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PRC Debt-for-Nature Swaps

The Dark Side of Debt Relief in Africa

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PRC Debt-for-Nature Swaps:
The Dark Side of Debt Relief in Africa

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Debt-for-nature swaps are surging in popularity among the environmental and finance communities. These swaps exchange outstanding debt for environmental projects. As the largest bilateral lender to African countries, Beijing is well-positioned to use debt-for-nature swaps to gain greater leverage on the Continent. China can then portray its activities as environmentally responsible and sustainable. However, the way China designs swaps may limit U.S.-Africa collaboration and restrict African countries' sovereignty over their sustainable development.

At this early stage, the United States has an opportunity to limit the coercive and extractive use of this debt relief strategy. The United States should work with the international community to establish universal standards and push for transparent and inclusive negotiations.

Introduction

Debt-for-nature (DFN) swaps are a financial tool where heavily indebted countries receive debt relief if they agree to undertake specific conservation or sustainability projects.[1] These swaps mandate biodiversity protection, sustainable infrastructure development, or climate change adaptation projects.[2] Climate finance is the focus of the 2024 U.N. Climate Change Conference.[3] Recently, there has been public support for China to engage in DFN swaps,[4] and China is negotiating a "debt-for-development" swap with Egypt in 2024.[5]

DFN swaps let China bolster its reputation and its investments. Conducting DFN swaps positions China as a leader in sustainable development and innovative debt relief.[6] Debt relief through DFN swaps stabilizes China's lending portfolio, a majority of which is in debt distress.[7]

China's DFN swaps will harm African countries' autonomy and limit opportunities for U.S.-Africa collaboration. Chinese-led swaps mean China will dictate the type of projects funded. The use of Chinese workers in these projects will limit skill and knowledge transfer between China and Africa. Secretive negotiations may increase long-term debt,[8] pushing African countries closer to China. The required use of Chinese companies would crowd out U.S. firms, limiting collaboration.[9]

The United States can mitigate the negative impacts of Chinese DFN swaps by negotiating transparency, standard practices, and inclusivity for swaps. These solutions limit China's involvement and ensure swaps align with the development agendas of local actors. The United States must scale up its engagement with African countries to compete with China.

Debt-for-Nature Swaps: Reviving a Controversial Tool to Tackle the Debt and Climate Crises

"Debt-for-Nature swaps are no longer just a viable economic option; they are a lifeline for our planet."[10]

– John Antonio Briceño (Prime Minister of Belize) and Jennifer Morris (CEO, The Nature Conservancy)

Debt-for-nature swaps refinance debt in exchange for conservation and sustainability projects.[11] Supporters of DFN swaps link the debt and climate crises.[12] Low-income countries are the most adversely affected by climate change despite contributing few emissions.[13] However, heavy debt burdens leave little room for these countries to fund climate resilience.[14]

While the structure of each DFN swap varies, they have three common traits:

- *Bilateral or tripartite*. Bilateral swaps directly restructure debt between creditor and debtor countries.[15] In a tripartite swap, an NGO (typically the WWF or The Nature Conservancy)[16] buys back debt and sells it to debtor countries at a discount.[17] Both models free up funds that can be used for conservation or resilience projects.

- *Insured for risk.* Refinanced loans are often insured by multilateral development banks or similar organizations to lower interest rates from bad sovereign credit ratings.[18]

- *Nature conservation or climate adaptation.* Past DFN swaps funded conservation, but a new model, debt-for-adaptation swaps, would trade debt for "climate adaptation and resilience projects."[19] Debt-for-adaptation swaps could fund green infrastructure projects.[20] This model matches the debt-for-green-development swap China is negotiating with Egypt.

DFN swaps originated during the Latin American debt crisis of the 1980s.[21] Their popularity has fluctuated over time,[22] but there has been a recent resurgence in interest from the development community.[23]

DFN swaps remain controversial for four reasons:

- *Encroaching on sovereignty*. DFN swaps require countries to submit to the agenda of another country or organization.[24] Outside participants' plans "might conflict with already existing conservation programs, including re-settlement of local communities or issues of land ownership."[25] Recent DFN swaps have made progress on this issue by consulting local NGOs and governments.[26]

- *Economically inefficient conservation*. DFN swaps are not the best form of debt relief or conservation funding. According to the IMF, "…debt-climate swaps are generally a less efficient form of supporting climate action than conditional grants because some of the debt relief generated by debt swaps will end up subsidizing non-participating creditors."[27]

- *Minimal impact on debt burden*. Substantial transaction and monitoring costs and long negotiations have prevented large-scale DFN swaps.[28] Past DFN swaps have been too small scale to make meaningful impacts on either debt or environmental conservation.[29] Newer swaps in Belize and the Galapagos show progress in increasing transaction scale[30].

- *High-risk lending*. DFN swaps often take place with politically unstable countries. A DFN swap with Gabon was finalized two weeks before a military coup in August 2023.[31] While the junta has honored the commitment thus far,[32] this scenario demonstrates that political risk could undermine DFN swaps.

Environmentalists and African Leaders Are Pushing for More Swaps

Growing concern about climate change and the COVID-19-era debt crisis put DFN swaps back in focus.[33]

Two groups have made a renewed push for debt-for-nature swaps over the past five years:

- *Multinational conservation organizations*. The Nature Conservancy has facilitated most of the new generation of DFN swaps.[34] The World Wildlife Fund has similarly supported these swaps.[35]

- *African leaders*. In 2023, Kenyan President Ruto, the chair of the African Union, the president of the African Development Bank, and the chief executive of the Global Center on Adaptation jointly called for "a more imaginative use for debt relief — for example, debt-for-nature swaps…"[36] The Kenyan National Assembly recently approved a plan to use DFN swaps starting in July 2024.[37] Other leaders like the Ghanaian president have also supported more DFN swaps.[38]

Renewed interest in DFN swaps led to the creation of a DFN task force at the 2023 United Nations Climate Change Conference (COP28).[39] The task force aims to increase the number and scale of DFN swaps.[40] The U.S. Development Finance Corporation and the Inter-American Development Bank will initially chair the task force.[41]

Why China Will Swap: Reputational Benefits, Risk Mitigation, and Development Opportunities

"By working internationally and utilizing global events such as CBD COP15, China will be able to gain considerable positive public attention and support for the benefits derived from debt for nature swaps."[42]

-Green Finance and Development Center

DFN swaps will benefit China by protecting its investments while bolstering its reputation and providing opportunities to make its infrastructure projects more environmentally friendly. The detrimental effects on the United States and African countries depend on the nature of the benefits China receives from these swaps.

The benefits China receives from DFN swaps fall into two categories:

- *Reputational Benefits*. Reputational benefits are the soft power benefits China obtains from performing DFN swaps. China will receive reputational benefits from taking the lead on debt relief and environmental protection through DFN swaps. These benefits reduce negative publicity from "debt-trap diplomacy" and accusations that the BRI funds unsustainable energy projects.[43]

- *Tangible Benefits.* Tangible benefits are the hard power benefits China receives from participating in DFN swaps. Tangible benefits are derived from using Chinese workers and firms, setting the agenda, and increasing the NPV of loans. These benefits ingrain China into African sustainable development and limit opportunities for U.S.-Africa collaboration.

China can receive three reputational benefits from DFN swaps:

- *Protecting investments*. DFN swaps allow China to engage with BRI partner countries while preventing debt default. "…As of 2022, 60 percent of China's overseas lending portfolio was owed by borrowers in distress."[44] Recently, China has shifted from traditional lending to emergency loans to de-risk its investment portfolio.[45]

- *Improved lending reputation*. Beijing recently transitioned from the largest bilateral creditor to the "world's largest official debt collector."[46] China's unwillingness to forgive debt fuels claims of "debt-trap diplomacy" or the idea that China saddles countries with unsustainable debt to gain power and influence.[47] Participating in DFN swaps will augment China's reputation by showing its commitment to debt relief.[48] Research by Chatham House shows that China's Ministry of Foreign Affairs and the China International Development Cooperation Agency are interested in debt forgiveness for "diplomatic reasons."[49]

- *Greenwashing the BRI*. Xi Jinping at the 2023 Belt and Road Forum expressed support for green infrastructure projects.[50] DFN swaps provide a way to actualize these desires.

> According to a report commissioned by the People's Bank of China, "A debt for nature swap… would be contributing directly to China's advancement toward its national mandate to become an Ecological Citizen and its determination to green the Belt and Road Initiative."[51]

China is well-positioned to conduct DFN swaps with Africa for these three reasons:

- *PRC is the largest creditor*. China is still "the world's largest official source of international development finance," and Africa's largest creditor despite decreases in lending due to the debt crisis.[52] Kenya, which recently passed legislation to facilitate swaps, owes 64% of its bilateral debt to China.[53] China can conduct DFN swaps on a larger scale than other creditors because of its large lending profile.

- *Prevalence of Chinese firms*. Chinese firms already have a significant presence on the African continent. Between 2013 and 2020, Chinese firms went from building 12% to 31% of large infrastructure projects in Africa.[54] U.S. companies struggle to compete.[55] Western firms are more risk-averse and are less likely to pay bribes, which limits their ability to do business on the Continent.[56]

- *Global support for Chinese DFN swaps*. There is growing support in the development community for China to participate in DFN swaps. Boston University's Global Development Policy Center promotes Chinese DFN swaps as a dual solution to the climate and debt crises. In 2022, the African Development Bank (AfDB) encouraged member countries to consider DFN swaps.[57] The AfDB mentioned China as an ideal partner for swaps.[58]

China has begun negotiating a DFN swap with Egypt. Beijing and Cairo signed a memorandum of understanding for a "debt-for-development swap" in October 2023 with implementation starting in 2024.[59] Reports say the swap will free up 100 to 120 million USD for green development projects.[60] Details surrounding the exact terms of the agreement are sparse.

The Implications for Africa and the United States

"In 1990 American and European companies scooped up more than 85% of construction contracts on the continent. Chinese firms did not even get a mention. Now Western firms are struggling to win business in a fast-growing market."[61]

-The Economist

DFN swaps could strengthen China, but the structure of these swaps will disadvantage African countries and U.S.-Africa relations. These negative implications stem from the tangible benefits China receives from DFN swaps.

Less U.S.-Africa Collaboration, Weakened African Autonomy

Swaps could benefit Chinese firms and companies while limiting U.S.-Africa collaboration and African ownership over sustainable development.

China's implementation of DFN swaps could harm Africa and the United States in several ways:

- *Less local involvement in project management*. Chinese firms use local labor for low-skill positions and Chinese labor for management when staffing projects.[62] Chinese management limits the transfer of technical knowledge between Chinese companies and the African workforce.[63] It may become impossible to operate sustainable projects without support from Chinese workers and firms. Heavy Chinese involvement means African governments and firms have less ownership over their sustainable development. A lack of local involvement also means less indigenous knowledge for the United States to engage with for future development projects.

- *Unfair debt renegotiations*. China's debt renegotiations are notoriously secretive to avoid moral hazard among debtor governments.[64] China has used these opaque agreements to increase the Net Present Value (NPV) of loans, making recipient countries worse off in the long term.[65] According to AidData, "In the Republic of Congo, where Beijing had greater exposure and the borrower had limited leverage, China Eximbank actually increased the value of its portfolio in net present value terms by 23%."[66] More debt means African countries will continue to have high debt servicing obligations, limiting fiscal space for development. High servicing costs leave less room for U.S.-Africa collaboration.

- *China sets the conservation agenda* DFN swaps can impose unwanted projects on recipient countries.[67] Recent DFN swaps through The Nature Conservancy have involved extensive local consultation on conservation plans.[68] However, "Chinese companies that implement aid projects… rarely engage with local stakeholders such as civil society or nongovernmental organizations (NGOs)."[69] Adaptation or conservation projects from Chinese DFN swaps may not match African countries' needs.[70] Projects may instead focus on areas that allow Beijing to export its excess production capacity.[71]

- *U.S. firms unable to compete on projects*. If Chinese firms carry out DFN swap-funded programs in Africa, U.S. firms will have fewer opportunities to participate in development projects. China requires the use of Chinese firms in some BRI projects and these companies have a strong and growing presence in Africa.[72] The continued use of Chinese firms on development projects "…has the potential to displace American companies [and] set technical standards that are incompatible with U.S. products",[73] which will reduce opportunities for U.S.-Africa private sector collaboration in the future.

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Recommendations: Curbing Tangible Benefits Through Transparent and Standardized Swaps

"At this year's BRI forum, Chinese officials stated that they would push for more transparency in BRI projects. This is laudable. But transparency in international finance should not be subject only to the bilateral policies of lending nations. It should also be enforced by international institutions, like the IMF."

-Michael Bennon (Stanford University Global Infrastructure Policy Research Initiative)[74]

To prevent the adverse effects of Chinese DFN swaps in Africa the United States could employ the following strategies to limit tangible benefits:

Option One: Establishing Standardized Practices for DFN Swaps

There are currently no standards for conducting DFN swaps.[75] Unregulated swaps open the door for predatory deals, prolonged negotiations, and high transaction costs.[76] By advocating for universal practices, the United States can mitigate China's tangible benefits from DFN swaps and ensure these deals benefit recipient countries.

The United States has a unique opportunity to shape future swaps as the co-chair of the new DFN swap task force. The task force is currently focused on the scale of swaps, but the United States can use its leadership to advocate for standards.[77]

The United States should advocate for the following guidelines:

- *Standard debt reductions*. The United States can push for standards that mandate specific reductions to the NPV of debt, to ensure swaps provide real relief.

- *Engaging local stakeholders in planning*. Required consultation with local conservation NGOs and governments can ensure that DFN swaps are "in line with the debtor country's conservation goals."[78]

- *Building capacity in recipient countries*. Promoting knowledge sharing and technology transfer between countries will ensure DFN swaps build capacity in Africa. These requirements could include commitments to use local labor in management positions.

There is no guarantee that Chinese development finance institutions will join the multilateral DFN task force. However, China's recent involvement in debt relief initiatives like the Debt Servicing Suspension Initiative (DSSI) is encouraging.

Option Two: Negotiating for Transparent Swaps

Opaque swaps enable corruption and let China design DFN swaps that benefit Beijing.[79] The murkiness of these deals means "there is still no reliable list of BRI projects, no disclosure of the lending standards China follows, nor even the amount China has invested."[80] By promoting transparency, the United States can limit the coercive aspects of these deals and ensure proper evaluation and monitoring.

The United States could develop bilateral agreements with China that mandate transparency in DFN swaps. These agreements could model recommendations from organizations like Publish What You Fund, which publish guides on improving transparency in development finance.

These agreements may include commitments to:

- *Share project-level information.* Development finance institutions (DFIs) should publish detailed lists of every project each year. Published information must include descriptions of projects and historical data.[81]

- *Publish data on evaluation and monitoring.* DFIs must provide data on the predicted and actual impact of projects.[82]

- *Make data accessible.* The above information should be available to a wide audience. It should be clear and easy to analyze.[83]

The United States can leverage China's reputation to ensure compliance. If China refuses to agree to transparency standards, this will reflect poorly on China's debt forgiveness practices, limiting the positive publicity from DFN swaps.

China's aversion to reporting the specifics of its development finance means the United States should also support open-source sources for data collection. Initiatives like AidData and Boston University's CODF Database track Chinese projects globally. These sources can help the United States and its partners evaluate the effects of Chinese development finance. [84]

Conclusion

Chinese debt relief could increase the economic prospects of African countries despite the risks. DFN swaps demonstrate a shift from China's historical aversion to debt relief. With the average African government spending 17% of GDP on debt servicing, these countries have little fiscal space to focus on sustainable development.[85] Debt relief is a necessity. However, the benefits of these swaps will only come to fruition if they are designed in a way that does not damage African autonomy and U.S.-Africa relations.

The United States is already losing ground in Africa compared to China. DFN swaps could worsen this divide. China has been Africa's largest partner in trade since 2009 while U.S.-Africa trade has declined since 2008.[86] The United States needs strong ties to Africa now more than ever to ensure access to key minerals and to maintain security relationships. If the United States does not negotiate for better DFN swaps, it is handing China an opportunity to increase Chinese influence on the Continent.

The United States can preserve opportunities to engage with African countries through sustainable development by guaranteeing that DFN swaps are standard and transparent. Ensuring China cannot mandate the use of Chinese workers and firms opens opportunities for U.S. companies. Advocating for African agency within these swaps also positions the United States as a champion for low-income countries fighting climate change.

The United States needs to step up its capacity on the Continent to capitalize on increased debt sustainability in Africa. U.S. infrastructure firms are not currently competitive against Chinese ones.[87] The United States must support existing programs like Power Africa and expand the work of the Development Finance Corporation to increase its presence in African countries.[88] Together, these strategies will address gaps in U.S. policy to build strong relationships going forward.

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