framework for both financial and non-financial indicators is crucial. It benefits the debtor as well as the creditor to better understand the utilization of resources and manage fungibility concerns.

  o ESCWA’s technical assistance in this aspect can ensure establishing a *quality framework for monitoring and evaluation and an effective communication strategy*, including setting eligibility criteria for climate-resilient projects and investments that are results-based, long-term programmes or multiple projects in one or more sectors. Setting such climate-resilient investment programme is easier in countries using results-based budgeting, which can be supported well through ESCWA’s regional programme for technical assistance.

➢ Another challenge could be to scale up the projects through *additional funds from donors and development partners*. Mobilizing complementary grant funds from donors and development partners to long term climate-resilient investments is often a concern due to potential fear of the donor on misappropriation of funds or risks associated with predictability of domestic investment into the project in the long term or lack of a quality monitoring framework. A well-designed negotiated debt swap along with a proper monitoring and evaluation framework provides *predictability of flows and their usages to climate-resilient investments*, which supports long term planning for climate action and acts as a market signal of the government’s commitment to the long-term planning objectives. Debt reduction efforts, with good policies, can strengthen commitments of donors and ensure more predictable flow of funds through selective transfers that improves development effectiveness.78

  o The DSM managed by ESCWA can work as a catalyst to convince donors and development partners at the regional and global level to support strong climate-resilient projects and programmes in multiple countries in the region. This helps donors to enhance their development effectiveness in the sense that the DSM increases opportunities to provide grant support to targeted projects and programmes aimed at accelerating the SDGs and climate action.

➢ While a voluntary swap should raise the credit quality of the borrower going forward, a usual challenge that developing country may face is that *a swap could send negative

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77 Proposals that are part of large multi-year projects with results-based programme focus are more likely to convince creditors. In building a long term programme, debtor countries may consider setting targets for reducing debt stock based on strong performance, such as reducing debt by X per cent by 2030 against the baseline, or improving expenditure on climate-resilient projects related to specific sector by X per cent of GDP by 2030 against the baseline, in accordance with national development plans.

signals to the financial market. However, this should not to be the case in this context since the debtor is not at default; rather the debtor is committing to use the debt conversion amount in long-term, climate-resilient projects and investments that can transform and stimulate economic growth and job creation. Therefore, the government’s actions should project positive market signals.

6. **Conclusions**

The evidence suggests that climate finance and securing resources to accelerate the achievement of the SDGs are easy victims at times of fiscal pressures. Ensuring predictability of climate/SDG finance and its scale up is difficult for low-and-middle income countries when public budgets are under stress to meet other development priorities. External support is also often donor-driven and *ad hoc*. Therefore, innovative tools of financing are required to scale up public international climate finance, which is imperative to support Arab States to implement their NDC targets. A long-term climate/SDGs debt swap mechanism presents such an opportunity.

Historical examples of debt swap offer several important lessons about their effectiveness as well their mechanism of implementation. While debt swap arrangements have continuously evolved over the period since the 1980s, especially those related to debt for nature and debt for development swaps, their impact has been mixed. Furthermore, their potential has not yet been achieved since debt relief from most debt swaps has been negligible as compared to the total external public debt of debtor countries. The DfN swaps that were negotiated commercially and with involvement of market intermediaries often had complex designs and were focused on earmarking small projects and generating incentives for alignment with environment projects. Debt swap experiences of other organizations in the United Nations family are also still emerging, with differing arrangements depending on their intended scale and area of focus.

This paper proposes a more practical and innovative approach of pursuing a long-term Debt Swap Mechanism (DSM) that can assist Arab States through support provided by ESCWA. The emphasis of the DSM is on setting up bilateral debt swaps, especially for the middle-income Arab States that are facing high fiscal stress due to their increasing debt service obligations that need to be managed despite the adverse economic consequences of the COVID-19 pandemic.

The DSM underscores the importance of a result-oriented framework of long-term earmarking of funds from the conversion of debt to climate-resilient investment programme, aligned with the national development plans and NDC targets. The proposal also underscores the critical role of ESCWA to ensure effective implementation of the Climate/SDGs Debt Swap Mechanism through transparent monitoring and implementation arrangements. The paper acknowledges that the debt swaps are not the panacea for debt relief, nor can they meet all finance needs for climate actions. However, they have the potential to make significant impact on these twin objectives.

Given the composition of debt in the MICs, the bilateral debt swaps proposed by the ESCWA DSM have a significant potential to mobilize urgent financing needs to mitigate the impact of the pandemic on national budgets, and mobile resources to finance action on climate change and the SDGs and to help the Arab region to build forward better.
References


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Technical Assessment of Climate Finance for the Arab States.


### Annex I

Creditors of Selected Indebted Countries in the Arab Region

<table>
<thead>
<tr>
<th>Creditors</th>
<th>Egypt, 2019 (Millions of $)</th>
<th>Jordan, 2019 (Millions of $)</th>
<th>Tunisia, 2017 (Millions of $)</th>
<th>Morocco, 2019 (Millions of $)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bilateral Creditors:</td>
<td>40,500.00</td>
<td>3,497.72</td>
<td>4,165.00</td>
<td>9,067.78</td>
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<tr>
<td>Japan</td>
<td>2,400.00</td>
<td>1,059.05</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>USA</td>
<td>1,200.00</td>
<td>49.35</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>China</td>
<td>6,800.00</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>European countries</td>
<td>7,000.00</td>
<td>1,493.89</td>
<td>1,485.00</td>
<td>5,986.15</td>
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<td>Germany</td>
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<td>637.46</td>
<td>-</td>
<td>-</td>
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<tr>
<td>France</td>
<td>1,600.00</td>
<td>856.43</td>
<td>1,485.00</td>
<td>-</td>
</tr>
<tr>
<td>UK</td>
<td>2,200.00</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Arab Countries</td>
<td>23,100.00</td>
<td>-</td>
<td>198.00</td>
<td>1,275.16</td>
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<tr>
<td>Saudi Arabia</td>
<td>-</td>
<td>-</td>
<td>135.00</td>
<td>-</td>
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<tr>
<td>Kuwait</td>
<td>-</td>
<td>-</td>
<td>63.00</td>
<td>-</td>
</tr>
<tr>
<td>Saudi Arabia, UAE &amp; Kuwait</td>
<td>23,100.00</td>
<td>-</td>
<td>-</td>
<td>-</td>
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<tr>
<td>Other countries (Arab and Foreign)</td>
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<td>895.43</td>
<td>1,951.00</td>
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<td>Multilateral Creditors:</td>
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<td>ADF &amp; AfDB</td>
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<td>AfDB</td>
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<td>EIB</td>
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<td>IMF</td>
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<td>IsDB</td>
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<td>World Bank</td>
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<tr>
<td>World Bank &amp; IDA</td>
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<td>2,988.21</td>
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<td>Other regional and international associations</td>
<td>4,800.00</td>
<td>663.26</td>
<td>1,938.00</td>
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<td>Other Creditors:</td>
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<td>8,659.52</td>
<td>11,867.00</td>
<td>8,855.25</td>
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<tr>
<td>Foreign banks and companies</td>
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<td>150.17</td>
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<td>-</td>
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<tr>
<td>Eurobonds and other local bonds in $</td>
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<td>8,509.35</td>
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<td>-</td>
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<tr>
<td>Bondholders and commercial banks</td>
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<td>-</td>
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<td>8,855.25</td>
</tr>
<tr>
<td>Private (Market)</td>
<td>-</td>
<td>-</td>
<td>5,744.00</td>
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<tr>
<td>Other debt (including sukuk)</td>
<td>-</td>
<td>-</td>
<td>6,123.00</td>
<td>-</td>
</tr>
</tbody>
</table>

*Source: Ministry of Finance Annual Reports of Respective Countries.*