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THE ROLE OF THE PARIS CLUB IN
MANAGING DEBT PROBLEMS

ALEXIS RIEFFEL



INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

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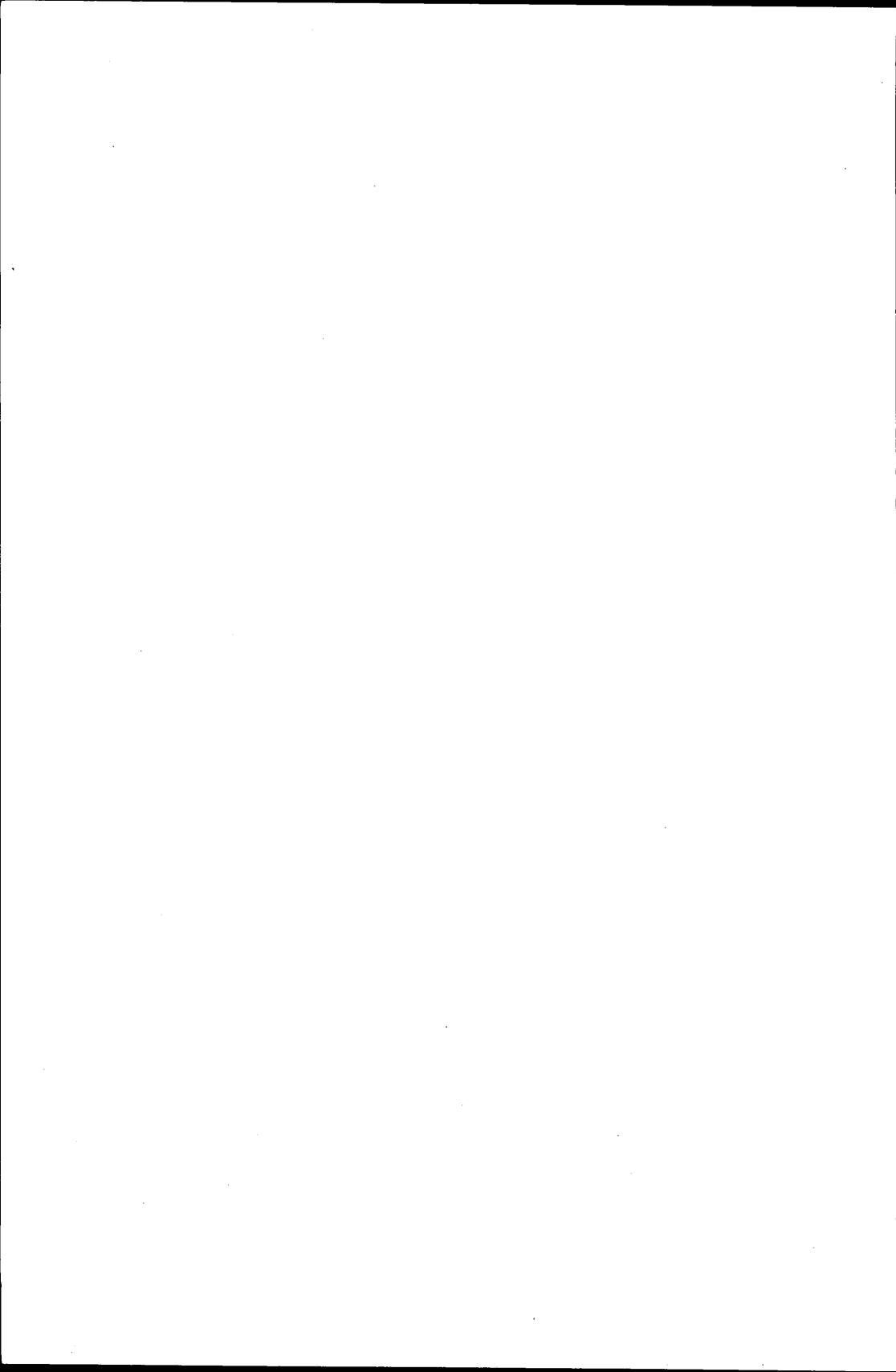
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The Role of the Paris Club in Managing Debt Problems

The world of economics and finance is full of mysteries. While many are genuine and arise from the complexity of human behavior, some appear artificially contrived by groups of players who find it convenient or advantageous to camouflage their activities from others. The Paris Club is a mystery of the second category, but less by design than by circumstance.

From 1978 to 1984, in a wave of debt crises that shattered confidence in the international financial system, twenty-nine countries appeared before the Paris Club to negotiate fifty-six debt-rescheduling agreements. Roughly \$27 billion of debt-service obligations were deferred in these negotiations. Of necessity, the Paris Club assumed a more prominent role in the world of international finance, and important steps were taken to modernize its procedures.

Profiting from a greater willingness among the creditor countries to discuss the Paris Club in public, this essay begins with a general introduction in Section 1. In Sections 2 and 3 it reviews the basic principles and procedures of rescheduling negotiations in the Paris Club as they existed and were modified in the 1978-84 period, and in Section 4 it discusses the North-South dimension of debt.

The hallmarks of the Paris Club are its efficiency and its adaptability. Compared with these virtues, its shortcomings appear trivial. Nevertheless, the Paris Club is currently wrestling with two problems that are examined in some detail in Section 5. The first is prolonged recourse to debt relief through a succession of Paris Club agreements—a phenomenon described here as “serial rescheduling.” The second is the emergence of debt-rescheduling arrangements imposed unilaterally by debtor countries, without negotiations with their creditors, that involve debt owed by private-sector borrowers—a phenomenon described here as “unilateral rescheduling.”

Finally, Section 6 looks briefly at the role of the Paris Club in the Summit strategy for managing debt problems that was adopted in 1983.

Creditors and debtors understandably have a different appreciation of the Paris Club. From a creditor-country perspective, which is my viewpoint, the instinct is to conclude that the Paris Club has been tempered by the heat of the 1978-84 period and has emerged a stronger instrument in the service of the international financial community. For others who feel that the Paris Club

Special thanks are extended to Todd Crawford, of the Treasury Department, for his many valuable suggestions.

works against the interests of debtor countries, this essay may help to persuade them that the Paris Club is better than any alternative.

1 An Introduction to the Paris Club

The procedures for resolving an international debt crisis resemble a three-ring circus. In the center ring, the government of the debtor country negotiates with the International Monetary Fund to obtain a balance-of-payments loan in return for adopting a well-defined set of economic policies designed to eliminate its payments problem. In the second ring, the debtor government negotiates with creditor governments to lighten the burden of servicing outstanding debt and to obtain new financing. In the third ring, the debtor government negotiates with private creditors for debt relief and new financing.

Paris Club negotiations are part of the activity in the second ring. London Club negotiations with commercial banks take place in the third ring. There are close links among the activities in all three rings, but some basic distinctions separate them. Among the distinctions, perhaps the most important is that debt-rescheduling negotiations are organized from the perspective of the creditors, not the debtors. Credits from official institutions are discussed in the Paris Club regardless of whether the borrower is a public-sector or private-sector entity. Credits from commercial banks are discussed in the London Club, again regardless of the borrower's status.

Of course, it is not quite as simple as this. First, many credits from private lenders carry a guarantee of repayment provided by an official agency such as the U.S. Export-Import Bank, and credits to private-sector borrowers often carry a guarantee of repayment provided by the government of the debtor country. Forget the debtor-country guarantee: it does not influence where the credit is discussed. But a guarantee from an official creditor-country agency puts the credit on the Paris Club's platter. Second, credits extended by international lending institutions such as the World Bank are traditionally exempted from rescheduling. Third, nonbank private creditors (e. g., exporters or producers—or, more generally, "suppliers") have no established forum for negotiating a debt-relief arrangement. Fourth, commercial banks will generally discuss the provision of new credits in their London Club negotiations, but official creditors have made it a matter of principle not to discuss new credits in the Paris Club.

The spontaneous and informal character of many small circuses is also found in both the Paris Club and the London Club. Contrary to the impression conveyed by many journalists, and to the expectations of most countries experiencing their first debt crisis, neither club has a fixed membership or institutional structure. Each rescheduling negotiation with official creditors

or commercial banks has an *ad hoc* character and can be considered a different "club."

In short, the Paris Club is not an international organization. It represents a set of *procedures* currently used for negotiating arrangements to defer payment obligations on credits extended or guaranteed by creditor-country government agencies to both public-sector and private-sector borrowers in debtor countries unable to meet fully their external debt obligations. The London Club represents the parallel set of procedures used for negotiating similar arrangements with respect to credits extended by commercial banks.

While neither "club" has members or a charter, their practices regarding participation are distinctive. In the Paris Club, the traditional participants (as creditors) are the governments of the major industrial countries of the West—generally speaking, the twenty-four members of the Organization for Economic Cooperation and Development (OECD). However, one of those countries (Turkey) has participated only as a debtor, and in any single rescheduling negotiation there are usually a dozen or more OECD countries that do not participate because they have not extended a significant amount of credit to the debtor country. Furthermore, other countries have participated as creditors, including Argentina, Israel, Mexico, and South Africa. In the London Club, the practice is simpler. All commercial banks that have any exposure to the debtor country participate. Smaller banks are represented by their countries' leading international lenders, which serve on a "steering committee" that negotiates with the debtor, but the negotiations are conducted on behalf of all banks.

The specific procedures of the Paris Club evolved gradually over almost thirty years. The first Paris Club rescheduling occurred in 1956 when Argentina agreed to meet in Paris with its official creditors to find a mutually acceptable basis for rescheduling payments due on officially supported export credits. Argentina returned twice, and Brazil, Chile, and Turkey together went to Paris five times in the late 1950s and early 1960s to obtain debt relief on obligations to governments, because the creditors had been overzealous in promoting exports to these rapidly modernizing countries. There were no parallel London Club negotiations, because commercial banks were not major creditors; the short-term trade credit that they did provide was not generally considered to have contributed to the countries' debt crises.

An aberration occurred in the late 1960s when creditor governments experimented with the use of debt relief as a form of development assistance. India and Pakistan, in particular, sought the rescheduling of aid loans to ease balance-of-payments strains. Several debt-rescheduling arrangements were negotiated, but these are not considered Paris Club agreements because neither country was in a position of "imminent default" and the granting of debt

relief was not tied to IMF "conditionality." Again, commercial banks were not significant creditors and there were no London Club negotiations.

The debt-relief negotiations with Indonesia and Ghana in the early 1970s did qualify as Paris Club negotiations, even though the terms were highly concessional, because both countries were in default and had negotiated standby arrangements with the IMF. In each of these cases, external borrowing had mushroomed even as the productive capacity of the country's economy deteriorated. Debt relief on terms similar to those granted in the past would have imposed payment obligations exceeding the countries' ability to generate foreign exchange. Encouraged by political reversals which brought to power governments that were committed to developing market-oriented economies, the creditors granted Indonesia and Ghana exceptionally long repayment periods and favorable interest rates on the rescheduled debt. These cases illustrate the degree of flexibility possible in a Paris Club rescheduling, and they have been recalled with increasing frequency since 1981. Once again, commercial banks were not involved in either case because they were not significant creditors.

The mid-1970s constituted a period of transition. Commercial banks had to provide debt relief in an organized fashion for the first time (Zaire), and the London Club emerged as the standard rescheduling procedure for these creditors. Other noteworthy developments during this period were the first serious North-South negotiations on debt and the first signs of an epidemic of debt problems in Africa.

At the beginning of 1978, the Paris Club was a well-tested instrument with a respectable record; it had concluded twenty-six separate negotiations with twelve different countries over twenty-two years. The 1978-84 period tempered but did not change the instrument in any fundamental way, even though the Paris Club concluded more than twice as many agreements (fifty-six) in those seven years as in its first twenty-two. However, the frequency of rescheduling has not slackened, and some countries appear to have become dependent upon debt relief. Is there a basic flaw in the Paris Club approach? Would some of the alternative approaches proposed in recent years have been more effective? The discussion that follows answers "No" to both questions, but it points out several weaknesses in existing arrangements.¹

2 Principles of the Paris Club

Imminent default, conditionality, and burden sharing are the three fundamental principles of Paris Club rescheduling. Additional principles, or "basic concepts," can be found in other accounts or in the UNCTAD resolution on

¹ A more comprehensive discussion of rescheduling cases in the 1975-83 period can be found in Brau, Williams, *et al.*, 1983.

debt problems of developing countries adopted in 1980 (see section 4 below). They either follow logically from these three or are distinctly less important.

The First Principle: Imminent Default

Compared with devaluing or cutting back imports or diverting more local products to export markets, debt relief is an attractive option to a government facing balance-of-payments difficulties. Consequently, requests for debt relief are addressed to creditor countries with some frequency. The principle of imminent default is the main defense erected by creditors against capricious requests for debt relief. Creditor governments will not entertain a request for debt relief unless there is evidence that the debtor country will default on its external payments in the absence of such relief. The existence of substantial external payments arrears is generally regarded as sufficient evidence that the imminent-default criterion has been met.

Analytically, the test of imminent default is the existence of an *ex ante* financing gap. The techniques for measuring this gap improved considerably in the 1978-84 period and now form an important element in the preparation for Paris Club negotiations and the negotiations themselves. The starting point is usually the IMF's balance-of-payments projection for the debtor country for the coming year. The various components are rearranged in terms of sources and uses of foreign exchange. If projected uses exceed sources, this constitutes *prima facie* evidence that a situation of imminent default exists. Use of the IMF's projections avoids haggling over whether sources could be higher and uses lower, because the IMF's projections are deemed to reflect an objective assessment of the outlook in the context of the best politically feasible policy mix.

The accompanying table contains an example of a sources-uses calculation used by the U.S. government in preparation for the 1978 rescheduling negotiation with Peru. The individual items correspond to a projection found in the staff paper prepared for the IMF Executive Board describing the proposed standby arrangement with Peru. In contrast to the presentation normally used by the IMF, interest payments are grouped with principal payments rather than other current-account items, and both gross loan disbursements and repayments are shown rather than simply net disbursements. Also, where the creditors' estimates of disbursements and repayments diverge significantly, these are substituted for the estimates of the IMF. (Divergences occurred with disturbing frequency in the 1978-84 period.)

There was only one case in the 1978-84 period when debt relief was granted by official creditors in the absence of imminent default. The Pakistan rescheduling of 1981 was a throwback to the "aid" reschedulings of the late 1960s. During 1980, following the Soviet invasion of Afghanistan, Pakistan's Western creditors were anxious to strengthen Pakistan's stumbling economy.

PERU: PROJECTED SOURCES AND USES OF FOREIGN EXCHANGE, 1979
(in millions of dollars)

	<i>Sources</i>	<i>Uses</i>
Exports	\$2,380	...
Imports	...	\$1,910
Investment income (excluding debt service)	10	130
Other nondebt services (net)	...	10
Transfers (net)	60	...
Loan disbursements	900	...
Investment (net)		20
Short-term capital, errors and omissions (net)	...	80
IMF (net)	10	...
Swap repayment		60
Reserve increase	...	180
	<u>\$3,360</u>	<u>\$2,390</u>
Balance before debt service	\$ 970	...
Debt service:		
Bilateral official creditors:		
Principal		\$ 335
Interest		200
Commercial banks:		
Principal		390
Interest		300
Multilateral and others		
Principal		315
Interest		60
		<u>\$1,600</u>
Financial gap		\$ 630

NOTE: The financial gap is more than closed by 90 percent relief on principal payments owed to bilateral official creditors and commercial banks.

Although some creditors were prepared to participate in a Paris Club negotiation despite the absence of a situation of imminent default, others (including the United States) argued successfully that a different "venue" should be found to preserve the integrity of the Paris Club process. The eventual solution was to negotiate debt relief in the framework of the World Bank-led aid consortium for Pakistan, which happened to be the forum used for the debt-relief negotiations with Pakistan in the late 1960s. The concern over the pre-

cedent created by this "political" use of debt relief is reflected in the fact that U.S. participation in the negotiations required a presidential decision.

The case of Peru can be used to illustrate some complications with the application of the principle of imminent default. Thanks partly to the individuals who happened to be representing creditor countries in Paris Club negotiations at the time, there was a spirit of experimentation early in the 1978-84 period. One of the notable innovations was to grant debt relief to Peru on two years of payments (1979 and 1980) rather than the standard one year. This was a contentious innovation, with opponents arguing that it would violate the principle of imminent default since there was some evidence that Peru would be able to meet all its payment obligations in the second year. The eventual compromise was to make the second year of relief conditional upon a subsequent standby arrangement with the IMF, in which an *ex ante* financing gap was identified for that year.

To the astonishment of many, Peru's balance-of-payments situation improved so dramatically during the course of 1979 that it decided to forego the relief offered for 1980 by both official and commercial-bank creditors. This is the only case of a country giving back debt relief granted in the Paris Club. One effect was to harden the position of those who had argued against a two-year rescheduling. Another effect was to leave the creditors with a singular fondness for Peru that manifested itself in an unusually generous rescheduling arrangement five years later. Unfortunately, the creditors' favorable predisposition toward Peru was not validated by Peru's performance under its 1983 Paris Club agreement.

The Second Principle: Conditionality

Having established the debtor country's need for debt relief, the creditors' next concern is to make sure that the country quickly regains its ability to service external debts fully and on schedule. Naturally, they begin by looking for the causes of the country's debt problem and asking that steps be taken to eliminate these causes.

This natural reaction was reinforced by the creditors' experience with debt rescheduling in the 1978-84 period. A major lesson learned was the importance of requiring the debtor country to implement a sound package of economic policies. The lesson is epitomized in the view that debt relief does not solve debt problems: good policies do.

At the beginning of the 1978-84 period, numerous creditor-country negotiators were inclined to believe that the debt problems being addressed were largely beyond the control of the debtor countries and would disappear once debt relief was granted on the appropriate terms. By the end of 1984, the opposite sentiment was equally prevalent: with the benefit of even the most

generous rescheduling terms, certain debtor countries would probably remain uncreditworthy. The shift in mood, however, had remarkably little impact on the terms offered. The terms tended to reflect, more than anything else, the debtor country's ability to service debt in the next year or two and the creditors' desire to avoid precedents for more generous rescheduling terms.

The experience of the 1978-84 period also served to highlight a large contradiction at the heart of the Paris Club process. Creditors should reward far-reaching measures that lead to a rapid restoration of creditworthiness by offering more generous terms. Yet the stronger the corrective measures taken by a debtor country, the less relief is needed. Thus, creditors cannot reward good policies without violating the first principle. They cannot give relief that is not needed.

Creditors could negotiate with a debtor country to obtain the required policy reforms, but they have found a much simpler and politically safer device. As a precondition to Paris Club negotiations, the creditors insist that the debtor country conclude a standby arrangement with the International Monetary Fund.

IMF conditionality is absolutely central to the Paris Club process, because, more than any other factor, it determines the success or failure of the debt-relief operation. At the same time, it can be a weak point in the process, because the creditors are at the mercy of whatever accommodation is reached between the IMF and the debtor country.

The practical problem associated with obtaining conditionality by proxy through the IMF becomes a "chicken or egg" dilemma. Before concluding a standby arrangement with the debtor country, the IMF staff would like to know how much debt relief the creditors plan to provide so that it can assure the IMF Executive Board that the arrangement is viable, that is, that there will be no financing gap after allowing for debt relief and IMF drawings. The creditors, however, want to see the standby before they negotiate, because the policy commitments in the standby and the related balance-of-payment projections influence the amount of debt relief they are willing to offer.

This tug-of-war became acute in the 1978-84 period but was handled quite pragmatically in cases as different as those of Brazil (1983) and Sudan (1982-84).

In the case of Brazil, as with Mexico, the IMF played a major role in determining the amount of debt relief that would be required during the standby period. It was forced to do this because of the very large amounts of debt service due to commercial banks, the importance the banks attached to remaining current on interest payments, and the banks' reluctance to provide net new financing. The Fund managed its role successfully by consulting extensively with both official and private creditors during its negotiations with Brazil. In

effect, the debt-relief terms were pre-negotiated via the IMF and were subsequently confirmed formally in the Paris and London Clubs.

In the case of the last three rescheduling agreements with Sudan, a different approach could be taken because commercial banks were not major creditors and official creditors have more flexibility than banks in rescheduling interest and extending new credits. To simplify a bit, the Fund staff negotiated standby's with Sudan and submitted them to the IMF Executive Board for *provisional* approval. The standby's did not go into effect (Sudan was unable to draw on the IMF) until negotiations with its creditors yielded a combination of debt relief and new money that eliminated the *ex ante* financing gaps specified in the standby's. These financing gaps were so large that even 100 percent debt relief (i. e., the deferral of all obligations, including interest payments) would have left sizable gaps. Since official creditors will not negotiate new money arrangements in the Paris Club, the IMF organized a special pledging session for balance-of-payments assistance to Sudan.

As noted above, the 1978 Paris Club agreement with Peru was for two years of debt relief, the second year linked to the conclusion of an IMF standby arrangement covering that year. "One-plus-one" agreements of this kind, with the IMF playing a key role, were subsequently negotiated with Togo, Turkey, Sudan, Sierra Leone, Zaire, and Liberia. (The 1980 agreement with Turkey was for three years; the others were for two.) With the exception of the Peruvian and Turkish agreements, all of these extended agreements broke down. The countries were either unable to conclude a follow-on IMF arrangement or quickly fell out of compliance with it. The creditors found themselves in a very awkward situation. Following the letter of the Paris Club agreements, the second year's relief should have been withdrawn. In each case, however, the debtor's balance-of-payments situation was very weak and there was no chance of getting paid what was due. These experiences soured the creditors on extended debt-relief agreements. Nevertheless, in response to a Summit-level political commitment, they concluded a "multi-year" rescheduling agreement with Ecuador in 1985. At the same time, considerable efforts were made to ensure that this agreement would be more successful than the extended arrangements negotiated in the 1978-81 period. The circumstances surrounding this case are discussed below in section 6.

Finally, in three cases IMF conditionality was not possible because the debtor countries were not members of the IMF: Poland, Cuba, and Mozambique. Since the creditors could not tie debt relief to an IMF standby, they negotiated directly with the debtors over policy reforms. In each case, a small task force of creditor-country experts was formed to visit the debtor country, evaluate the nature of its debt problem, and identify the measures to be taken to overcome it. The most difficult part of this process was trying to decide whether debt relief for these countries should be linked to meaningful re-

forms or to a set of quantitative "performance criteria" of the sort found in IMF standby agreements, such as the budget deficit, the exchange rate, the level of foreign borrowing, or the size of foreign-exchange reserves. In the end, the pragmatists prevailed, arguing that the statistical base was too weak or too easy to manipulate and that the traditional performance indicators were less meaningful in centrally planned economies. Thus these agreements conformed more to the form than the substance of the conditionality principle. There were occasionally intense negotiations over specific economic and financial targets, but without much expectation that the allocation of resources or the structure of incentives in the debtor country would change significantly.

The case of Poland was one of the most problematical for Paris Club creditors, especially because commercial banks negotiated rescheduling arrangements without any conditionality and left little foreign exchange for official creditors. Mozambique became a member of the IMF in September 1984, and it will therefore be possible for official creditors to obtain IMF conditionality in subsequent rounds of rescheduling in the Paris Club. Cuba stands out as the case in which the good faith of the debtor in undertaking reforms has been most in doubt, in spite of its good performance in meeting its revised debt-service schedule.

The Third Principle: Burden Sharing

The principle itself is simple: all creditors must provide relief that is commensurate with their exposure to the debtor country. The application of the principle, however, is one of the most complicated aspects of Paris Club negotiations.

There are four broad categories of creditor to consider, each one trying to get the best deal possible: (a) multilateral lending institutions, (b) official creditors participating in the Paris Club negotiations, (c) official creditors *not* participating in those negotiations, and (d) private creditors, notably commercial banks.

Multilateral lending institutions. As of the end of 1984, the multilateral lending institutions were the only category that had clearly established a preferential claim on the foreign-exchange resources of a country seeking debt relief. The category included the IMF, the World Bank, and the Asian, African, and Inter-American development banks, as well as certain other institutions such as the European Investment Bank and the OPEC Special Fund.

The arguments for exempting multilateral institutions from rescheduling are twofold. The first is that the debtor country as well as the creditor countries are members of the institutions and therefore both benefit from the exemption. The second is that the institutions bear their share of the burden of relief by continuing to lend to the debtor country.