Chapter 7 - The catalytic approach to debt workout in practice: coordination failure between the IMF, the Paris Club and official creditors pp. 134-149

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The catalytic approach to debt workout in practice: coordination failure between the IMF, the Paris Club and official creditors

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Introduction

This chapter examines the effectiveness of the ‘catalytic approach’ to crisis and debt-workout lending in the international financial architecture – the belief that IMF intervention triggers renewed private capital inflows which complement adjustment programmes – in achieving private sector involvement in crisis resolution. 1 A country with external debt problems must find a balance between financing its external deficit and economic adjustment. 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 domestic population. Hence measures that increase private financing in the face of external debt problems should also increase countries’ policy space.

Involving private creditors in crisis resolution is crucial for a number of reasons. First, burden-sharing by private creditors is necessary to obtain balance between the pain of adjustment borne by the domestic population and private creditors (see this volume’s introduction). Second, private sector involvement is needed to prevent moral hazard and thus reduce the probability of future crises. Third, participation and fresh private capital is necessary since official creditors – the International Monetary Fund (IMF) in particular – generally lack the

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1 Hence, this chapter focuses on solutions to sovereign debt problems in which the private sector more or less voluntarily takes part. Chapter 10, however, compares a case employing this approach (Brazil) to one in which a solution is enforced on creditors (the case of Argentina).
resources to fully meet the financing needs of the crisis-hit country. Last but not least, the extent 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 depends on its output side effectiveness in involving private creditors, and vice versa.

In principle, we can distinguish two forms of private sector involvement in crises. The first concerns the idea of ‘bailing in’ existing creditors who stand to lose in order to deal with the problem of burden-sharing. Of course ‘bailing in’ existing creditors is not easy and is unlikely without some form of ad hoc arm-twisting or compulsion or more institutionalised measures which might include debt standstills or an internationally agreed mechanism for dealing with sovereign debt, each attracting uncertain levels of perceived legitimacy in the eyes of the private sector. Second, the catalytic approach involves the voluntary participation of private creditors in the recovery phase triggered by official intervention. The more the first form involves compulsion and a lack of legitimacy, the more it might deter future investors and thus undermine the effectiveness of the second, the catalytic approach. This chapter first addresses the effectiveness of the catalytic approach, and will subsequently address possible alternatives. As noted in this volume’s introduction, periods of calm such as between 2002 and 2007 ought to provide the best circumstances for discussing and designing major changes in the international financial architecture, and from this standpoint, the IMF’s proposal for a Sovereign Debt Restructuring Mechanism (SDRM) to achieve greater levels of predictability and burden-sharing in post-crisis debt workout situations was well-timed (see Krueger 2002). 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. With the IMF withdrawing its plan in 2004 (see introduction and Chapter 2),

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2 Though now that crisis is once again upon us, we might in consolation take up the widely understood dictum echoed by White House chief of staff Rahm Emanuel, that one should never allow a crisis to go to waste (The New York Times 2008).

3 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 2006a). Collective Action Clauses (CACs) for debtors and bondholders, standardised and promoted by the G10, became the market standard.
the international community still relies on the catalytic approach for private sector involvement.

This chapter examines whether and how effectively the catalytic approach has worked since the late 1980s. In some cases, the IMF was successful in attracting private capital: for example to Mexico in 1994 and to South Korea in 1998. In other cases, 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 over this period reveals that IMF intervention generally did not generate new capital by private creditors. In other words, the output legitimacy of this specific element of the global financial architecture is in doubt. We go on to analyse how the concurrently available coercive instrument – the Paris Club’s ‘comparability of treatment’ clause – works in relation to the IMF system. Our findings here lead to our conclusions regarding the reform of the international financial architecture.

Our results indicate that part of the explanation for weakness of the catalytic approach lies in the failure of various multilateral and bilateral creditors to coordinate their crisis lending. In about 25 per cent of all cases, the total amount provided by official creditors exceeded the debtor’s financing need. This overlending by official institutions facilitated private sector withdrawal (bail-out) rather than incentives for additional capital inflows. This coordination failure must be surmounted to improve the effectiveness of the catalytic approach in future crises. Yet the essentially voluntary catalytic approach may arguably still require a more or less acceptable coercive instrument to first bail in private creditors. The bilateral creditors assembled in the Paris Club indeed constitute such a coercive instrument; Paris Club debt-restructuring agreements contain a ‘comparability of treatment’ clause according to which the debtor country must restructure its outstanding private debt on comparable terms. Failure to do so supposedly comes at the cost of losing the Paris Club agreement or the refusal of Paris Club members to restructure debt in the future.

We have therefore included the Paris Club’s ‘comparability of treatment’ instrument in our study, for it contributes to our understanding of the effectiveness of coercive instruments. Our findings indicate that only some private creditors are actually bailed in: short-term debts are excluded from the Paris Club’s ‘comparability of treatment’ clause which then does not have the intended effect on total private capital flows because the country’s overall balance sheet is not structurally improved. If a coercive instrument is to prove effective, it must encompass all types of private capital flows.
This chapter is organised as follows. We first describe the principles behind the catalytic approach, which essentially assumes official intervention will attract private capital to the crisis-hit country. As the catalytic approach only applies in cases where official financing falls short of the overall financing needs of the country, we proceed to estimate countries’ financing needs relative to the official financing offered. Thereafter we turn to the track record of the Paris Club’s ‘comparability of treatment’ clause in attracting private capital. The chapter concludes with a discussion of policy implications – the balance between public and private contributions, and the effectiveness of various options in dealing with the problems of external debt.

**The catalytic approach: theory and evidence**

The catalytic approach is a strategy of the International Financial Institutions (IFIs) 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. The gap between a country’s financing need and the finance available can be reduced by adjustment measures taken by the country’s government to reduce the current account deficit, and by loans provided by official and private creditors. The catalytic effect arises if private sector inflows successfully complement official creditors’ contributions to fulfil the gross financing requirement. These private sector loans are represented by the box ‘Remaining financing gap: catalytic effect’ in Figure 7.1.

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4 In IMF documents the financing need is known as ‘gross financing requirement’.
But why would private investors provide additional money? Official creditors can trigger private capital inflows (1) by providing liquidity – the *lending* channel – and (2) 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 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) unworkable 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 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 that of the World Bank. The evidence, however, is disappointing, and shows that a catalytic effect is at best present only under specific conditions. When measured as the effect on private capital flows, it 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) present some evidence of a particular type of IMF programme – namely Extended Fund Facilities (EFFs) – having a catalytic effect, Edwards (2006) for these same programmes reports a statistically significant negative effect. When measured as the effect on bond issuances and spreads, the evidence of a catalytic effect seems more convincing (Eichengreen and Mody 2001; Eichengreen *et al.* 2006; Mody and Saravia 2006). But studies present contradictory 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 for this type of country. Furthermore, 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. Case studies here underline the poor record of the catalytic approach. Examining seventeen countries under an IMF programme, Killick (1995) found the IMF programme to be associated with larger capital inflows in only two cases, while Ghosh *et al.* (2002), comparing IMF programme projections with outcomes for current and capital account balances, show
that the catalytic effect on which programmes were premised was systematically overestimated.

**Estimating the financing gap**

A core concept in all IMF programmes is the country’s ‘financing gap’. This 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 7.1, the financing gap is the difference between the financing need and estimated private capital inflows. The resolution of any financial crisis entails closing the financing gap through policy adjustments 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: 77–8). For the catalytic approach to work, the total sum of the official financial package must fall short of the financing gap, so that additional private capital can fill the remaining gap.

Correctly measuring the financing gap is thus crucial to determine the existence of a catalytic effect. As Figure 7.1 illustrates, all variables other than private capital flows and the current account deficit are ex ante known by the IMF. The question then is: how might one estimate the financing gap? The answer is not straightforward for the following two reasons.

First, projecting what can be raised from private creditors is no simple affair. When designing its programmes, the IMF estimates the flow of private capital for the year the programme is approved and for a number of years thereafter. In 60 per cent of cases, the IMF overestimates first-year private capital flows (IMF 2004a: 27). This optimistic bias results from considering constraints on official lending first, and then adjusting estimated private capital flows – which thus do not reflect private investors’ willingness to invest in the country (Benelli 2003; IMF 2004a). The maximum amount the IMF can loan to a country is pre-defined by the country’s quota, or in individual cases, limited by political considerations or for reason of the IMF’s own financial solidity. Aware of these constraints, IMF staff generate optimistic projections to get large programmes approved by the Executive Board. Benelli (2003) found that the larger the loan relative to the country quota, the greater the projection bias. Optimistic projections were further made to restore confidence, to show that the IMF together with other multilateral and bilateral creditors could fully finance the gap. 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 was, therefore, reduced by arbitrarily increasing the assumed rollover rate of short-term debt. (IMF 2003a: 37)

A second difficulty in measuring the financing gap entails defining an acceptable current account balance. When countries are in need of IMF lending, their reserves are by definition insufficient to balance all (private and other) capital outflows. Any change in capital outflows entails a corresponding shift in the current account balance. When designing its programmes, the IMF estimates the size of private capital flows and uses this estimate to project changes in the current account balance. But as outlined above, the IMF often overestimates available private capital, thereby underestimating both the actual adjustment of the current account balance and the financing gap.

IMF projections are thus unreliable measures for estimating financing gaps. To standardise the measurement of official lending, we thus employ the easier to measure concept of ‘financing need’. The question then becomes: what proportion of a country’s financing need is taken up by multilateral and bilateral creditors? This is also the measure used by private creditors, who face the same difficulties as the Fund in estimating the financing gap. Its use allows us to more easily construct a reliable measure for the future current account balance.

In one study, the IMF itself uses a country’s debt-stabilising current account balance as a benchmark to calculate its current account adjustment when evaluating its programmes (IMF 2004a). The ‘debt-stabilising current account balance’ is that which stabilises 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 external debt increases by the same rate as GDP. Since an increase in external debt is equal to the current account deficit, the ‘debt-stabilising current account’ equals the growth rate of GDP times the external debt level.5

5 See IMF (2004: 30) for the exact formula of the debt-stabilising current account balance.
Using the debt-stabilising current account balance to calculate financing need thus surpasses the problem of biased current account balances within IMF programme documents. We thus measure a country’s financing need by calculating the debt-stabilising current account balance (using data from the World Development Indicators) and adding this value to the values for debt amortisation, repayment of arrears, accumulation of gross international reserves, and IMF repurchases and repayments as provided by the IMF from its MONA database. Thereafter, 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.

**Official financing and the effect on private capital**

This section’s analysis is based on annual data covering the years 1988–2004 for sixty-five developing and emerging market economies (see van der Veer and de Jong 2007). For all years, both countries with and without an IMF programme were 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. We estimated the total financing need of these countries using the procedure set out in the previous section, and found that in 25 per cent of the observations, official financing exceeded the country’s financing need (Table 7.1). In such cases public financing, rather than catalysing private capital, is likely to facilitate its exit. Note also that overlending is not limited to countries with a high level of external debt.

To determine whether IMF programmes lead to additional private capital inflows, we estimate an equation of private capital inflows in

<table>
<thead>
<tr>
<th>Number of observations</th>
<th>External debt / GDP &lt; 40</th>
<th>External debt / GDP 40 – 60</th>
<th>External debt / GDP &gt; 60</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<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>
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. The control variables include three groups of indicators representing: (1) long-term potential growth and market size; (2) the country’s capacity to pay or reimburse investments; and (3) macroeconomic performance and stability. A two-step Heckman selection procedure is used to control for sample selection (see the appendix). The equation is estimated for each of three types of IMF programmes: Stand-By Arrangements (SBAs), Extended Fund Facilities (EFFs) and Poverty Reduction and Growth Facilities (PRGFs). SBAs aim to solve short-term balance of payments problems; EFFs are geared to alleviate protracted balance of payments problems; and PRGFs are concessional loans to low-income countries. SBAs and EFFs are mostly used by middle-income countries.

The results for the full sample suggest that SBAs facilitate the exit of private investors, whereas no effect on private capital flows is found for the other two programmes (Table 7.2, first column).

As stated above, a catalytic effect can only materialise if official finance falls short of the amount needed. Distinguishing between observations where official finance is larger or smaller than the country’s financing need indeed reveals that overlending negatively affects private capital flows in countries with an SBA (Table 7.2, last two

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**Table 7.2. 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 (–2.00)**</td>
<td>–1.061 (–0.82)</td>
<td>–1.444 (–2.07)**</td>
</tr>
<tr>
<td>Extended Fund Facility</td>
<td>–1.288 (–1.25)</td>
<td>–1.900 (–1.04)</td>
<td>–1.038 (–1.33)</td>
</tr>
<tr>
<td>Poverty Reduction and</td>
<td>0.096 (0.12)</td>
<td>2.558 (1.64)*</td>
<td>–1.519 (–1.76)*</td>
</tr>
<tr>
<td>Growth Facility</td>
<td></td>
<td></td>
<td></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 as per cent 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 as per cent of exports, lagged dummy for IMF programme.

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6 See table A-3 in van der Veer and de Jong (2007) for the list of variables used.
columns). In these cases the private sector is effectively bailed out. For PRGFs a marginally significant positive (negative) effect was found for cases where total official financing was smaller (larger) than the financing need. These results suggest that if we can expect any catalytic effect, it is for PRGFs.

The overall conclusion is that the catalytic effect remains elusive: official creditors thus cannot rely on private investors to voluntarily provide finance to crisis-hit countries. These disappointing results underpin the case for employing more coercive instruments to achieve private sector involvement in crisis resolution.

The Paris Club and coercive ‘comparability of treatment’

The difficulty of predicting the reaction of private capital markets is an important and often-heard argument against the introduction of coercive instruments to achieve private sector involvement. Fear of increased borrowing costs indeed informed Mexico and Brazil’s opposition to the SDRM. The international financial architecture nevertheless contains, and has been using since the mid-1950s, the coercive ‘comparability of treatment’ instrument in Paris Club debt-restructuring agreements. According to the ‘comparability of treatment’ clause, debtor countries must arrange agreements on comparable terms with private creditors. Paris Club agreements are thus ideal cases to study how private capital markets react to coercive instruments to achieve private burden-sharing. This section examines these Paris Club agreements, and thereby 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), though 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 debt covered in agreements since 1983 has been $509 billion. In spite of this 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 creditor countries – a number of rules and principles were codified in

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7 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, the UK and the USA.

8 See the Paris Club website, www.clubdeparis.org.
a United Nations resolution at the end of the 1970s. The following rules and principles are operated today: (1) decisions are made on a case-by-case basis; (2) decisions require consensus; (3) only countries with an IMF programme can apply; (4) creditors agree to implement the agreed terms; and (5) ‘comparability of treatment’ obliges the debtor country to seek debt 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 has developed a series of ‘terms’ that allow for more flexible and generous treatment of debt.9

The Paris Club introduced the possibility of debt reduction in 1988. In debt rescheduling, the entire stock of debt on which the debtor defaults is never rescheduled (Brown and Bulman 2006: 18); only a part of the arrears on debt-service payments, as well as those obligations due over a specified period of time, are consolidated into a new loan. This effectively adds a second layer of debt to what already exists, increasing the country’s total outstanding external debt. Debt rescheduling by the Paris Club thus failed to adequately address the chronic debt problems of many low-income countries. Subsequently, for roughly forty heavily indebted poor countries (HIPC), 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). The Paris Club maintained its policy of no debt reduction for middle-income countries until 2003. In that year the Paris Club agreed on the Evian Approach for non-HIPC countries, which gave creditors the option of debt reduction for these countries as well.

The principle of ‘comparability of treatment’ requires countries benefiting from Paris Club debt restructuring to seek similar (comparable) relief from their private creditors. As the principle has no legal basis, its effectiveness depends on the Paris Club’s threat of cancelling the agreement, and being less cooperative in future negotiations. For its part, the debtor country can use the threat of default to push other creditors to agree to a comparable restructuring. But as a former insider in the Paris Club notes: ‘the basic flaw in the comparable treatment principle is the absence of a consideration of how the application of the principle in a

9 Ordered from no debt reduction to more than 90 per cent debt reduction, these terms are: classic (no debt reduction); Houston (some debt reduction); Toronto (33 per cent); London (50 per cent); Naples (>50 per cent); Lyon (80 per cent); and Cologne (>90 per cent). In addition, ad hoc terms are sometimes applied as well. See www.clubdeparis.org.
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particular case will affect future flows of private capital to the debtor country’ (Rieffel 2003: 284).

The ‘comparability of treatment’ clause is essentially a coercive mechanism to achieve private sector involvement in crisis resolution. Its effectiveness in safeguarding net total private capital inflows, however, is questionable. Apart from its non-legal basis, the ‘comparability of treatment’ clause only applies to debt with a maturity of more than one year; it thus excludes short-term debt. In addition, even if the Paris Club through the clause is successful in involving private creditors with outstanding accounts, private capital markets may more generally shy away from investing in countries where they perceive they may be forced to agree to less advantageous interest and repayment conditions in the future. In this respect, it also matters whether the Paris Club agrees to rescheduling or to bilateral debt relief. Under ‘comparability of treatment’, debt rescheduling implies fewer concessions by private investors than debt reduction, and thus less incentive to disinvest. On the other hand, rescheduling debt neither reduces future debt services nor improves the (long-run) financial position of the country. Private agents could thus interpret a rescheduling agreement as lowering the possibility of repayment of their own claims, inducing them to withdraw their money.

In sum, whether the ‘comparability of treatment’ clause in Paris Club agreements 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 distinguished between countries that had signed an IMF agreement only and those that had signed a Paris Club agreement in addition to an IMF agreement. As in the previous section, 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 an SBA or an EFF, and increases private capital inflows when a country has signed a PRGF. Hence a Paris Club agreement may have variable effects, depending on whether the country has signed an SBA, EFF or a PRGF.

Van der Veer and de Jong (2007) offer two, partly complementary, explanations for these differing effects: (1) the nature – debt

10 Lex Rieffel participated in numerous Paris Club negotiations since the 1970s during his eighteen years with the US Treasury Department.
11 The Paris Club does not deal with short-term debt as its restructuring can significantly disrupt the capacity of the debtor country to participate in international trade. See www.clubdeparis.org.
12 This was observed in the 1999 agreement between Pakistan and the Paris Club creditors when the private financial community opposed inclusion of bond restructuring under the ‘comparability of treatment’ clause (see IMF 2001a: 5).
rescheduling or debt reduction – of the Paris Club agreement; and (2) the term structure of the country’s external debt.

First, the contradictory effects of Paris Club agreements could be explained by the different incentives that result from debt rescheduling and debt reduction. A deal involving debt reduction improves both a country’s short- and long-term financial position; debt rescheduling only improves a country’s short-term position while its long-term position deteriorates. If ‘comparability of treatment’ is applied, the private sector has to agree to larger write-offs under debt reduction. Private investors then 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 will most likely 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). Most debt relief is granted to countries with a PRGF, and thus to low-income countries. Here Paris Club debt reductions can result in debt cancellations of up to, and even over, 90 per cent under the ‘Cologne terms’. As such, the resulting positive effect on total private capital inflows is more likely to be evidence of a catalytic-type effect – in accordance with debt overhang theory – than evidence of effective enforcement of private debt reductions following the ‘comparability of treatment’ clause.

A second and complementary explanation for the varying effects of Paris Club agreements lies in the term structure of a country’s external debt. Private investors can easily withdraw their money if short-term debt constitutes a relatively high proportion of a country’s external debt. The ratio of short-term debt to total external debt is 13, 11 and 7 per cent for countries with an SBA, EFF and PRGF, respectively. The negative effect of a Paris Club agreement on countries with an SBA or EFF may thus reflect the greater mobility of private capital in these countries, combined with the negative assessment of the country’s financial position due to the rescheduling of debt (the dominant type of Paris Club restructuring in countries with an 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 debt restructuring is more important than the losses incurred by private creditors in the process. Stated otherwise, bailing in 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 regarding the probability of future repayment. Debt reduction by bilateral donors implies a reduction in the amount a country must eventually pay its
official creditors, while debt rescheduling effectively increases a country’s future payment obligations. Private investors are thus more willing to provide fresh capital in cases of Paris Club reductions.

**Conclusion**

Private sector involvement is a crucial element of crisis resolution. It contributes to equal burden-sharing, prevents moral hazard, and supplements necessarily limited official funding. The extent 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 debtor country authorities, and for public acceptance of the adjustment measures as legitimate. In turn, successful implementation of adjustment measures increases the chance of private capital inflows. This highlights the importance of involving private sector creditors as part of an effective debt workout if IMF policy is to be perceived as legitimate on the output side.

This chapter investigated the effectiveness of the catalytic approach in achieving this private sector involvement in crisis resolution, as well as the effectiveness of the Paris Club’s more coercive ‘comparability of treatment’ clause. In the period examined, coordination failures among official creditors worked against catalysing private sector involvement. Addressing this problem of coordination within the current international financial architecture may improve output side effectiveness of external debt workout processes and increase policy space for countries experiencing difficulties.

Our evidence revealed the failure of various multilateral and bilateral creditors to coordinate their crisis lending. A prerequisite for private sector involvement is that the public sector does not bail out private creditors; the total amount provided by official agents should fall short of the debtor’s financing need. But in about 25 per cent of cases, official institutions provide more 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 over lend, official money is likely to facilitate a rush to the exit by private investors. In cases where the amount of official finance is less than the financing need, regression analysis shows only weak evidence of an inflow of private funds, and only to low-income countries that have signed a PRGF. Even if official finance falls short of a country’s financing need, the catalytic approach appears unreliable as a policy to achieve private sector involvement.

A second coordination failure emerged from our study of the Paris Club’s coercive ‘comparability of treatment’ instrument, whereby
debtors are obliged to strike a deal with the private sector comparable to that made with the Club. Attempts by the IMF to catalyse private capital in countries with an SBA or EFF were counteracted by Paris Club involvement in these cases. Paris Club debt rescheduling in these countries – which effectively increases a country’s external debt – in combination with the Paris Club’s coercive bail-in of private creditors, conflicts with the IMF’s aim of voluntary private sector involvement via its catalytic approach. Estimations, therefore, showed that the Paris Club clause generally did not have the intended effect on net total private capital flows. The Paris Club agreements gave rise to additional inflows of private capital only in low-income countries that had signed a PRGF and where the Paris Club had 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 led to an outflow of private capital.

In sum, coordination failures among official creditors in general and the IMF and the Paris Club in particular have worked against effective catalysis in particular cases. While overcoming these coordination failures is warranted, the catalytic approach – even with improvements in the current international financial architecture – may still prove 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 prove necessary. Yet our results also show that the coercive bail-in of only some private creditors – with short-term debts 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. Private capital markets will generally react negatively to a worsening balance sheet, overriding any positive effect on net total private capital flows as a result of an effective but partial bail-in. Hence any potential coercive instrument must encompass all types of private capital flows. From this perspective, debt standstills are a likely candidate for future policy development.

Appendix: the estimation procedure

As in other empirical studies on the effects of IMF programmes, a two-step Heckman selection model was used to obtain the estimations presented in the text. The first step involved estimating a probit model for the chance a country has signed an IMF programme. The results of this estimation were 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 has signed an IMF programme or not. This lambda was added to the list of explanatory variables of the ‘equation of interest’. Both equations in the Heckman selection model were estimated simultaneously by using a maximum likelihood procedure:

\[ B = \gamma Z + u_2 \]  \hspace{1cm} \text{(selection equation)}  \hspace{1cm} (1)

\[ y = \beta X + u_1 \]  \hspace{1cm} \text{(equation of interest)}  \hspace{1cm} (2)

\[ u_2 \sim N(0, 1), \quad u_1 \sim N(0, \sigma) \]  \hspace{1cm} \text{and}  \hspace{1cm} \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 of having 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.