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Clubbing in Paris: Is Debt Sustainability an Illusion?

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I Introduction

Official debt restructuring poses numerous challenges. The challenge for the international community is to maintain the sanctity of loan contracts and contractual obligations, while at the same time strengthening arrangements for crisis prevention. This task requires timely action and mechanisms to address short-term liquidity constraints to prevent their escalation into unsustainable debt and at the same time provide a lasting solution to those debtors who are facing long-term debt sustainability problems. The arrangements have to be designed in a way that the level of debt stocks and the ensuing debt servicing is guided by the principle of ability to pay, thereby ensuring that debt servicing does not divert resources from growth and poverty reduction. In addition, it is desirable that such a restructuring mechanism functions according to the principles of neutral arbitration and assessment, transparency, adequate representation of debtors and creditors, efficiency and symmetry between creditor groups.

The Paris Club[1], whose secretariat is housed in the French treasury in Paris, has functioned as informal official debt restructuring machinery since 1956. Its membership comprises the OECD countries and the Bretton Woods institutions, with the IMF playing a significant role. The institution has evolved over time and is currently facing new

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* The views expressed are those of the author and do not necessarily represent the views of the Financing for Development Office, Department of Economic and Social Affairs of the United Nations

[1] The 19 Paris Club permanent members are governments with large claims on various other governments throughout the world (the claims may be held directly by the government or through its appropriate institutions). The following countries are permanent Paris Club members: Austria, Australia, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, the Netherlands, Norway, Russian Federation, Spain, Sweden, Switzerland, United Kingdom and United States of America. Russia is the only non-OECD country that is a member. Other creditor countries have been invited to participate in negotiations with individual countries where they have sizeable exposures.

challenges. A new debate is emerging on the reform of the official debt restructuring mechanism as a result of dynamic changes in the world economy where some developing countries have witnessed unprecedented growth. A direct consequence of this is the increase in contributions by developing countries in funding development in the South.[2] An emerging issue is the gap in debt restructuring architecture as regards the incorporation of new providers of development finance into official debt restructuring. Statements made in the General Assembly’s informal review of the Monterrey consensus chapter on external debt in March 2008 reflect the view that developing country providers of development finance are un-willing to join the Paris Club as its modalities and rules were not reached in a transparent multi-lateral process. They propose setting up a multi-lateral International Debt Commission.

In addition, the growing importance of private debt in total external debt poses new challenges for the Paris Club, which requires its debtors to seek comparable treatment from other creditors, including private creditors. Strains are visible in implementing this principle as debtors are handicapped by the lack of legal status of Paris Club agreements. Apart from moral suasion and relationship based outcomes, the legal basis for private and official non-Paris Club creditors to provide treatment comparable to that of the Paris Club is weak and non-binding.

The present architecture has also shown signs of strain as some debtor countries are caught in a process of serial rescheduling of official debt owed to Paris Club creditors. An unpacking of this issue involves some understanding of the complex relationship between the IMF, Paris Club and debtors. It is also necessary to assess whether the IMF’s role in official debt restructuring is neutral as a broker between debtors and creditors. There are also issues related to transparency and efficiency of the machinery. The ongoing process on the Review of the Monterrey Consensus on Financing for Development provides an excellent opportunity to evaluate the successes and failures of the existing machinery and agree on a universally accepted approach to debt restructuring.

[2] The Paris Club Secretariat and the Bretton Woods Institutions labeled creditors from the South “free-riders,” riding free on the borrowing space provided by debt relief through the HIPC and MDRI initiatives. With growing opposition from the South to these attacks, references to “free rider” have gone down.

This discussion brief on official debt restructuring is based on the author's on-going research on the Paris Club. The objective is to highlight some issues which merit further discussion and research in evaluating the Club's role and success as an ad hoc official debt restructuring machinery. It is intended to kick off a forward looking discussion on possible ways to improve official debt restructuring, by building-up on its

Debt Commission to ensure speedy and fair debt relief, was put also forward but ended in failure for the G77 as the advanced countries resisted this proposal. However, discussions at UNCTAD played a role in institutionalizing the Paris Club, and agreement was nevertheless reached to codify the principles and procedures that had guided the Paris Club negotiations during its first twenty years in a UN resolution. As a part of this North-South Dialogue the Paris Club secretariat agreed to invite the Secretary General of UNCTAD to send an observer to participate in such meetings on the same basis and terms as the representatives of other international organizations.[6]

By the 1980s the Paris Club members saw the futility of providing relief through rescheduling payments for low income countries and it began to negotiate debt reduction agreements with some of these countries. The number of agreements went up dramatically in the 1980s[7]. The treatment accorded was insufficient to deal with the debt overhang in these countries and in the late 1990s eligible[8] low-income countries were granted debt stock relief under the HIPC initiative. The IMF maintained a “preferred creditor status” until the launch of the Multi-lateral debt relief initiative (MDRI) in 2005 under which 100 percent of the eligible owed by HIPC completion point countries’ debt to IMF, IDA and AfDB could be written-off. Non-HIPC countries continued to receive flow treatment at the Paris Club.[9] As regards the middle income countries and upper middle income countries, the Paris Club did not engage in debt reduction[10] but began to apply the principle of burden sharing (comparability of treatment between official and private sector debt relief) more broadly and unilaterally to force bondholders to reduce their claims on individual countries. In effect, the G-7(8) used the Paris Club for cutting back public resources required to resolve financial crisis in non-HIPCs by increasing the losses absorbed by bond holders.

[6] Trade and Development Board Resolution 132 (XV) 15 August 1975.
[7] See www.clubdeparis.org
[8] The eligibility criteria and the debt thresholds for entry into the HIPC and enhanced HIPC remain controversial as there was no well reasoned basis for defining the threshold levels for entry thereby excluding a number of low-income countries facing challenges in reducing poverty and freeing up resources for development.
[9] Pre-Evian approach notable politically motivated exceptions were agreements with Egypt and Poland which contained debt reduction.
[10] Barring some politically motivated debt reductions.

A second attempt was made at reform by the IMF during 2002 to establish permanent debt restructuring machinery with proposals to bring the Paris Club under the aegis of the Sovereign Debt Restructuring Mechanism (SDRM). This ended in failure not only to reform the Paris Club but also to move ahead with a Sovereign Debt Restructuring Mechanism. These discussions took place in the backdrop of the East Asian crisis which drew attention to the debt problems in some middle income countries. It led the G-8 to announce the Evian Approach[11] in 2003 which included consideration of the problems of middle income countries and the acceptance that their problems could not in each case be dealt with as a short-term liquidity problem. In addition it recognized the new reality of the dominance of private capital flows over official flows and thus stressed coordination between private and Paris Club creditors.

III The changing role of the Paris Club

Originally, rescheduling at the Paris Club was perceived to lead to an avoidance of default and debt relief was understood to be an unusual event. It was intended to be an exigent and short-term remedy to a liquidity problem and treated on merits alone without consideration of any long-term relief. It was not to be directly associated with development assistance. Over time, the Paris Club became increasingly involved with long-term debt problems and exigencies of development expenditure in low-income countries. Presently, the negotiations at the Paris Club deal with three sets of problems

1. Liquidity problems
2. Solvency problems
3. Debt relief for development expenditure

The three types of operations require assessments of debt sustainability, estimates of total financing required for development and financing gaps. The identification of the type of problem facing a country is crucial for the Paris Club terms applied and amount of debt relief granted. Although the Paris Club secretariat and its members are increasingly involved in new areas such as financing development expenditure through debt relief, there is no in-house technical capacity in the Paris Club secretariat to assess

[11] See Annex 1I for list and explanation of terms applied to Paris Club agreements.

such operations. The technical work[12] is carried out by the IMF for middle income countries[13] and by the World Bank and IMF for low-income countries though their HIPC debt sustainability framework and the joint debt sustainability framework for low income countries.[14] A country cannot reschedule its debt without a prior program with the IMF. The IMF is thus increasingly involved in mediating debt-rescheduling agreements between debtor countries and official creditors through its role in the Paris Club. The Fund's technical work in this area is of crucial significance in determining the amount of debt relief that a country can obtain and the terms of the agreement at the Paris Club.

IV The relationship between the IMF and the Paris Club

An IMF approved stabilization program indicates the IMF's "seal of approval" and makes it possible for a country to approach the Paris Club[15] and communicate its intent to negotiate. The conditionalities attached to the program signal the "credibility" of a country's reform efforts placed under IMF monitoring. It builds up the confidence of Paris Club creditors in the country's ability to meet its future obligations.

The analysis provided by the IMF in projecting a country's balance of payments and identifying the "over-all financing gap" captures the short-fall in the country's resources to meet its external obligations. The gap is expected to be met through 'exceptional financing" which includes IMF credits, bi-lateral and multi-lateral aid, expected private capital flows and resources released through the restructuring at the Paris and London club. The IMF determines the size of the "financing gap" to be met by Paris Club creditors by carrying out prior informal consultation with them to establish the gap that they would be willing to fill up through a rescheduling of debt. The amount to be deferred, the consolidation period, cut-off dates and the repayment period[16] are negotiated at the Paris Club.[17] The IMF's balance of payment projections has a bearing

[12] The staffs of the World Bank and IMF have been involved with the Paris Club since the early 1960s.
[13] The debt sustainability analysis is a model of "debt dynamics" which makes distinctions between liquidity and insolvency scenarios difficult.
[14]

on the agreements reached at the Paris Club. Thus debt relief is intricately linked to the IMF program.

In practice the Fund is not as neutral as may be desirable for a neutral assessor and arbitrator of a fair debt restructuring mechanism. It is a creditor to the same countries it supports at the Paris Club, which weakens its role as an honest broker between debtors and creditors. Moreover, the conditionality tied to the Fund's programs have come under heavy criticism and its technical work in assessing financing gaps as well as debt sustainability are not without its detractors.

IV.1 IMF as gatekeeper

The relationship between the IMF, the Paris Club and debtor countries is a complex one presenting considerable risks of conflict of interest. The IMF is a creditor to the same countries that it represents at the negotiations. It is accountable to its Board for its balance sheet: protecting its own position is therefore a paramount objective in its operations. It accompanies countries to the Paris Club to reschedule debt based on financing scenarios which are met with deferred payments to finance its own programs. New lending by bilateral donors clears arrears on debt servicing accruing on the Fund's balance sheet. In practice, the financing of Fund Programs often becomes dependent on debt relief. There is thus, no compatibility between the role of the IMF as gatekeeper for concessional resources and, on the other hand, as creditor and therefore a stakeholder in the inflow of the same resources. Lending by BWIs has often prolonged the un-sustainability of the debt burden of many countries as cases of debt overhang were dealt with as short-term balance of payments problems. This also impacted lending by bi-laterals. An Independent Evaluation Report of the Policy and Operations Evaluation Department of the Ministry of Foreign Affairs of the Netherlands in 2003 highlighted that lending practices were encouraged by the interest of the IFI's to conclude new loan agreements. While the new multilateral flows trigger bi-lateral aid, it is increasingly used to repay early IMF and other IFI credits.[18] The IMF tacitly enjoys "preferred creditor status" in debt relief operations.[19] Increasing debt burdens through this process led to a considerable build-up of arrears culminating in the HIPC initiative, which to a considerable extent was a write-off of arrears, counted as a flow of aid thereby limiting the resources released to finance development.[20]

The objective of the IMF to protect its own balance sheet thus led to myriad processes culminating in the flow back of resources to the IMF and other IFIs through bi-lateral loans and debt relief operations.[21] As a consequence of this conflict of interest, countries may fail to receive aid, not because of a lack of good policies or governance, but because their debt is not high enough. This has led to adverse selection. In practice, the IMF could not play a neutral role between debtors and creditors because the Paris Club agreements are intricately tied to financing of its own programs.

IV.2 Over optimistic forecasts

In addition to the issue of conflict of interest, the technical work underlying IMF programs in making balance of payments projections has come under scrutiny. These assessments are static and do not take alternative financing scenarios and policies into account. Moreover, since multi-lateral surveillance has a strong country orientation, the impact of polices of the industrialized countries on global interest rates, commodity prices, etc. are not factored into these assessments. The significance of commodity price shocks and international interest rates, amongst other factors, are important explanatory variables accounting for default on external payments.

It has been established that the IMF's analytical work often yielded over-optimistic expectations of a country's performance. Its forecasts of growth, expected capital flows, and export earnings resulted in an overstated case of th with conditionality fed a rich array of literature and international debate in the 1980s and 1990s. In view of the heightened cr

funding while facilitating access to finance required by these countries to achieve the Millennium Development Goals.

IDA allocations are based on a performance based evaluation system and per capita income in this framework. The DSF selects three debt ratios to judge debt sustainability. These are the ratio of presen

taking cyclicality of capital flows and ability to pay into account. The analysis requires inclusion of both, the cost of funds, as well as the return on their use, so that the level of debt is growth enhancing rather than a hindrance to development. It is difficult to distinguish between liquidity and solvency issues and we will perhaps never reach that goal but further improvements may be necessary, both as a tool of crisis prevention and for deciding on the type of treatment a country needs at the time of debt restructuring.

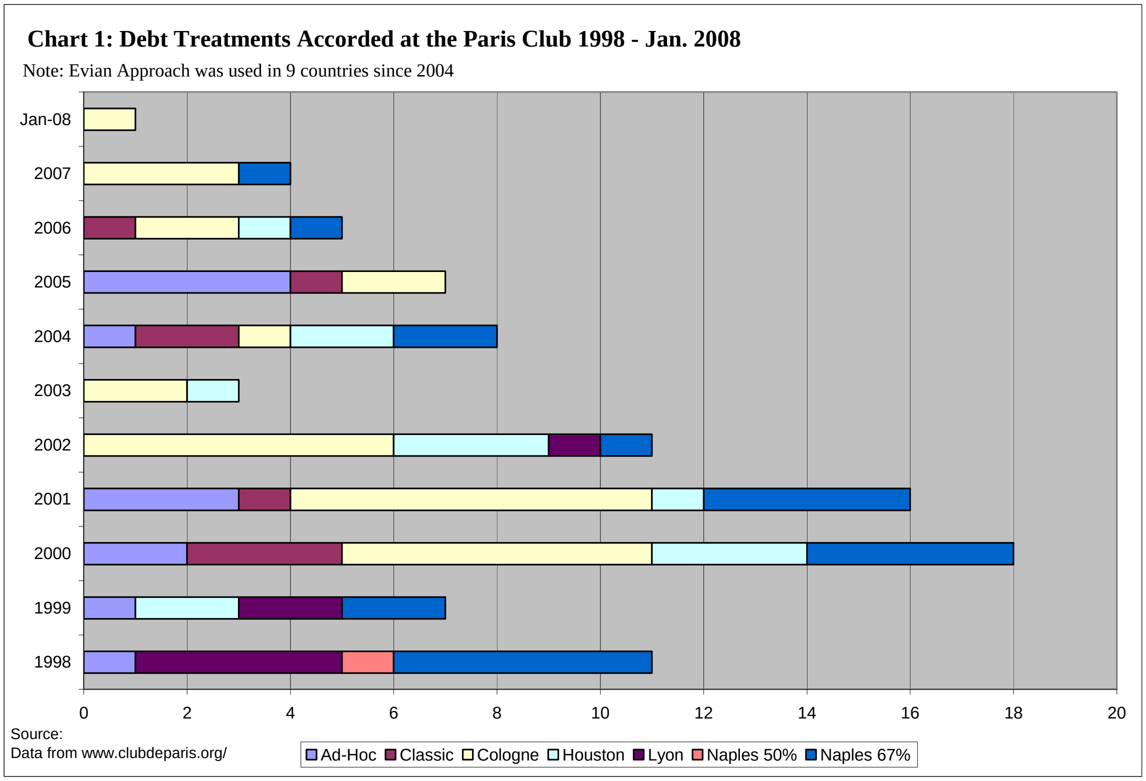
V. Issues in Paris Club debt restructuring

The assessment of the efficiency of the Paris club in dealing with debt repayment problems guided by debt sustainability considerations is now inseparable from the new overriding objective of financing development expenditure, the latter in many cases becoming a necessity because of the inadequate treatment of the former. Although debtors have often been blamed for irresponsible borrowing, the financial architecture for debt restructuring may itself have contributed to debt distress in countries through serial rescheduling, because very often an unsustainable debt problem was treated like a short-term liquidity constraint and contributed to the ensuing debt over-hang in some low-income and middle income countries. At the Paris Club, the negotiations and the terms of the agreement that were intended to keep countries on a short leash proved self-defeating, given the number of times several countries came back to the club for a rescheduling. In the case of low-income countries, recognition of this in some selected countries led to eligible debt stocks written-off under the HIPC initiative as high debt burdens was a serious impediment in poverty reduction in these countries. The relatively new Evian approach constitutes political acceptance by the members of the Paris Club that serial rescheduling is futile and that debt in deserving middle income countries needs to be written off too, although the approach is still in its infancy.[25] Other issues relate to the lack of transparency and the informal basis for comparable treatment with the private sector.

What criteria would one adopt to judge the success of the Paris Club? One option would be to assess if debt relief was followed by a permanent exit from the Paris Club.

[25] See the discussion on assessing debt sustainability for the difficulty in utilizing present approaches to the principles outlined in the Evian approach.

Chart 1 below captures the business activities of the Paris Club in the period 1998-Jan.2008 and the treatment



accorded in debt negotiations. The number of Cologne terms agreements show HIPC debt write-offs have been an important part of business activity at the Paris Club. Debt service forgiveness in the case of Naples terms and flow treatment of debt service to defer payments in the future under classic and Housn-s.7ny non( )Tj3(ebt)19.36 -70.68 TD.0005 Tc.2173

V.1 Serial Rescheduling

In recent years a favorable international environment and developments in domestic bond markets has led to agreements in 2007 for three countries, Peru, Jordan and Gabon, to pre-pay agreed amounts of their debt to their Paris Club creditors. These countries have undergone serial rescheduling at the Paris Club alongside many others as shown in table 1. In order to assess the success of Paris Club efforts, it is useful to understand how they got into serial rescheduling in the first place.

Serial rescheduling is a term applied to countries that come often to the Paris Club. The original objective of the Club to enter into debt rescheduling only in exceptional cases did not work in practice. Why did countries come frequently to the Paris Club? This section focuses on the structure of the restructuring machinery in order to provide an explanation for serial re-scheduling and the pile up in the stock of debt in some countries. The objective is to understand the factors behind serial rescheduling in order to design an improved framework for official debt restructuring. It is recognized that the external environment, commodity prices and growth performance amongst other factors play a role in determining a country's ability to service its debt, but the focus of analysis here is to bring forth another contributory factor - the structure of the restructuring machinery

An overview of the frequency with which countries have been to the Paris Club is given below in table 1. The first point to note is that both countries which are now covered under the HIPC initiative and non-HIPC countries have undergone serial rescheduling. The frequency ranges between four and fourteen times. Does serial rescheduling present a gap in International Financial Architecture?

Table 1: Serial Rescheduling 1980-2008

	Income Classification	1980-1990	1990-2000	2000-2003	2004-2008	Total

A country either runs into liquidity or a solvency problem. In order to avert an external crisis it approaches the IMF and negotiates a new loan and signs up to an IMF program, typically a Stand-by Arrangement. Although the Stand-by Arrangement is for a year and can be extended, the conditions attached to the program deal with structural and institutional changes which are not feasible under the period of the IMF program.[28] The Paris club agrees to defer payments to the future depending on the size of financing gap that needs exceptional financing by the IMF. The consolidation period is usually very short. The agreements lead to the bunching of repayments in the future at a higher cost (negotiated in bi-lateral agreements). The problem is then compounded by the fact that the quantitative framework underlying the Fund program and negotiation at the Paris Club are based on optimistic scenarios which are not realised in practice, leading to renewed debt servicing problems and a new arrangement with the fund. This in turn leads to new cycle of rescheduling and higher levels of debt servicing. Debt stocks then rise because of new IMF credits and bi-lateral loans.[29]

The main causes of serial rescheduling are:

- Short consolidation periods to keep debtors on a short leash
- Mistakes in projections by the IMF and the difficulty of differentiating whether a problems is related to liquidity or solvency
- «Snowballing» debt because of bunching of repayments due to lower grace periods; market interest on non-ODA on new rescheduling; and new credits issued after rescheduling

Analyses provided to support debt negotiations do not include the terms of the first loan contract, and how much of the original principal and accrued interest have been repaid, and separate the cost of subsequent Paris Club rescheduling and their attendant bi-lateral agreements. A debt write-off for instance, may cover the high late fee, penalties and higher interest cost in bi-lateral agreements. The issue can be illustrated with the case

[28] The same is applicable to other IMF programs.
[29] It is ironic that developing country creditors are being called "free riders" riding free on the debt space created by debt relief when the OECD creditors themselves lent to countries they had given debt relief.

of the recent Nigerian negotiation. Odiadi (2008) reports that Nigeria borrowed $13.5 billion from an entity and has since then paid back $ 42 billion as interests and penalties, and owed the same entity $ 30 billion. The numbers cited are indicative of the cost of rescheduling to a country. Debt relief needs to separate the costs of rescheduling from the terms of the original contract. The write-offs are the creditors' share of the burden for their past mistakes in assessing the problem and the type of treatment granted which contributed to the debt build-up. But the signal that such agreements send out is that of the risk posed by the country ─ its incapacity to meet its obligations. Where private capital flows are significant it may even impact spreads and credit ratings adversely. Information is needed on all agreements and their attendant interest rates and debt stocks considered in bi-lateral agreements to evaluate the amount of the new relief granted is due to past mistakes made by the restructuring machinery.

Cases in which a country came for a rescheduling to finance a Fund Program with no apparent debt distress signals needs to be evaluated carefully. There has to be some de-linking of the intricate relationship betw session and it is not an invitee to the actual negotiation for Paris Club agreements. Representatives from the Bretton Wood institutions[30] are, however, known to be in the negotiating room[31]. Moreover, the Paris Club negotiated agreement only covers the amount of debt treated and the period of rescheduling. The all too crucial agreement on interest rates on rescheduled debt[32] are agreed individually with each creditor in bi-lateral agreements which continues to remain a highly untransparent[33] and time-consuming process,[34] with reports of some bi-lateral agreements at variable and/or quasi-market interest rates which are likely to pose additional risks to developing countries and may endanger the previously concessional element of the debt treated. There is no system in place for observers to oversee the bi-lateral process. The list of loans covered and interest rates negotiated in bi-lateral agreements are not available publicly. The interest cost of the rescheduling is important in analyzing the implications for debt sustainability and the cost of negotiation to the debtor. Although a single standardized form can avoid time consuming bi-lateral negotiations, in fifty two years of its functioning the PC has not been able to resolve the different legal systems and institutional arrangements to make this possible.

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[30] The BWIs play an important role in data reconciliation. Often discrepancies between the records of debt owed to official creditors in debt management offices in countries is at variance with the data furnished by

public sector. This is due to the difficulty of differentiating between a debt problem and the use of these approaches to cut back public resources either for funding a Fund program or dealing with crisis prevention and resolution. Moreover, the principle cannot be legally enforced as the Paris club itself does not have a legal basis. This constitutes a problem for debtors as they get engaged in protracted negotiations with creditors. Thus a timely and speedy resolution to debt distress is problematic. The requirement, however, is that timeliness and speed are essential for crisis prevention to avoid a fully blown-out debt problem. Thus the informal relationship between official and private creditors and the lack of a rules-based system for their engagement is a deterrent to an efficient debt restructuring mechanism.

VI Lessons for the future

In a globalized world where emerging market economies are now contributing roughly half of the World's GDP and many other developing countries are on a growth trajectory, strengthening multi-literalism is the only way that one can deal with financially integrated economies. A gap in financial architecture for debt restructuring is becoming apparent as all official creditors are not members of the Paris Club and the dominance of private capital flows to the developing world make consideration of private

5. A simplified process is needed so that the Paris Club negotiation and bi-lateral

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ANNEX I: List of Terminology used in Paris Club Agreements[36]

Active agreement: A Paris Club rescheduling agreement is said "active" until the date of the last repayment maturity expected by the agreement. Over this date, maturities expected by the agreement were, in theory, repaid.

Agreed Minutes: Participating creditor countries and the debtor country usually sign an Agreed Minute at the end of a negotiation session. This is not a legally binding document, but a recommendation by the heads of delegations of Participating creditors countries to their governments to sign a bilateral agreement implementing the debt treatment. When there are only a few creditors concerned, the Paris Club agreement is exchanged through mail between the Chair of the Paris Club and the government of the debtor country, and is called "terms of reference". In some cases, the multilateral debt agreement has also been called "memorandum of understanding".

Appropriate Market Rate: An interest rate defined in a bilateral agreement implementing the Paris Club Agreed Minutes, based upon standard interest rates of the currency considered, plus a management fee. This rate may be fixed or variable and does not include a country-risk premium.

Arrears: It is a debt due and not paid as of a given date. Arrears may be late payments as well as debt due a long time before.

Bilateral Agreements: Agreements reached bilaterally between the debtor country and agencies in each of the participating creditor countries; these establish the legal basis of the debt restructuring set forth in the Agreed Minute. Bilateral agreements specify the interest rate on amounts deferred or rescheduled (moratorium interest), which is agreed bilaterally between the debtor and each creditor.

Bilateral deadline: It is the date by which all bilateral agreements must be concluded. The period for concluding bilateral agreements is now generally six to seven months from the date of the Agreed Minute.

Commercial credits: (i) Credits granted by a bank or a supplier to a debtor country for nts areguagrantted by on Appropriate
istituationoaae includdh in theclaiumtreaddh in thecoa
of the Paris Clu.(i(i)Non-ODAl credits are som)819(e)TJ9.679 0 TD.0083 Tc-.0018 Tw[imm)8.6(ts referred

Concessional Treatment, Concessionality: Concessionality can occur either through a

Debt swaps: These operations may be debt for nature, debt for aid, debt for equity swaps or other local currency debt swaps. These swaps often involve the sale of the debt by the creditor government to an investor who in turn sells the debt to the debtor government in return for shares in a local company or for local currency to be used in projects in the country. Paris Club creditors and debtors regularly conduct a reporting to the Paris Club Secretariat of the debt swaps conducted.

Decision point: In the context of the Heavily Indebted Poor Countries (HIPC initiative), at the decision point, the Executive Boards of the IMF and World Bank formally decide on a country's eligibility, and the international community commits to provide sufficient assistance by the completion point for the country to achieve debt sustainability calculated at the decision point.

Deferral: A debt treatment may defer some debt due immediately or in the near future to a later date. When a new long-term payment profile is defined, the treatment applied is not a deferral, but a reprofiling or a rescheduling.

Effectively rescheduled portion: The portion of total payments covered by the rescheduling agreement that are rescheduled or otherwise deferred until after the end of the consolidation period.

Eligible debt : Debt that may be treated in the context of a Paris Club agreement.

Exit rescheduling : An exit treatment is the last rescheduling a country normally gets from the Paris Club. The aim is that the debtor country will not need any further rescheduling and will thus not come back for negotiation to the Paris Club.

Flow treatment: A standard Paris Club agreement provides a way of tiding a debtor country through temporary balance of payments difficulties during a given period of time. This is referred to as a flow treatment, as opposed to a stock treatment.

Goodwill clause: Refers to creditors' willingness as expressed in the Agreed Minute to meet to consider a further debt rescheduling in the future, subject to fulfillment t the debtor country of certain specified conditions.

Grace period and maturity: Paris Club Agreed Minutes specify the first and last payment dates, but do not refer to the length of the grace period or to the maturity, In this paper, grace periods and maturity on rescheduled current maturities are counted from the end of the consolidation period. In the case of the rescheduling of arrears and late interest on arrears, they are measured from the beginning of the consolidation period.

Initiative clause: The standard undertaking in the Agreed Minute that the debtor country will seek to restructure debts owed **to other creditors on terms comparable to those outlined in the Agreed Minute.** This clause appears as one of the general recommendations and reads:

In order to secure comparable treatment of public and private external creditors on their debts, the Delegation of (debtor country) stated that their Government will seek to secure from external creditors, including banks and suppliers, rescheduling or refinancing arrangements on terms comparable to those set forth in this Agreed Minute for credits of comparable maturity, making sure to avoid inequality between different categories of creditors.

Late interest: Interest that accrues on arrears. The late interest rate usually includes the original interest rate of the credits, plus a penalty.

Local currency clause: It refers to a provision in the Agreed Minute (normally in cases where private debt is rescheduled) whereby the debtor country undertakes to establish or extend the necessary mechanisms to ensure that debtors other than the Government can make into the central bank or other appropriate institutions the local currency counterpart payments corresponding on the due dates.

Moratorium interest, Interest on the consolidation: Interest rate applied on the rescheduling. The interest rate and the conditions applying to the claims of Paris Club creditor countries are defined in bilateral agreements.

Most-favored-nation clause: The standard undertaking in the Agreed Minute whereby the debtor country agrees not to accord to creditor countries that did not participate in the multilateral agreement repayment terms more favorable than those accorded to the participating creditor countries for the consolidation of debts of comparable term.

Multiyear rescheduling agreement (MYRA): Agreements that granted by official creditors, that cover consolid

Stock treatment: As opposed to standard flow treatments, some Paris Club treatments apply not only to the payments falling due in a particular period of time, but to the whole stock of debt from which those payments fall due. The intention of any agreement which deals with the stock of debt in this way is to provide a country with a final treatment by the Paris Club called an exit rescheduling.

Terms of reference: When there are only a few creditors concerned in a debt treatment, the Paris Club agreement is not an Agreed Minute, but "terms of reference". The terms of the treatment are defined through an exchange of letters between the President of the Paris Club and the government of the debtor country.

Topping-up: In a subsequent debt reduction, granting more debt reduction on debt the Paris Club previously reduced to provide even further debt relief (e.g., when increasing the cancellation level from 33.33% of Toronto terms to 67% of Naples terms).

Transfer clause: A provision in the Agreed Minute that commits the debtor government to guarantee the immediate are unrestricted transfer of foreign exchange in all cases where the private sector pays the local currency counterpart for servicing its debt to Paris Club creditors.

ANNEX II: Standard Terms of Treatment[37]

Paris Club treatments are defined individually, by consensus of all creditor countries.

3. **Description:** Credits (whether ODA or non-ODA) are rescheduled at the appropriate market rate with a repayment profile negotiated on a case-by-case basis.

Cologne Terms:

1. **History:** In November 1999, the Paris Club creditor countries, accepted to raise the level of cancellation for the poorest countries up to 90% or more if necessary in the framework of the HIPC initiative. As of today, 28 countries have benefited from the Cologne terms.
2. **Eligibility:** To qualify for these terms, debtor countries must be eligible for Naples terms and: **(i)** have a sound track record with the Paris Club and continuing strong economic adjustment; **(ii)** have been declared eligible to the enhanced HIPC Initiative by the boards of the IMF and the World Bank.
   The level of debt cancellation required to achieve debt sustainability from each creditor is calculated by the international financial institutions based creditors' relative exposure in net present value terms of total external debt, as defined under the framework of the HIPC initiative. The Paris Club provides its share of the debt reduction needed to achieve debt sustainability on the understanding that all other creditors (public, private and multilateral) also make a consistent contribution to the common objective of debt sustainability.
3. **Description:**
   3.1. **Non-ODA** credits are cancelled up to a 90% level or more if necessary in the context of the HIPC initiative (including topping-up). The outstanding part is rescheduled at the appropriate market rate according to standard table "A1" (23 years with a 6-year grace and progressive repayment period).
   3.2. **ODA** credits are rescheduled at an interest rate at least as favourable as the original concessional interest rate applying to these loans, according to standard table "D2" (40 years with 16-year grace and progressive repayment). This rescheduling results in a reduction of the net present value of the claims. The reduction in the NPV varies from one country to another, depending on the original interest rate of the claims. By contrast, the Paris Club rescheduling has a

<u>Houston Terms:</u>

1. **History:** In September 1990, Paris Club creditors agreed to implement a new treatment of the debt of the lower middle-income countries. This new treatment called " Houston terms " grant three substantial enhancements with respect to classic terms, that can be implemented on a case by case basis:

    - **Non-ODA** repayment periods are lengthened to or beyond 15 years and ODA repayment periods are lengthened up to 20 years with a maximum of 10-year grace;
    - **ODA** credits are rescheduled at a concessional rate;
    - **Debt swaps** can be conducted on a bilateral and voluntary basis.

    As of June 2007, 20 countries have benefited from the Houston terms.
2. **Eligibility: (i)** low level of income (GDP per capita smaller than $2995), **(ii)** high indebtedness (defined as reaching at least two of the following three criteria: debt to GDP higher than 50%, debt to exports higher than 275%, scheduled debt service over exports higher than 30%); **(iii)** have a stock of official bilateral debt of at least 150% of private debt.
3. **Description :**

    3.1. **Non-ODA** credits are rescheduled at the appropriate market rate over around 15 years with 2-3 years grace and progressive payments raising year by year. In the past, some Houston terms reschedulings were made over 15 years with 8 year grace and equal payments each year.

    3.2. **ODA** credits are rescheduled at an interest rate at least as favourable as the original concessional interest rate applying to these loans, over 20 years with a maximum 10-year grace. This rescheduling usually results in a reduction of the net present value of the claims, as the original concessional rate is smaller than the appropriate market rate. The Paris Club rescheduling has a positive effect on the expected value of the ODA claims, as the creditors salvage value relative to the recovery of otherwise defaulted amounts.

    3.3. Houston terms also include the possibility for creditor countries to conduct, on a bilateral and voluntary basis, **debt swaps** with the debtor country. Debt swap operations may in principle be carried out without limit on official development assistance (ODA) loans, and up to 20% of the outstanding amount or 15-30 million SDR for non-ODA credits. Paris Club creditors and debtors regularly conduct a reporting to the Paris Club Secretariat of the debt swaps conducted.

<u>Napples Terms</u>:

1. **History:** In December, 1994, Paris Club creditors agreed to implement a new treatment on the debt of the poorest countries. These new terms, called "Naples terms", grant two substantial enhancements with respect to London terms, that can be implemented on a case by case basis, on the level of reduction and the conditions of treatment of the debt:

    - for the poorest and most indebted countries, the level of cancellation is at least 50% and can be raised to 67% of eligible non-ODA credits. Creditors agreed in September 1999 that all Naples terms treatments would carry a 67% debt reduction;

- stock treatments may be implemented, on a case-by-case basis, for countries having established a satisfactory track record with both the Paris Club and IMF and for which there is sufficient confidence in their ability to respect the debt agreement.

As of today, 35 countries have benefited from Naples terms.

2. **Eligibility:** Eligibility for the Naples terms is assessed on a case-by-case basis, taking into account the track record of the debtor country with the Paris Club and the IMF and of various criteria, including having a high level of indebtedness, being only eligible for IDA financing from the World Bank, and having a low GDP-per-capita (755 $ or less).
3. **Description:**

3.1. **Non-ODA** credits are cancelled to a 67% level (after possible topping-up). Creditors may chose to implement the 67% debt reduction by one of the two following options:

- "**Debt Reduction Option**" ("DR"): 67% of the claims treated are cancelled (after possible topping-up), the outstanding part being rescheduled at the appropriate market rate according to standard table "A1" (23 years repayment period with a 6-year grace and progressive payments);
- "**Debt Service Reduction Option**" ("DSR"): the claims treated are rescheduled at a reduced interest rate according to standard table "A3" (33 years repayment period with progressive payments). In case of stock treatment, table A3 is replaced by standard table "A5".

Two other options were also designed, but have been very seldom used:

- the "**Capitalisation Of Moratorium Interest**" ("CMI") option, similar to the "DSR" option (with a reduction of 67% in net present value) but with slightly different repayment profiles;
- the "**Commercial Option**", with longer repayment profiles but no reduction of the claims in net present value. It was agreed that creditors would refrain from using this option to very exceptional circumstances.

3.2. **ODA credits**, are rescheduled at an interest rate at least as favourable as the original concessional interest rate applying to these loans, according to standard table "D2" (40 years with 16-year grace and progressive repayment). This rescheduling results in a reduction of the net present value of the claims, as the original concessional rate is smaller than the appropriate market rate. The reduction in the net present value varies from one country to another, depending on the original interest rate of the claims. By contrast, the Paris Club rescheduling has a positive effect on the expected value of the ODA claims, as the creditors salvage value relative to the recovery of otherwise defaulted amounts.

3.3. Naples terms also include the possibility for creditor countries to conduct, on a bilateral and voluntary basis, **debt swaps** with the debtor country.

These swap operations may in principle be carried out without limit on official development assistance loans (ODA), and up to 20% of the outstanding amount or 15 up to 30 million SDR for non-ODA credits.

Paris Club creditors and debtors regularly conduct a reporting to the Paris Club Secretariat of the debt swaps conducted.

The Evian Approach:

In October 2003, the G-7 finance ministers agreed to adopt a new initiative, termed the "Evian approach", providing more flexible debt restructuring through the Paris Club for non-HIPC and middle-income countries. The novelty of the approach was the introduction of a debt sustainability framework to provide an orderly, timely and predictable debt workout so as countries in such a situation and potentially considered for the HIPC initiative was defined by the international financial institutions.

The HIPC Initiative entails coordinated action by the international financial community, including multilateral institutions, to reduce to sustainable levels the external debt burden of these countries. This assistance entails a reduction in the net present value (NPV) of the future claims on the indebted country. Such assistance helps to provide the incentive for investment and broaden domestic support for policy reforms. The HIPC Initiative was enhanced in September 1999.

Eligibility: A country must satisfy a set of criteria to be eligible for special assistance. Specifically, it must:

- be eligible only for concessional assistance from the IMF and World Bank ("IDA-only");
- face an unsustainable debt burden, beyond available debt-relief mechanisms such as Naples terms (where low-income countries can receive a reduction of eligible external debt of 67 percent in NPV terms);
- establish a track record of reform and sound policies through IMF- and World Bank-supported programs.

Participation of Paris Club creditors to the HIPC initiative:

- **Preleminary period.** To qualify for assistance, the country must adopt adjustment and reform programs supported by the IMF and the World Bank and pursue those programs for three years. During that time, it will continue to receive debt relief from Paris Club creditors and other official bilateral and private creditors, as well as traditional concessional assistance from all the relevant donors and multilateral institutions.
- **Decision point.** At the end of the first phase, a debt sustainability analysis is carried out to determine the current external debt situation of the country. In most cases if the external debt ratio for that country after traditional debt relief mechanisms is above 150 percent for the present value of de

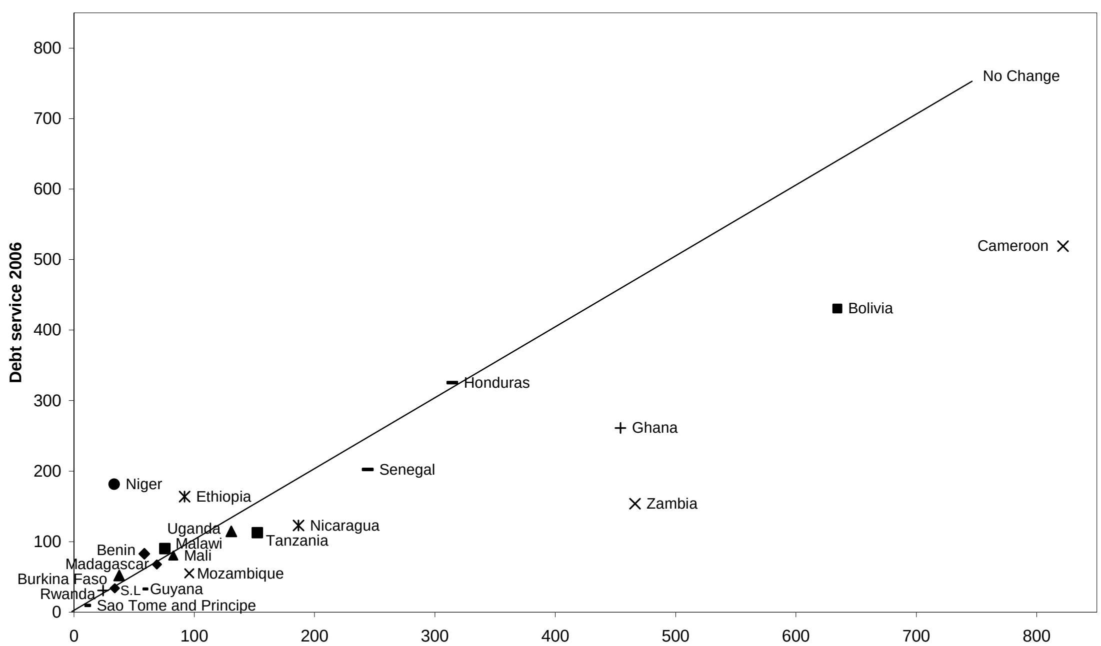
ANNEX III: Arrears and Nominal Debt Relief in the HIPC Countries

Arrears and Nominal Debt Relief in the HIPC Countries
(in US$ millions)

	Arrears in 1996 (HIPC Launch)	Completion Point	Nominal Debt Service Relief	Arrears in 2006
Benin	79.60	Apr-03	460	0.46
Bolivia	81.21	Jul-01	2060	…
Burkina Faso	47.97	Jun-02	930	78.90
Cameroon	1375.75	Jun-06	4917	647.09
Ethiopia	4782.99	May-04	3275	409.46
The Gambia	2.05	Jan-08	..	22.92
Ghana	33.53	Jul-04	3500	61.44
Guyana	179.96	Jan-04	1354	162.06
Honduras	245.09	May-05	1000	59.37
Madagascar	1758.53	Nov-04	1900	408.59

ANNEX IV: Evolution of Debt Service for Countries that had reached completion point

Evolution of debt service for countries that had reached completion point (in US$ millions)



Source: Compiled from World Bank GDF 2007 information

Debt service in year before completion point

Note: The Gambia and Mauritania have been excluded due to lack of data