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The Catalytic Approach in Practice:
Coordination Failure between the IMF, the Paris Club and Official Creditors alike

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Abstract

For the period since the late 1980s this paper examines the effectiveness of the catalytic approach – the belief that IMF intervention triggers private capital inflows. The results indicate that this approach is often ineffective due to two coordination failures between official creditors. The first is the failure of the various multilateral and bilateral creditors to coordinate their crisis lending. As a consequence in about 25 percent of all cases, the total amount provided by official creditors exceeded the countries financing need and thus facilitated private sector’s withdrawal from the country in stead of generating an incentive for additional capital inflows. The second coordination failure arrives from the involvement of the bilateral creditors, united in the Paris Club. Paris Club debt restructuring agreements contain a ‘comparability of treatment’ clause, according to which the debtor country has to restructure its outstanding private debt under comparable terms. This coercive way of bailing-in private creditors in combination with a Paris Club debt rescheduling agreement worked against the IMF’s aim of voluntary private sector involvement via its catalytic approach. We conclude that bailing-in some private creditors – short-term debts are excluded from the Paris Club’s ‘comparability of treatment’ clause – will not have the intended effect on total private capital flows if the country’s balance sheet is not structurally improved. Hence, any coercive instrument to be implemented must encompass all types of private capital flows.
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1 Introduction

In this chapter we examine the effectiveness of the catalytic approach – the belief that IMF intervention triggers private capital inflows – in achieving private sector involvement in crisis resolution. A country with external debt problems has to find a balance between financing its external deficit and adjusting the economy. Financing part of the deficit reduces the burden of adjustment and provides the government with time to implement new policy measures. A gradual adjustment is assumed to lessen the burden on the shoulder of the domestic population.

Involving private creditors in crisis resolution is crucial for a number of reasons. First, burden sharing by private creditors is needed in order to obtain a balance between the pain of adjustment borne by the domestic population and private creditors (see the Introduction to this volume). Second, private sector involvement is needed in order to prevent moral hazard and thus reduce the probability of a crisis in the future. Further, such participation is necessary since official creditors, the International Monetary Fund in particular, in general lack the resources to fully address the financing need of the crisis-hit country. Last but not least, the extend to which the IMF succeeds in creating a sense of equal burden sharing between public and private agents is crucial for the implementation of IMF programmes by the authorities of the debtor country, and for the adjustment measures to be accepted by the public. In turn, successful programme implementation increases the chance of private capital inflows. In other words, the legitimacy of IMF policy is dependent on its output effectiveness regarding the involvement of private creditors and vice versa.
In principle, two ways of obtaining private sector involvement can be distinguished. First, via the catalytic approach, which refers to a voluntary participation of private creditors triggered by official intervention. Second, by use of compulsory measures, such as debt standstills or an internationally agreed mechanism for dealing with sovereign debt. As noted in the Introduction to this volume, periods of calm such as the years 2002-07, form ideal circumstances to discuss and design major changes in the international financial architecture, including mechanisms for sovereign debt workouts. From this view the IMF’s proposal for a Sovereign Debt Restructuring Mechanism (SDRM) was well timed (see Krueger 2002). It was an effort to achieve greater levels of predictability and burden sharing in post-crisis debt workout situations. The proposal, however, was defeated by a combination of intense private sector lobbying, US-based opposition, and the opposition of two key emerging market economies, Mexico and Brazil (see Introduction and Chapter 2 of this volume). The IMF withdrew its plan in 2004. As a result, the international community still relies on the catalytic approach for private sector involvement.

In this chapter we investigate whether and how this catalytic approach worked since the late 1980s and draw conclusions on the necessity of reform of the international financial architecture. During this period the IMF was successful in attracting private capital in some cases such as Mexico in 1994 and South Korea in 1998. In other cases, however, official rescue loans were not accompanied by an inflow of private capital: for example Thailand and Indonesia in 1997, and Argentina in 2000. An analysis of IMF programmes during this period reveals that in general the intervention of the IMF did not generate new capital by private creditors.
Our results indicate that part of the explanation for the ineffective catalytic approach lies in two coordination failures between official creditors, which have worked against effective catalysis in particular groups of IMF programme countries. The first coordination failure is the failure of the various multilateral and bilateral creditors to coordinate their crisis lending. In about 25 percent of all cases, the total amount provided by official creditors exceeded the countries financing need. This overlending by official institutions facilitated private sector’s withdrawal from the country in stead of generating an incentive for additional capital inflows. The second coordination failure arrived from the involvement of the bilateral creditors, united in the Paris Club. Paris Club debt restructuring agreements contain a ‘comparability of treatment’ clause, according to which the debtor country has to restructure its outstanding private debt under comparable terms. Failure to do so supposedly comes at the cost of losing the Paris Club agreement or of a refusal by the Paris Club members to restructure debt in the future. This coercive way of bailing-in private creditors in combination with a Paris Club debt rescheduling agreement worked against the IMF’s aim of voluntary private sector involvement via its catalytic approach.

Overcoming these coordination failures is needed in order to improve on the effectiveness of the catalytic approach in future crises. Yet, even then the catalytic approach may still prove to be insufficiently reliable as a core policy to achieve private sector involvement. A coercive instrument to bail-in private creditors might still be required. Our study of the Paris Club’s coercive instrument of ‘comparability of treatment’ contributes to an understanding of the effectiveness of coercive instruments. We conclude that bailing-in some private creditors – short-term debts are excluded from
the Paris Club’s ‘comparability of treatment’ clause – will not have the intended effect on total private capital flows if the country’s balance sheet is not structurally improved. That is, private capital markets in general will react, overruling any positive effect on net total private capital flows as a result of an effective but partial bail-in. Hence, any coercive instrument to be implemented must encompass all types of private capital flows.

The setup of this chapter is as follows. We first describe the catalytic approach, which essentially assumes that official intervention will attract private capital to the crisis-hit country. The catalytic approach will only work in cases where official financing falls short of the financing need of the country. Hence, we proceed with estimating the countries’ financing need and relate these estimates to the countries’ total official financing. Thereafter we turn to the success or failure of the ‘comparability of treatment’ clause of Paris Club deals in attracting private capital. A section discussing the policy implications concludes the chapter.

2 The catalytic approach: theory and evidence

The catalytic approach is a strategy taken by the international financial institutions to involve private creditors in solving a country’s balance of payments difficulties. These difficulties arise because the country’s financing need exceeds the projected inflow of private capital. This gap between a country’s financing need and the finance available can be reduced by adjustment measures taken by the country’s government, which will reduce the current account deficit, and loans provided by official and private creditors. The catalytic effect arises if the amount of private sector loans exceeds the amount of these loans foreseen before the official creditors make loans available. These private
sector loans are represented by the box “Remaining financing gap: catalytic effect” in Figure 1.

**Figure 1 Estimating a country’s financing gap**

<table>
<thead>
<tr>
<th>FINANCING NEED</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated</td>
<td>Debt</td>
<td>Repayment of</td>
<td>Accumulation of</td>
<td>IMF</td>
</tr>
<tr>
<td>current account</td>
<td>amortization</td>
<td>arrears</td>
<td>net international</td>
<td>repayments</td>
</tr>
<tr>
<td>deficit</td>
<td></td>
<td></td>
<td>reserves</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>AVAILABLE FINANCING</th>
<th>Total estimated private capital flows</th>
<th>Remaining financing gap:</th>
<th>Estimated private capital flows</th>
</tr>
</thead>
<tbody>
<tr>
<td>Official financing:</td>
<td></td>
<td><strong>Catalytic effect</strong></td>
<td></td>
</tr>
<tr>
<td>IMF and other</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>multilateral and</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>bilateral creditors</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

But why would private investors provide additional money? Two reasons (channels) are generally given. Official creditors can trigger private capital inflows by providing liquidity – the *lending* channel – and by their judgement of and influence on a country’s policies – the *policy* channel. The mere provision of credit by official creditors can give private creditors an incentive to roll over their existing loans and, additionally, to supply new loans (Bordo et al. 2004: 11). Moreover, the financial assistance of official creditors can tip the balance for the debtor country to embark on an otherwise (politically) infeasible adjustment programme (Morris and Shin 2006), thereby inducing creditors to roll over their loans. By signing an agreement, official creditors signal that a country has sound financial institutions and follows sensible policies. This ‘stamp of approval’ (Rodrik 1995) or ‘good housekeeping seal of approval’ (Bordo et al. 2004) supposes that the official creditors have an informational advantage compared to the private sector. Moreover, after having signed an agreement, the IMF will monitor a
country’s policies and thus serve as a ‘delegated monitor’ for private creditors (Tirole 2002).

In the empirical literature, much attention has been given to the catalytic effect of the IMF and to a lesser extent to that of the World Bank. The evidence on the existence of a catalytic effect is disappointing, however, showing that a catalytic effect is at best present under particular conditions. When the catalytic effect is measured as the effect on private capital flows, private capital is only triggered by bilateral loans (Rodrik 1995) or precautionary IMF programmes (Cassou et al. 2006). While Bird and Rowlands (2002) and Cassou et al. (2006) also present some evidence of a catalytic effect of a particular type of IMF programme, namely EFFs, Edwards (2006) reports a statistically significant negative effect of these programmes. When measured as the effect on bond issuances and spreads, however, the evidence of a catalytic effect seems more convincing (Eichengreen and Mody 2001; Eichengreen et al. 2006; Mody and Saravia 2006). Yet again, studies present opposing results. For example, Eichengreen et al. (2006) report a significant catalytic effect in countries with a high level of external debt, whereas Mody and Saravia (2006) find evidence of a negative effect in this group of countries. Further, it can be questioned whether the catalytic effect should be measured in terms of issuances and spreads. In the end, it is the size of total private capital flows that matters in the effort to bridge a country’s financing gap. In this respect, case studies underline the poor record of the catalytic approach. Examining seventeen countries under an IMF programme, Killick (1995) only found the IMF programme to be associated with larger capital inflows in two cases. In a similar vein, comparing IMF programme projections with outcomes for
current and capital account balances, Ghosh et al. (2002) show the catalytic effect on which the programme was predicted to be systematically overestimated.

3 Estimating the financing gap

A core concept in all IMF programmes is the country’s financing gap. This financing gap is the difference between what a country needs to raise to pay its maturing debts, arrears, accumulation of net international reserves, IMF repayments and ongoing deficits, and what it is projected to be able to raise from private creditors. In Figure 1, it is the difference between the financing need and estimated private capital inflows. The resolution of any financial crisis entails closing the financing gap by policy adjustment in combination with ‘exceptional financing’ in the form of official multilateral credit, aid from multilateral and bilateral donor agencies, debt-restructurings of bilateral and private debt and new sources of private financing (such as direct investment or return of flight capital) (Rieffel 2003: 77-78). As discussed, in order for the catalytic approach to work, the total sum of the official financial package needs to fall short of the financing gap, so that additional private capital inflows fill the remaining financing gap after official intervention.

Consequently, a correct measure of the financing gap is crucial for an investigation of the existence of the catalytic effect. As Figure 1 illustrates, all variables other than private capital flows and the current account deficit are ex ante known by the IMF. The question now is: how can the financing gap be estimated? The answer is not at all straightforward for the following two reasons.
First, projecting what can be raised from private creditors is a rather subjective ordeal. In practice, when designing a programme, the IMF estimates the flow of private capital in the year of approval of the programme and a number of years thereafter. Apart from the difficulty of estimating these flows, the IMF has a record of generating a too optimistic view of private capital flows in the first year in 60 percent of the programmes (IMF 2004: 27). This optimistic bias results from the practice that often estimates of private capital flows are adjusted to constraints on official lending and thus do not reflect private investors’ willingness to invest in the country (Benelli 2003; IMF 2004). The maximum size of IMF lending is predefined by the country’s quotas or in individual cases limited for political reasons or reasons concerning the financial solidity of the IMF. Being aware of these lending constraints, IMF staff generates optimistic projections to get large programmes approved by the IMF’s Executive Board. Benelli (2003) found that the larger the size of lending as a percentage of the country quota, the greater the projection bias. In addition, optimistic projections are made as to reduce the financing gap, so the IMF together with other multilateral and bilateral creditors can claim to fully finance the gap in an effort to restore confidence. A striking example of this arbitrary adjusting of the financing gap is given in an evaluation report published by the IMF itself:

In Korea, however, the initial failure of the programme was more directly related to deficiencies on the financing side. The package as announced in the press note included US$20 billion of bilateral assistance as a second line of defence, but there was considerable lack of clarity as to whether this amount was really available. The programme was originally based on the assumption that this amount would be needed to fill the estimated residual financing gap, but it was communicated to the staff at a fairly late stage that it should not count on this amount being available. The estimated financing gap
A second difficulty in measuring the financing gap is deciding on an acceptable level of the current account balance. When countries are in need of IMF lending their reserves are by definition insufficient to balance all private capital outflows. Therefore, any change in capital outflows brings about an almost exact opposite change in the current account balance. When designing a programme, the IMF estimates the size of private capital flows and uses this estimate to project the change in the current account balance. As outlined above, however, since the IMF starts from a too optimistic view on future capital flows in the majority of the cases, the current account also adjusts more than projected in these cases. Even more, as the IMF once again itself remarks: ‘It is possible, however, that because sufficient financing was not available, the programme projection incorporated greater adjustment than was considered economically desirable’ (IMF 2004: 27).

In short, the IMF often overestimates private capital available, thereby underestimating both the actual adjustment of the current account balance and the financing gap. From this observation it follows that the projections of the IMF cannot be used to estimate the financing gap.

Instead of using an unreliable measure of the financing gap, we use the easier to measure financing need to normalize the size of official lending. In other words, the question examined is: what part of the financing need of a country is taken up by multilateral and bilateral creditors? This question is equally relevant as private creditors find the same difficulties in estimating the financing gap and therefore use this measure...
instead. This variable reduces the difficulty of constructing a reliable measure to finding an appropriate value for the future current account balance.

In a study on the objectives and outcomes of IMF programmes, the IMF itself provides for such a measure of the current account balance (IMF 2004). When evaluating the outcome of IMF programmes it uses a country’s debt-stabilizing current account balance as a benchmark to value the country’s current account adjustment. The debt-stabilizing current account balance is the current account balance that stabilizes the external debt ratio given the historical performance of the economy. The intuition behind this measure is that a country’s external debt to GDP ratio remains constant if the external debt increases by the same rate as GDP. Since an increase in external debt is equal to the current account deficit, the debt stabilizing current account equals the growth rate of GDP times the external debt level.³

In short, when using the debt-stabilizing current account balance in the calculation of the financing need, the problem of using the biased value for the current account balance reported in the programme documents is surpassed. Therefore, we measure a country’s financing need by calculating the debt-stabilizing current account balance (using data from the World Development Indicators) and adding this value to the values for debt amortization, repayment of arrears, accumulation of gross international reserves and IMF repurchases and repayments as provided by the IMF from its MONA-database. Thereafter, the size of total official financing is measured as the total of the net use of Fund credit, official borrowing from multilateral and bilateral lenders and net official transfers as a percentage of the financing need.
4 Official financing and the effect on private capital

The empirical analysis of this section is based on annual data covering the years 1988-2004 for 65 developing and emerging market economies (see Van der Veer and De Jong 2007). For all years, both countries with and without an IMF programme are included. Due to missing observations the entire set is an unbalanced panel with a maximum of 722 observations. Out of these 722 observations 251 refer to country-year combinations in which an IMF-programme was in effect, and for which we have data from the IMF’s MONA-database. For these countries we estimate the total financing need by means of the procedure set out in the previous section and relate this estimate to the size of the financial package provided by official creditors. According to this ratio, in 25 percent of the observations official financing exceeded the country’s financing need (Table 2).

Table 2 Official lending in countries with an IMF programme

<table>
<thead>
<tr>
<th>Number of observations</th>
<th>External debt /GDP</th>
<th>External debt /GDP</th>
<th>External debt /GDP</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>&lt; 40</td>
<td>40 – 60</td>
<td>&gt; 60</td>
<td></td>
</tr>
<tr>
<td>&lt; 100% of financing need</td>
<td>30 (65%)</td>
<td>56 (82%)</td>
<td>103 (75%)</td>
<td>189 (75%)</td>
</tr>
<tr>
<td>&gt; 100% of financing need</td>
<td>16 (35%)</td>
<td>12 (18%)</td>
<td>34 (25%)</td>
<td>62 (25%)</td>
</tr>
<tr>
<td>Total</td>
<td>46</td>
<td>68</td>
<td>137</td>
<td>251</td>
</tr>
</tbody>
</table>

Only observations with an IMF programme.

In these cases public financing is likely to facilitate the exit of private capital instead of catalyzing private capital. Note also that overlending is not limited to countries with a high level of external debt. The number of cases with overlending is higher for the countries with a relatively low level of debt than for the countries with an intermediate level of external debt (Table 2, columns 1 and 2).

In order to investigate whether an IMF programme leads to additional private capital inflows, we estimate an equation of private capital inflows in which the
explanatory variables are a set of control variables explaining capital inflows under normal conditions, and a dummy variable which is 1 if the country has signed an IMF programme. This list of control variables includes three groups of indicators, representing i) long-term potential growth and market size, ii) the country’s capacity to pay or reimburse investments, and iii) macroeconomic performance and stability. A two-step Heckman selection procedure is employed to control for sample selection (see the Appendix for an explanation). The equation is estimated for each of three types of IMF programmes: Stand-By Arrangement (SBA), Extended Fund Facility (EFF) and Poverty Reduction and Growth Facility (PRGF). SBAs aim to solve short-term balance-of-payments problems, EFFs are geared at alleviating protracted balance-of-payments problems, and PRGFs are concessional loans to low-income countries. SBAs and EFFs are dominantly used by middle income countries.

The results for the full sample suggest that SBAs facilitate the run to the exit by private investors, whereas no effect on private capital flows is found for the other two programs (Table 3, first column).

Table 3 Official financing and the catalytic effect of IMF programmes

<table>
<thead>
<tr>
<th>Sample</th>
<th>Full sample</th>
<th>&lt; 100% of financing need</th>
<th>&gt; 100% of financing need</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stand-By Arrangement</td>
<td>-1.375</td>
<td>-1.061</td>
<td>-1.444</td>
</tr>
<tr>
<td></td>
<td>(-2.00)**</td>
<td>(-0.82)</td>
<td>(-2.07)**</td>
</tr>
<tr>
<td>Extended Fund Facility</td>
<td>-1.288</td>
<td>-1.900</td>
<td>-1.038</td>
</tr>
<tr>
<td></td>
<td>(-1.25)</td>
<td>(-1.04)</td>
<td>(-1.33)</td>
</tr>
<tr>
<td>Poverty Reduction and Growth</td>
<td>0.096</td>
<td>2.558</td>
<td>-1.519</td>
</tr>
<tr>
<td>Facility</td>
<td>(0.12)</td>
<td>(1.64)*</td>
<td>(-1.76)*</td>
</tr>
<tr>
<td>Observations</td>
<td>722</td>
<td>248</td>
<td>474</td>
</tr>
<tr>
<td>F-test</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
</tbody>
</table>

Significance level, *** = 1%, ** = 5%, * = 10%. Regressors not reported: export growth, external debt in percent of gross domestic product (GDP), GDP per capita, inflation rate, interest rate, investment rate, reserves in months of imports, real GDP growth, short-term debt to reserves, short-term debt to total external debt, total debt service in percent of exports, lagged dummy for IMF programme.
As discussed above, a catalytic effect can only materialize if the amount of official finance is less than the amount needed. Distinguishing between observations where official finance is larger and smaller than the country’s financing need indeed reveals that the negative effect on private capital flows in countries with a SBA is caused by the cases of overlending (Table 3, last two columns). In these cases the private sector is effectively bailed out. Further, for PRGFs a marginally significant positive (negative) effect is found for the cases where total finance is smaller (larger) than the financing need. These results suggest that if there is any catalytic effect, it is expected to be for PRGFs. The overall view, though, is that the catalytic effect is not found, so that official creditors cannot rely on private investors’ voluntary providing finance to a crisis-hit country. The disappointing results of the catalytic approach build the case for more coercive instruments to achieve private sector involvement in crisis resolution.

5. The Paris Club and its coercive instrument of ‘comparability of treatment’

An important and often stated argument against the introduction of any coercive instrument to achieve private sector involvement is that it is difficult in advance to predict how private capital markets will react. In fact, fear of increased borrowing costs, was key to Mexico’s and Brazil’s opposition against the Sovereign Debt Restructuring Mechanism. Yet, the international financial architecture has had and used one particular coercive instrument ever since the mid 1950s, that is, the principle of ‘comparability of treatment’ attached to Paris Club debt restructuring agreements. According to this ‘comparability of treatment’ clause, debtor countries are obliged to arrange an agreement
on comparable terms with private creditors. As such, Paris Club agreements form an ideal case to study the potential reaction of private capital markets on a coercive instrument to achieve private burden sharing. In this section we study the effects of Paris Club deals, which in our view contributes to understanding the (in)effectiveness of coercive instruments more generally.

The Paris Club is an informal group of creditor governments that meets regularly in Paris to restructure official bilateral debt. It has nineteen permanent members—mainly OECD countries—but other creditors can participate on a case-by-case basis. Since 1956 the Paris Club has reached 406 agreements concerning 84 debtor countries. The total amount of debt covered in the agreements since 1983 has been $509 billion. In spite of such activity, the Paris Club is strictly informal and is usually described as a ‘non-institution’.

In order to reach agreements—which are individually implemented by the creditor countries—a number of rules and principles were developed and codified in a United Nations resolution at the end of the 1970s. The following rules and principles are operated today: i) decisions are made on a case-by-case basis and only when ii) a consensus has been reached; iii) only countries with an IMF programme, providing conditionality, can apply for debt treatment; iv) creditors agree to implement the terms agreed; and v) ‘comparability of treatment’ obliges the debtor country to seek a restructuring with other bilateral and private creditors on comparable terms. This final principle of ‘comparability of treatment’ creates a direct link between a Paris Club agreement and the debtor country’s decision to service its outstanding private debt. In
order to support the case-by-case norm, the Paris Club developed a series of ‘terms’ that allowed more flexible and generous Paris Club treatment of debt.\footnote{7}

In 1988, the Paris Club introduced the possibility of debt reduction next to debt rescheduling. Within a debt rescheduling, the entire stock of debt on which the debtor defaults is never rescheduled (Brown and Bulman 2006: 18). Only part of the existing arrears on debt service payments, as well as those obligations falling due over a specified period of time, are consolidated into a new loan. This effectively adds a second layer of debt to that already existing, increasing a country’s total outstanding external debt. As a result, the debt reschedulings by the Paris Club failed to give an adequate answer to the chronic debt problems of a substantial group of low-income countries. Subsequently, for roughly forty heavily indebted poor countries—HIPC’s—the Paris Club departed from its normal rules to grant progressively more generous debt reduction with a view to reducing the burden of foreign debt below an agreed threshold (Rieffel 2003: 57). Until 2003, the Paris Club maintained its policy of no debt reduction for the middle-income countries—non-HIPC countries. Then, the representatives of the creditor countries agreed upon the Evian Approach for non-HIPC countries, which gave the Paris Club creditors the option to agree on debt reduction for these countries too.

The principle of ‘comparability of treatment’ requires countries benefiting from Paris Club debt restructuring to seek to obtain similar (comparable) relief from their private creditors. The principle is not grounded on a legal basis and thus its effect depends on the Paris Club’s threat of cancelling the restructuring agreement reached, or taking a less cooperative stance in future negotiations. The debtor country, on its behalf, uses the threat of default to bring the other creditors to agree on a comparable
restructuring. As a former insider of the Paris Club notes, however: ‘the basic flaw in the comparable treatment principle is the absence of a consideration of how the application of the principle in a particular case will affect future flows of private capital to the debtor country’ (Rieffel 2003: 284). 8

Essentially, the ‘comparability of treatment’ clause is a coercive mechanism to achieve private sector involvement in crisis resolution. The effectiveness in terms of safeguarding net total private capital inflows, however, might be questioned in advance. Apart from its non-legal basis, the ‘comparability of treatment’ clause only applies to debt with a maturity of more than one year. Short term debt is excluded. 9 In addition, even if the Paris Club by means of the clause is successful in involving private creditors with credit outstanding, one can argue that private capital markets more generally might shy away from investing in a country if they expect to be forced to agreeing to less advantageous interest and repayment conditions in the future. 10 In this respect, it also matters whether the Paris Club agrees to reschedule or to reduce bilateral debt. Under ‘comparability of treatment’, debt rescheduling would imply fewer concessions by private investors than debt reduction, and thus reduced incentives to disinvest. On the other hand, rescheduling debt does not reduce future debt services and does, therefore, not improve the financial position of the country. Consequently, private agents could interpret a rescheduling agreement for bilateral debt as lowering the possibility of repayment of their own claims, inducing them to withdraw their money from a country.

In sum, whether the ‘comparability of treatment’ clause in Paris Club deals helps or hampers the IMF to catalyse private capital is an empirical matter, which we settled in Van der Veer and De Jong (2007). In that paper we made a distinction between countries
that signed an IMF agreement only and those which signed a Paris Club agreement in addition to an IMF agreement. As in Section 4, we distinguish between three types of IMF agreements: SBAs, EFFs and PRGFs. It appeared that a Paris Club agreement reduces net private capital inflows when a country has signed a Stand-By Agreement or an Extended Fund Facility, and increases these inflows when a country has signed a Poverty Reduction and Growth Facility. Hence, a Paris Club agreement has a different effect, depending on whether the country has signed a SBA or EFF on the one hand or a PRGF on the other.

Van der Veer and De Jong (2007) offer two, partly complementary, explanations for these differing effects of Paris Club agreements: i) the nature – debt rescheduling or debt reduction – of the Paris Club agreement, ii) and the term structure of the countries’ external debt. First, the contradictory effects of Paris agreements could be due to the different incentives resulting from a debt rescheduling versus a debt reduction. A deal involving debt reduction improves both a country’s short-term and long-term financial position. Debt rescheduling, on the other hand, merely improves a country’s short-term financial position. Its long-term position deteriorates. If ‘comparability of treatment’ is applied, the private sector has to agree on larger write-offs under debt reduction than under debt rescheduling. Hence, private investors have to weigh their own share in debt reduction against the positive effects of the country’s enhanced ability to pay its arrears. Regression analysis reveals that a Paris Club rescheduling is most likely to lead to an outflow of private capital, whereas a debt reduction enhances the inflow of private capital (Van der Veer and De Jong 2007: Table 6). The majority of debt reductions is granted to countries with a PRGF, end thus to low income countries. These debt reductions
approved by the Paris Club can result in debt cancellations of up to and over 90 percent under the so-called ‘Cologne terms’. As such, the resulting positive effect on total private capital inflows is more likely to be evidence of a catalytic type of effect – in accordance with debt overhang theory – than being evidence of effective enforcement of private debt reductions following the ‘comparability of treatment’ clause.

A second and complementary explanation for the different effects of Paris Club agreements is given by the term structure of the country’s external debt. Private investors can easily withdraw their money from the country if short-term debt constitutes a relatively high proportion of the country’s external debt. The ratio of short term debt to total external debt is 13, 11, and 7 for countries with a SBA, EFF, and PRGF, respectively. Consequently, the negative effect of a Paris Club agreement in addition to a SBA or EFF could reflect the greater mobility of private capital in these countries in combination with the negative assessment of the country’s financial position due to the mere rescheduling of debt, which is the dominant type of Paris Club restructuring in countries with a SBA or EFF.

From these results Van der Veer and De Jong (2007) conclude that how private capital markets assess the overall financial position of the country after the debt restructuring, is more important than the losses incurred by some private creditors in the process. Stated otherwise, bailing-in some private creditors will not have the intended effect on total private capital flows, if the country’s balance sheet is not structurally improved. Essentially, private investments are based on considerations about the probability of future repayment. Debt reduction by bilateral donors implies a reduction of the amount a country is due to pay to official creditors. Debt rescheduling, on the other
hand, effectively increases a country’s future payment obligations to the Paris Club creditors. Consequently, private investors are more willing to provide fresh capital in case of Paris Club reductions.

6. Conclusions

Private sector involvement is a crucial element of crisis resolution. It contributes to an equal sharing of the burden, it prevents moral hazard problems, and it supplements official funds, which are often too limited. Also, the extend to which the IMF succeeds in creating a sense of equal burden sharing between public and private agents is crucial for the implementation of IMF programmes by the authorities of the debtor country, and for public acceptance of the adjustment measures. In turn, implementation of the adjustment measures increases the chance of private capital inflows. Stated otherwise, the legitimacy of IMF policy is dependent on its output effectiveness regarding the involvement of private creditors and vice versa. In some cases, Mexico in 1994 and Korea in 1997, the IMF was quite successful in inducing private investors to take their share of the burden. In other crises, however, for example Thailand and Indonesia in 1997, private creditors seem to have been more successful in avoiding losses, which goes at the expense of the people in the country concerned.

In this chapter we have investigated the effectiveness of the catalytic approach in achieving private sector involvement in crisis resolution. In the period examined, two coordination failures between official creditors have worked against effective catalysis. Overcoming these coordination issues within the current international financial architecture might improve on the effectiveness of the catalytic approach.
The first coordination failure to surface from our examination of the catalytic approach is the failure of the various multilateral and bilateral creditors to coordinate their crisis lending such that the total financing package does not exceed the debtor country’s financing need. A prerequisite for private sector involvement is that the public sector does not bailout private creditors. Hence, the total amount of finance provided by official agents should fall short of the debtor’s financing need. Examining the size of official finance in terms of a country’s financing need reveals that in about 25 percent of the cases, official institutions provide more finance than is needed. Regression analysis shows that in these cases IMF programmes lead to an outflow of private capital. In other words, when official creditors lend more than necessary, official money is likely to facilitate a rush to the exit by private investors. Coordination between the main official institutions is therefore needed in order to prevent a bail-out of private creditors. Moreover, in cases where the amount of official finance is less than the financing need, regression analysis shows only weak evidence of inflow of private funds, and only in low income countries that signed a Poverty Reduction and Growth Facility (PRGF). Therefore, even if official finance falls short of a country’s financing need; the catalytic approach is likely to be unreliable as a policy to achieve private sector involvement.

The second coordination failure came up from our study of the Paris Club’s coercive instrument of ‘comparability of treatment’, showing how intentions by the IMF to catalyse private capital in countries with a Stand-By Arrangement (SBA) or Extended Fund Facility (EFF), were counteracted by Paris Club involvement in these cases. Paris Club debt reschedulings in these countries – which effectively increase a country’s external debt – in combination with the Paris Club’s coercive way of bailing-in private
creditors, is in tension with the IMF’s aim of voluntary private sector involvement via its catalytic approach.

In sum, the coordination failure between official creditors in general and the IMF and the Paris Club in particular has worked against effective catalysis in particular cases. Overcoming these coordination failures is warranted in order to improve on the effectiveness of the catalytic approach in future crises. Yet, even with these relatively minor improvements in the current international financial architecture, the catalytic approach may still prove to be insufficiently reliable as a core policy to achieve private sector involvement. Creating a more coercive instrument to bail-in private creditors might in the end still be necessary.

Our study of the Paris Club’s coercive instrument of ‘comparability of treatment’ contributes to an understanding of the effectiveness of coercive instruments. According to this clause, debtors are obliged to strike a similar deal with the private sector. Estimations, however, showed that this clause in general did not have the intended effect on net total private capital flows. The Paris Club agreements give rise to an additional inflow of private capital only in low income countries that signed a PRGF, and the Paris Club decided to reduce bilateral debt. Given the high level of Paris Club debt reductions in these cases, we interpret this result as evidence of a voluntary catalytic type of effect – in line with debt overhang theory. In all other cases these deals lead to an outflow of private capital.

From these results, we conclude that bailing-in some private creditors – short-term debts are excluded from the Paris Club’s ‘comparability of treatment’ clause – will not have the intended effect on total private capital flows if the country’s balance sheet is not
structurally improved. That is, private capital markets in general will react negatively to a deteriorated outlook of a country’s balance sheet, overruling any positive effect on net total private capital flows as a result of an effective but partial bail-in. Hence, any coercive instrument to be implemented must encompass all types of private capital flows. From this perspective, standstills are a likely candidate.
Appendix The estimation procedure

As in other empirical studies on the effects of IMF programmes, a two-step Heckman selection model is used for obtaining the estimations presented in the text. The first step involves estimating a probit model for the chance a country has signed an IMF programme. The results of this estimation are used to construct a selection bias control factor—lambda—equivalent to the Inverse Mill’s Ratio. This factor is a summary measure, reflecting the effects of all unmeasured characteristics related to whether a country signed an IMF programme or not. This lambda is added to the list of explanatory variables of the ‘equation of interest’. Both equations in the Heckman selection model are estimated simultaneously by using a maximum likelihood procedure:

\[(1) \quad B = \gamma Z + u_2 \quad \text{(selection equation)}\]
\[(2) \quad y = \beta X + u_1 \quad \text{(equation of interest)}\]

\[u_2 \sim N(0, 1), \quad u_1 \sim N(0, \sigma) \quad \text{and} \quad \text{corr}(u_1, u_2) = \rho\]

where ‘B’ is a binary variable indicating whether the country signed an IMF programme; ‘Z’ is a vector of variables indicating a country’s economic conditions which determines a country’s probability to have signed an IMF programme; ‘y’ is one of the four types of private capital flows; and ‘X’ is a vector of variables determining private capital flows, including the lambda mentioned above.
References


1 The SDRM was succeeded by a voluntary private sector initiative developed and led by the powerful representative of the global banking industry, the Institute of International Finance (IIF 2006). Collective Action Clauses (CACs) for debtors and bondholders, standardised and promoted by the G10, became the market standard.

2 In IMF documents the financing need is known as gross financing requirement.

3 See IMF (2004: 30) for the exact formula of the debt-stabilizing current account balance.

4 See Table A-3 in Van der Veer and De Jong (2007) for the list of variables used.

5 The permanent Paris Club members are: Austria, Australia, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, The Netherlands, Norway, Russian Federation, Spain, Sweden, Switzerland, United Kingdom, and the United States of America.

6 See the Paris Club website: www.clubdeparis.org.

7 Ordered from no debt reduction to more than 90% debt reduction, these terms are: classic (no debt reduction), Houston (some debt reduction), Toronto (33%), London (50%), Naples (>50%), Lyon (80%), and Cologne (>90%). In addition, ‘ad hoc’ terms are sometimes applied as well. See www.clubdeparis.org.

8 Lex Rieffel participated in numerous Paris Club negotiations since the 1970s during his eighteen years with the United States’ Treasury Department.

9 The Paris Club excludes short term debt from the treatments, as their restructuring can create a significant disruption of the capacity of the debtor country to participate in international trade. See www.clubdeparis.org.

10 This effect was observed in the case of the 1999 agreement between Pakistan and the Paris Club creditors. The private financial community opposed to the inclusion of bond restructuring as a requirement of Paris Club creditors under the ‘comparability of treatment’ clause (see IMF 2001: 5).