

# WILL DEBT-FOR-EQUITY IN MDG PROJECTS DELIVER?

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**G**rotesque inequalities in income and living standards characterized the last two decades ending the second millennium. The 1999 United Nations Human Development Report revealed that while 1.3 billion people struggled to live on less than US\$1 a day, the world's richest 200 people doubled their net worth between 1994 and 1998 to more than US\$1 trillion. The world's top three billionaires alone possess more assets than the combined Gross National Product of all the least developed countries and their combined population of 600 million people.<sup>1</sup>

These inequalities spawned around 840 million malnourished and close to one billion extremely poor and hungry people worldwide. More than 880 million people lack access to health services while 2.6 billion people have no access to basic sanitation.

This deplorable situation compelled world leaders to lay down a new global vision for humanity, called the Millennium Declaration, which they have committed to making a reality by the year 2015. The global imperatives of this declaration are specified and encapsulated in a set of eight achievable goals called the Millennium Development Goals (**MDGs**):

- 1 - Eradicate extreme poverty & hunger
- 2 - Achieve universal primary education
- 3 - Promote gender equality
- 4 - Reduce child mortality
- 5 - Improve maternal health
- 6 - Combat HIV/AIDS, malaria & other diseases



Photo by: Luis Liwanag

- 7 - Ensure environmental sustainability
- 8 - Global partnership for development.

The **MDGs** have 18 time-bound targets, measured by 48 quantifiable indicators for monitoring progress.

But the attainment of the **MDGs** depends on the financing capabilities of the governments of developing countries. Goal 8, in this sense, is viewed as the pipeline for realizing the **MDGs** because it lays down the framework for global partnership for development through an open system - increasing official development assistance [**ODA**] 0.7% of rich countries' GNP; technology transfer; and debt relief for developing countries. Goal 8 sets the tone for the elimination of poverty as a shared responsibility of both developed and developing countries rather than the sole responsibility of the latter. These commitments were further strengthened at the 2002 Monterrey Consensus.

To estimate the resources needed to achieve the **MDGs**, the UN created the Zedillo Commission and assigned it to present an **MDG**-costing report in time for the 2002 International Conference on Financing for Development at Monterrey, Canada in 2002. The report revealed that an extra US\$50 billion a year, from the **ODA** of donor-countries and internal sources of developing countries, would be required to meet the Goals.<sup>2</sup>

Both the **Declaration** and the **2002 Monterrey Consensus** admit that huge external debt payments of developing countries are drawing out much of the resources needed for rigorous spending on development. Target 15 of Goal 8 seeks to end

indebtedness by rechanneling resources to poverty elimination. [See Box 1]

and of the debtor government, to make payment at a higher price in exchange for cancellation of the debt.

Debt conversion is a means to provide development financing in an innovative manner, and implicitly includes some kind of debt relief. However, by no means should it be considered a way to solve the debt crisis.<sup>4</sup>

Debt swaps have different particular objectives. The main purpose of a debt-for-equity swap is to earn profits for an investor, while a debt-for-development arrangement aims to provide additional funds for development activities within a country.

### History Repeating Itself

A study commissioned by the United Nations Development Programme (UNDP) estimated the minimum resources required to meet the **MDGs** in the Philippines by 2015, specifically for improving basic education, health, water and sanitation services and facilities alone, at P2.5 trillion.<sup>5</sup>

Despite these limitations, the Philippine government states that it has "high" and "medium" probabilities of attaining these goals.<sup>6</sup> Many sectors believe otherwise, pointing to the increasing share of debt payments that impact negatively on spending for social services. [See **Table 1**] In 2005, nearly 33.24% of the national budget went to payments for interest on debts alone while only 28% was allotted to social services. If payments for debt principal were included, allocations for these, siphoned off from social spending on education, health, social security, employment, housing, land distribution and subsidies for local government units, would make up around 77% of the national budget. The government proposes a similar pie in 2006. If resources for poverty reduction will continue to be rechanneled to debt payments and if the population growth rate continues to rise, then achieving the **MDGs** may end up as a mere pipe dream.

Although heavily indebted, the Philippines is not included in the list of **HIPCs** eligible for debt discounts because it has proven that it can

#### Box 1

##### INDICATORS OF GOAL 8, TARGET 15

Deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term.

##### Indicator 42

Total number of countries that have reached their HIPC decision points and number that have reached their HIPC completion points (cumulative).

##### Indicator 43

Debt relief committed under HIPC initiative, US\$.

##### Indicator 44

Debt service as a percentage of exports of goods and services.

The debt relief initiative for Heavily Indebted Poor Countries (**HIPC**) is dubbed as the most successful innovation that opens to developing countries the possibility of freeing themselves from unsustainable debt burdens. To date, debt reduction packages have been approved for 28 countries, 24 of them in Africa, providing \$33 billion (net present value terms) in debt service relief over time.<sup>3</sup> Despite existing debate on the efficacy of the Initiative, it was so widely accepted that it ended up being reflected in the **MDGs** and was defined in the

Monterrey Consensus as a debt management strategy.

Apart from the HIPC process, developing countries have also engaged in debt swaps to ease the burden of debt payments. Some forms have involved equities while others merely channel payments into development projects. Whichever form it may take, a swap, to be effective and successful, should be based on the willingness of creditors to accept **less than face value for debts**

Table 1 EXPENDITURE PROGRAM BY SECTOR, 2000-2006 (In Million Pesos)							
	2000	2001	2002	2003	2004	2005	2006
<b>ECONOMIC SERVICES</b>	167,216	141,236	151,255	164,108	168,224	157,994	197,176
% of total for the year	24.50	20.18	20.39	20.22	19.4	17.2	18.72
<b>SOCIAL SERVICES</b>	212,982	217,217	230,495	235,568	250,205	254,263	293,390
% of total for the year	31.21	31.04	31.06	29.05	28.86	27.68	27.91
<b>DEFENSE</b>	36,208	32,782	38,907	40,645	42,683	44,173	52,427
% of total for the year	5.31	4.68	5.24	5.01	4.92	4.81	4.98
<b>GEN. PUBLIC SERVICES</b>	122,526	120,019	132,878	134,944	139,320	141,868	161,497
% of total for the year	17.95	17.15	17.91	16.61	16.07	15.44	15.33
<b>NET LENDING</b>	2,634	7,023	2,626	5,500	5,676	6,928	8,250
% of total for the year	0.38	1	0.35	0.68	0.65	0.75	0.78
<b>INTEREST PAYMENTS</b>	140,894	181,601	185,861	230,697	260,901	313,393	339,998
% of total for the year	20.65	25.95	25.05	28.43	30.09	34.12	32.28
<b>TOTAL</b>	682,460	699,878	742,022	811,462	867,010	918,619	1,053,277
% of total for the year	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: Budget Expenditures and Sources of Financing, DBM

pay its debts and even avoids to default by putting into law an automatic appropriation of debt payments in its annual spending program. This becomes an impediment to maximizing the MDG targets under the HIPC framework.

So House Speaker Jose De Venecia floated a proposal before the United Nations General Assembly in September 2005, apparently to expand the debt relief to include the rest of the HIPC and middle-income countries. The proposal, entitled "Debt for Equity in MDG Projects: A Philippine Proposal for Converting 50 Percent of the Debt Owed by the 100 Highly Indebted Countries to Equity Investments in the Millennium Development Goals of the United Nations," seeks a massive conversion of debts into equities to attract investments for MDG projects in heavily-indebted poor and middle-income countries. The proposal further insinuates its legitimacy by stating that "the HIPCs make up a tiny group—compared with the absolute number of poor peoples in the so-called middle-income countries."<sup>7</sup>

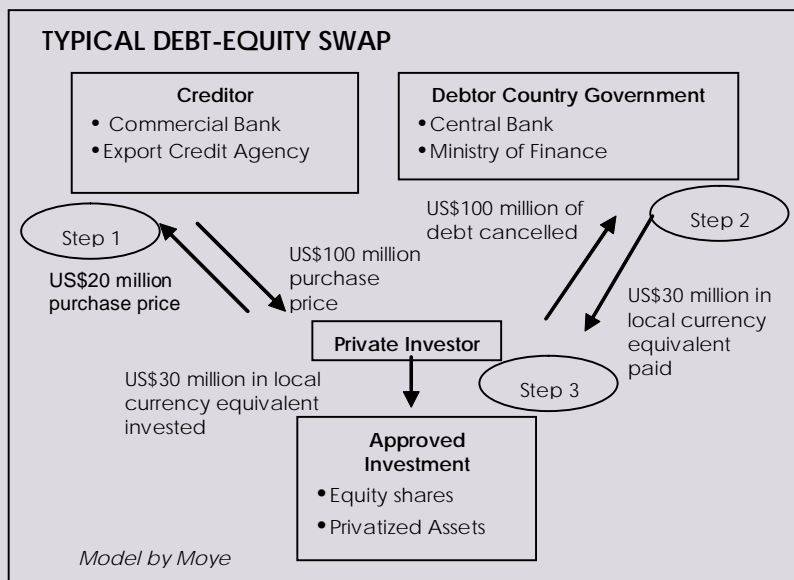
The proposal to convert debt payments to equities reportedly stirred up the interest of international financial institutions (IFIs). Ironically, the local community is

unimpressed because of the repercussions of the proposal.

Debt-for-equity swap [D/E] is not a new idea. It figured prominently among the creative solutions proposed for the international debt crisis in the 1980s, although its practice was already documented as early as 1965 in Brazil.<sup>8</sup> More than 40 developing countries have defaulted on loans and have been forced to reschedule debts with commercial banks or find other means of relief. The Brady Plan, named after US Treasury Secretary Nicholas Brady, proposed a set of individualized market-based debt and debt reduction mechanisms. One of these is debt conversion, a practice formerly used only by private firms, until the World Wide Fund suggested in 1984 that it could be used for conservation purposes.

A D/E swap converts the external debt of a debtor country into local currency funding for equity investment in that debtor-country. It is a multi-step and multi-party process involving at least three parties: the debtor, the foreign investor and the creditor-country [See Box 2]. Commercial and bilateral publicly guaranteed debt is the common type of debt that is eligible under the scheme. Typically, the investor (a bank or a private company) buys the debt at a

## Box 2



discount from face value on the secondary market or from a bilateral export credit agency. The debtor government then redeems the debt at a negotiated value in local currency or local currency instruments (e.g. bonds) that are then used to buy a share in an existing company (e.g. a public enterprise that is being privatized) or to buy property or productive capital (e.g. a factory, or land) in the debtor-country.<sup>9</sup>

In 1986, the Philippines already established D/E programs through Executive Order 32, which the Central Bank implemented through Circular 1111 under the Aquino Administration. It was suspended in April 1988 because of inflationary costs and the possibilities of "round tripping," through which investors with pesos engage in capital flight to obtain foreign currency, later converted through the swap into a much larger amount of pesos. In 1990, the scheme was resurrected but the impact was minimal.<sup>10</sup> Debt stock reduction from D/E swaps amounted to merely \$1.3 billion, compared with the total external debt of \$28.8 billion in July 1991.<sup>11</sup>

The literature on these transactions is rich and the lessons of debtor-governments that entered into these transactions, including the Philippines, are similar: **the scheme has little debt reduction capacity and does not solve the**

causes of indebtedness. On the contrary, it creates new forms of obligations and expenses that could have been channeled to better use, i.e. funding effective long-term debt management strategies.

### Philippine "Creativity"

A "creative way of easing debt burden and meeting debt obligations" is how the Philippine proposal was packaged in the international community. Although lacking in originality, its "uniqueness" lies in the blatancy of its repercussions and its lack of vision in keeping up with the visionary slant of the Millennium Declaration.

**D/E may be an attractive proposal to foreign investors, but its capability to build consensus is thin.** This scheme needs consensus from all three parties – creditor, debtor and investor – on areas of investment, how much of debt to involve and equity to purchase. As of end-2004, exactly 53.2% of total external debt is owed to foreign denomination securities, 29.5% to bilateral creditors, 14.2% to multilateral creditors and 3% to commercial creditors.

Since it is nearly impossible to apply this scheme to individual holders of foreign denomination securities, only less than half of the debt stock is left for D/E negotiations. The Paris Club, an informal group of official nation-creditors that provides financial services such as debt restructuring, debt relief and debt cancellation to indebted countries, has expressed interest in the proposal. But the possibility of translating this interest into real transactions is bleak since the International Monetary Fund and the World Bank often recommend debtor-beneficiaries only after solutions have failed. The catch is that the World Bank reportedly lauded the proposal but issued the stern warning that "debts should still be best reduced through fiscal prudence and effective tax collection."<sup>12</sup>

**The D/E proposal will not reduce our debt and will exact higher costs for debtor-countries.** The D/E proposal pleads not "...for debt forgiveness, not for debt moratorium, not for debt

cancellation, not for debt discounts," which in principle leads to debt stock reduction. It seeks instead for a "plow-back" of 50% of the interest payments due them. Since interest payments are automatically appropriated in the annual budget by virtue of Presidential Decree 1177, this means that full payment of scheduled debts should be done first before creditors could "return" half of the paid amount to finance MDG-related projects.

The "return" part is void of charity because of the costs that this represent for future generations. The Philippine proposal promise creditors two things: 1) they will not lose a single centavo which could have reduced debt stock; and 2) their plow-back will be converted into "equities.. and other kinds of financial assets.. that are value-creating, job-generating, and tradeable in themselves." The proposal further defines these reinvestment areas as reforestation, energy, mass housing, irrigation, food production, and post-harvest facilities, eco-tourism, mining, areas for land reclamation, education, hospitals and health care, and micro-finance - virtually everything that is generating revenues and critical for delivering basic social services. [See Box 3]

The proposal did not only promise to pay the entire dues as scheduled; it also transforms creditors into owners of the best assets in the debtor-country, sans tax and other transaction costs. More importantly, the cost to the country may even be higher if the profit and dividend rate and the potential capital gains of sold assets are larger than the principal and interest of the debt converted.<sup>13</sup>

A debtor-country will also be, in effect, subsidizing an investment from abroad that may have occurred anyway. If the proposal limits the scheme to foreign investors, D/E will be unfavorable to local investors and aggravate foreign domination of the economy.

The key factor in the success of debt conversion programs in the past depended on the degree of investment "additionality": the ability to attract foreign equity investments that will not otherwise come in. The Philippine proposal clearly does not provide additionality.

### Box 3

#### AREAS OPEN FOR DEBT-FOR-EQUITY SWAPS IN THE PHILIPPINE PROPOSAL

##### I. RE-INVESTMENT CHOICES

- Debt for Reforestation
- Debt for Energy
- Debt for Mass Housing
- Debt for Irrigation, Food Production, and Postharvest Facilities
- Debt for Ecotourism
- Debt for Wealth-Creating Projects (mining in minerals, oil and gas; land reclamation)

##### II. SOCIAL INVESTMENTS

- Debt for Education
- Debt for Hospitals and Health Care
- Debt for Microfinance

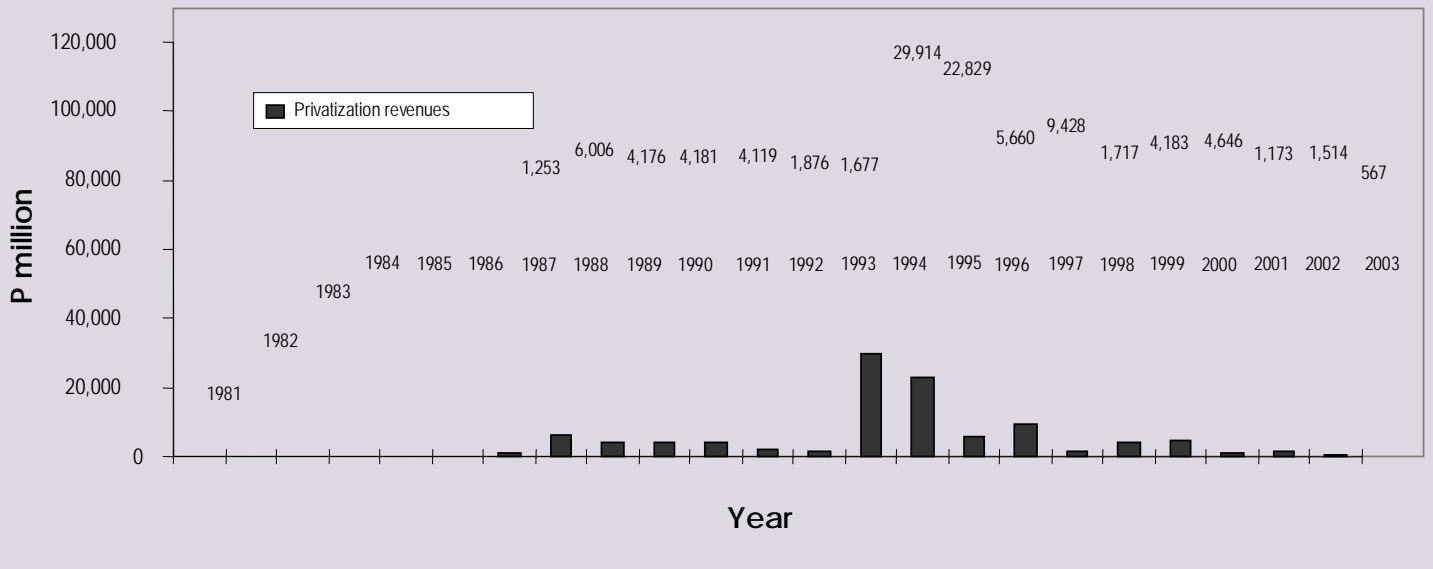
**D/E is amplified privatization and denationalization. This conclusion is well-documented in countries that went through the scheme. D/E hastens privatization or the transfer of state-owned assets and natural resources to foreign and private entities.<sup>14</sup>**

Selling of state-owned corporations has been used as a strategy to rake in revenues for debt-ridden governments. For some time, privatization did become the source of budget surplus, but this was only a brief indulgence [See Chart 1]. Revenues from privatization temporarily provided cash, but the loss in the nation's capital stock can never be recovered.

Private ownership of natural resources involves large-scale commercial production that compromises the stake of future generations. This is a violation of the constitutional provision on foreign ownership and exploitation of natural resources and various international agreements upholding sustainable development. In the long run, the cost of reducing poverty may be higher if the principles of sustainable development continue to be transgressed.

**On the contrary, D/E will create new forms of debts.** As practiced, external debt payments are financed by domestic debt borrowing. Since D/E does not vouch for any kind of cancellation or relief, the country will still have to resort to further borrowing from domestic sources such as

Chart 1  
NG Privatization Revenues, 1981-2003  
(P million)



bonds that are a sure way to cause inflation.<sup>15</sup> To avoid this, the debtor government must float new domestic debt, often at interest rates that are much higher than the international debt, to “sterilize” the swap payment. In any case, the debtor pays something, either in taxes, inflation or lost investment opportunity.

**D/E puts bad creditors off the hook.** In cases where a good portion of a country’s foreign debt is tainted with fraud, the swap is a “smooth” way of clearing their obligations. At present, the country continues to shoulder the burden of the Martial Law period. The outstanding balance of then President Ferdinand Marcos’ foreign debts 18 years after he was ousted stood at almost \$1.2 billion or more than P67 billion. The country is projected to pay more than \$183 million in principal of these debts this year, and another \$45.3 million in interest and other charges.<sup>16</sup>

The Vatican-backed Jubilee Campaign asserts that loans from onerous transactions and those that have not benefited the people should not be paid. These have been the strong arguments behind the **HIPC** initiative.

**D/E** does not promote transparency and accountability in addressing debt problems. Instead, public officials and private entities facing charges of corruption and signing onerous contracts are let off the hook.

**D/E is a step backward to the UN initiatives of debt cancellation for Heavily Indebted Poor Countries.** While debates on the benefits of the HIPC initiative are still ongoing, there is widespread acceptance of its potential to reduce debts. The proposed **D/E** may endanger the international campaign for cancellation of debts incurred by despotic and corrupt regimes and private entities.

The mechanism for releasing money from debt repayments and rechanneling it to poverty reduction, which is the essence of debt relief, is well-placed in Goal 8, and there is no need for the proposed debt-for-equity swap presented by the Philippine government last September.

Overall, **D/E** is designed for investors to incur profits and equities and for the government to rake in revenue rather than raise resources for development projects. Instead of wasting talents and efforts in promoting **D/E**, debt-saddled

governments should pursue a sustainable, just and effective debt management strategy consisting of the following:

- Exploring debt-for-development swaps that do not require policy conditionalities from creditors in exchange for MDG projects as an alternative to the Philippine proposal to the UN;<sup>17,18</sup>
- Conducting a transparent audit of all public sector debts as a basis for determining other illegitimate debts;<sup>19,20</sup>
- In conjunction with MDG 8, negotiating for an expanded 100% debt cancellation to open the list of beneficiary countries that are also in need;<sup>21</sup>
- Cancelling or annulling debts incurred from onerous agreements and contracts as provided for in the Philippine Civil Code and the Vienna Convention on the Law of Treaties between States and International Organizations or between International Organizations;<sup>22</sup> and
- Repealing the Automatic Appropriations Law.<sup>23</sup>

Congress should also look into its fiscal spending and policy gaps to realize the full potential of available domestic resources for MDG financing. The UNDP-commissioned-study proposed policymakers to:<sup>24</sup>

- Favor expenditures in support of basic social services;
- Mobilize the local government units to achieve the MDGs;
- Use cost-effective modes of delivering services or cutting back on waste and operational inefficiencies;
- Exert maximum effort to ensure that resources are used efficiently and effectively;
- Promote a policy environment conducive to sustained growth that allows the poor to participate in and benefit from such growth; and
- Pursue a stronger population management program

Civil society also sees the urgent need to tap other sources of development financing that require the government to:

- Plug tax leakages;<sup>25</sup>
- Increase the grant component of ODA instead of loans;<sup>26</sup>
- Move the tariff under the WTO regime upwards;<sup>27</sup> and
- Explore debt-for-development swaps that do not involve the transfer of assets as an alternative mode of converting debts to funding for development projects.

Still ecstatic from the "warm reception" of the international community to the idea proposed by JDV, President Gloria Macapagal-Arroyo even audaciously added a cultural ingredient to the basket of options under D/E, specifically four major concerns: 1) poverty alleviation strategy through a cultural caregiving program for the poorest of the poor; 2) support for endangered and intangible heritage sites and threatened indigenous cultural properties; 3) promotion of a culture of peace through the media; and 4) development of culturally-sensitive curricula.<sup>28</sup>

What appears to be a denationalization of assets will be stretched even further into a denationalization of our cultural values and heritage if the present D/E proposal pushes through. That there is no such thing as a free lunch is a basic principle of international cooperation. The conditionalities attached to debt payment arrangements could be used for cultural subjugation. The first thing that the US forces did during the Filipino-American War was to establish a public education system. Culture, indeed, is a political tool.

That debt resolution will incur significant costs is a given. The historical experience of debt resolution suggests that the longer painful restructuring efforts are postponed, the greater the overall costs of restructuring tend to be. Allowing the vagaries of the market to solve the debt problem is not the solution. The World Bank puts it even more bluntly: "There is no market solution to the debt crises."<sup>29</sup>

## Endnotes

- <sup>1</sup> 1999 Human Development Report
- <sup>2</sup> The Zedillo Commission was named after Ernesto Zedillo, the former President of Mexico and chairman of the High Panel on Financing for Development.
- <sup>3</sup> A Factsheet: Debt Relief Under the Heavily Indebted Poor Countries (HIPC) Initiative. September 2005. International Monetary Fund.
- <sup>4</sup> Kaiser and Lambert. Debt Swaps for Sustainable Development. A Practical Guide for NGOs. IUCN, SCDO and EURODAD, 1996.
- <sup>5</sup> The UNDP commissioned Dr. Rosario Manasan of PIDS to study the resource requirements for the **MDGs**. The estimates are based on MTPDP assumptions that the government will meet a 2.1% to 1.8% population growth rate and a GNP average increase of 4% to 6.5%. If these are not met, as much as P2.6 trillion, or an additional P1 trillion, will have to be spent to achieve these goals. Manasan, Rosario 2002 Philippines Country Study on Meeting the Millennium Development Goals. Manila: United Nations Development Programme.
- <sup>6</sup> Manasan says these performance rates, which NEDA has used, are based on the assumption that the population growth rate will be 2.1% to 1.8% and average GNP increase, 4% to 6.5%.
- <sup>7</sup> Debt for Equity in MDG Projects: A Philippine Proposal for Converting 50 Percent of the Debt Owed by the 100 Highly Indebted Countries to Equity Investments in the Millennium Development Goals of the United Nations. Jose De Venecia Speaker, House of Representatives Congress of the Republic of the Philippines
- <sup>8</sup> Dytianquin. January 1990.
- <sup>9</sup> Overview of Debt Conversion. Melissa Moye. Debt Relief International
- <sup>10</sup> The Economics of Debt-Equity Swaps: An Empirical Investigation on the Macroeconomic Impact and Critical Analysis of the Effectiveness of the Philippine Debt-Equity Conversion Program in External Debt Management. Norman G. Dytianquin. January 1990. Institute of Social Studies, Netherlands.
- <sup>11</sup> Philippine External Debt Management Program. Speech delivered by Governor Jose L. Cuisia Jr. Governor, Central Bank of the Philippines in 19 November 1991 to the Makati Business Club.
- <sup>12</sup> <http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,date:20050915~menuPK:34461~pagePK:34392~piPK:64256810~theSitePK:4607,00.html>. Wolfowitz Wants Action On Poverty, Not Just Talk, September 15, 2005.
- <sup>13</sup> The Economic Consequences of debt-swaps: The De Venecia Plan, Sixto K. Roxas
- <sup>14</sup> Moye. Debt Relief International
- <sup>15</sup> Freedom From Debt Coalition (FDC)
- <sup>16</sup> Raw data from the Bureau of Treasury – Debt Monitoring Analysis Division. IBON Facts and Figures Special Release. Repudiating Marcos’s Illegitimate Debts to Help Tame the Fiscal Crisis. 31 July 1995.
- <sup>17</sup> Statement of Unity. Freedom from Debt Coalition
- <sup>18</sup> FDC
- <sup>19</sup> Statement of Unity. Freedom from Debt Coalition
- <sup>20</sup> FDC
- <sup>21</sup> Beyond HIPC, Oxfam Briefing Paper, September 2005.
- <sup>22</sup> Several bills are filed in both Houses to cancel illegitimate debts.
- <sup>23</sup> Versions of this proposal are filed in both Houses.
- <sup>24</sup> Manasan
- <sup>25</sup> Bayan Muna
- <sup>26</sup> Social Watch
- <sup>27</sup> Bayan Muna and Social Watch
- <sup>28</sup> NCCA Press Release. RP’s Debt Equity Program to Include “Debt-for-Culture Swap”. September 16, 2005.
- <sup>29</sup> Claessens *et al.* The World Bank, p. 44.1991.



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