THE PARIS CLUB AT FIFTY

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From then to now

The Paris Club first meeting was held on May 16, 1956 with Argentina on the stand. The latest country to be hosted, on the eve of the Club fiftieth anniversary, was Moldova. This speaks for itself: the Paris Club deals with new countries with perennial problems, or so it seems.

The Paris Club has been created on the premise that countries may face transitory debt problems which could be solved by cooperative agreements of the creditors. This is in part a reflection of the days when it was created. Financial markets were then underdeveloped, and unable to refinance the debt of a country subject to a liquidity shock. The underlying goal of the Paris Club, in its early days, was to provide short run assistance, until growth would resume and solve the financial constraints faced by the country.

The following picture shows that there was some merit in this idea. It presents the pattern of growth of countries around each coming to the Paris Club, over the six years before and after the agreement. During the sixties and seventies, a Paris Club event was hardly noticeable in terms of economic growth, as countries soon caught up with the little hardship they suffered prior to their coming to the Club. In the eighties and the nineties, however, a Paris Club agreement came to be settled only after a protracted recession. Although it was followed by a return to higher growth, the rebound was itself relatively modest.

[1] This paper is prepared for the 50th anniversary of the Paris Club. It draws on a research to which participated Philippe Briard, Arnaud Vanneste, Guy Lalanne, Stephane Sorbe, Yanos Zylberberg, Antoine Lallour and Sebastien Villemot, whom I gratefully thank for their insightful contributions.

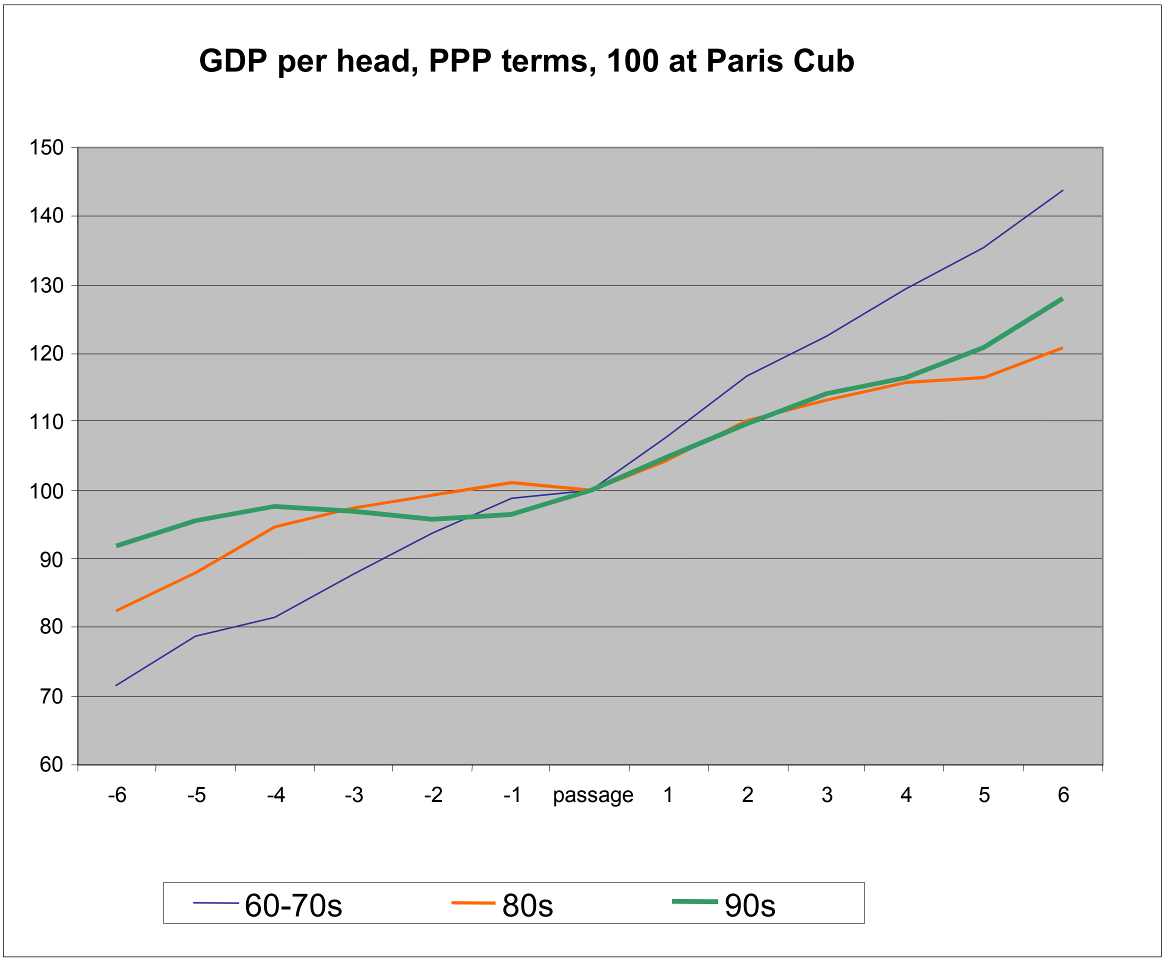
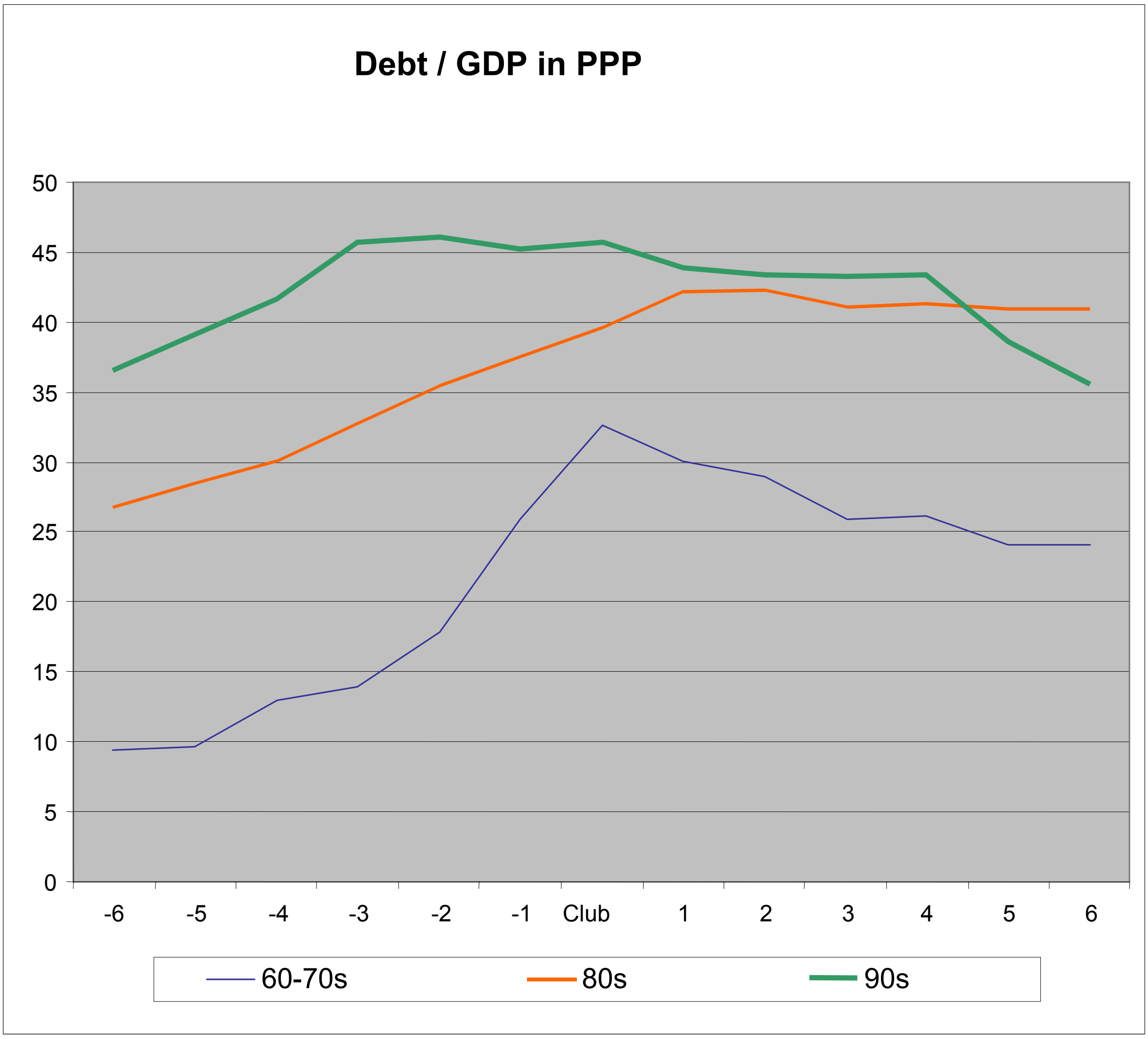


Figure 1

This is mirrored in the evolution of the debt ratios. In the eighties and nineties (which include the mid 2000s), the Paris Club agreements do not appear to have done much to restore the credit ratios of the countries involved. While the lowering of debt ratios was evident in the sixties and seventies, due to the resumption of growth, the later decades were rather disappointing. Only in the late nineties do such patterns emerge, but this was the outcome of the debt reduction initiatives.



The rise of poor countries risk

Financial globalization has changed the purpose of the Paris Club. For countries having access to financial markets, liquidity problems are theoretically impossible and practically rare[2]. Solvency problems however can be a lasting problem, but they are not ones that debt refinancing at market rate could address. This was slowly recognized, and culminated with the advent of the Brady plan and of concessional Paris Club terms of debt treatment.

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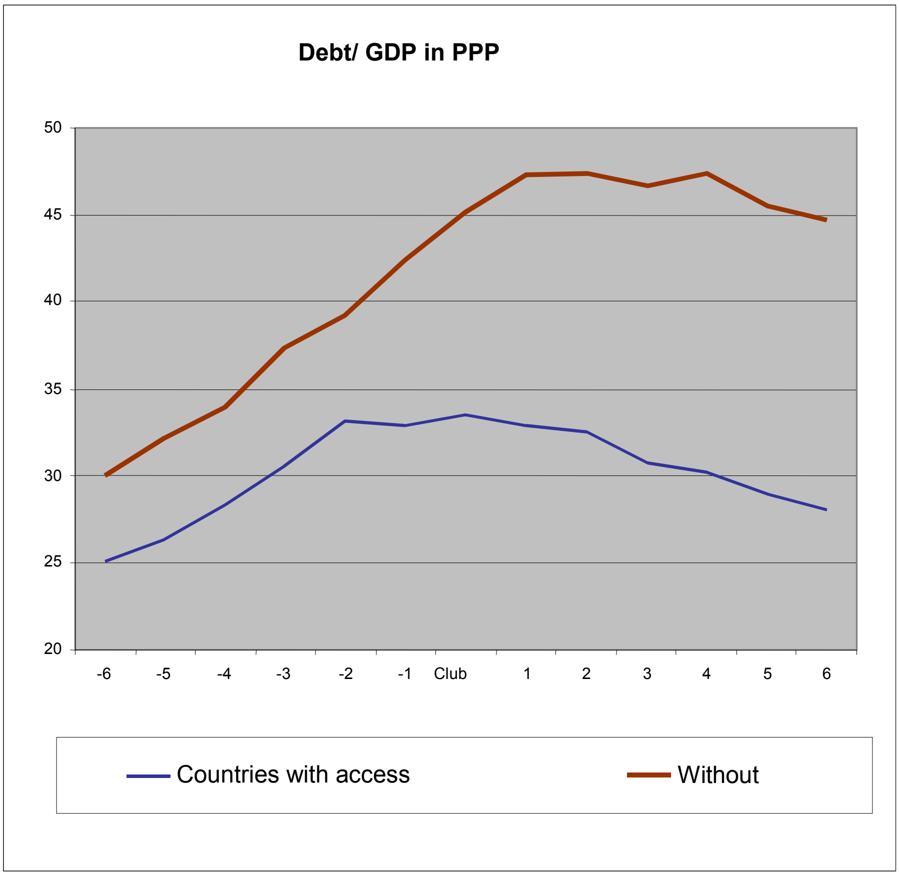
[2] New "self-fulfilling" pathologies are created however. The Mexican and the Asian crises are two examples at hand. In that case however what is needed is a lender of last resort, capable of injecting huge quantities of resources, not a piecemeal agreement.

For countries with no access to the financial markets, the initial practice of refinancing liquidity problems could remain, in principle, a worthy exercise. Moreover, it appeared that the poorest countries were no less victims of solvency problems than the emerging countries.

The following picture shows the Debt-to-GDP ratios prior and after a passage to the Paris club, distinguishing countries with or without access to the financial markets. As one sees, the countries without access experienced an even larger deterioration of their solvency ratios than countries having access to financial markets.



The recognition of these trends explains the various initiatives from Toronto to Cologne that changed the focus towards debt reduction. These moves have been all the more pressing that dealing with the debt of poor countries, without access to financial markets, increasingly became the core of the Paris Club activities. This is shown in the following table.

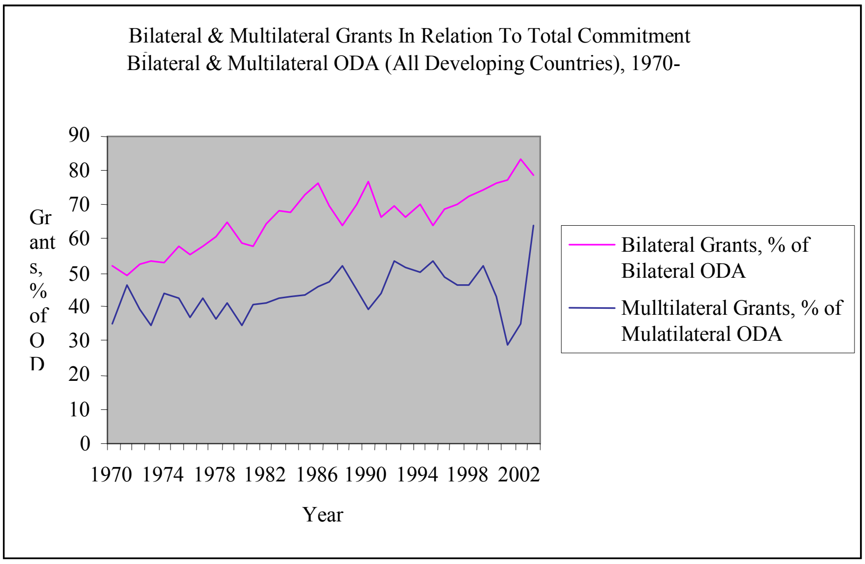
Number of Club de Paris agreements Depending on the access to financial markets			
	Access to financial markets	No access	% countries with access
60-70s	17	8	68%
80s	50	87	36%
90s	49	88	36%
2000-2005	14	63	18%

Source *Gelos et al.(IMF 2004)*

<u>Grants and loans</u>

Whatever the relevant doctrine, it is not the same thing to solve the problems which are faced by a country which has access to the financial markets, and to cure the debt problem of a poor country with no such access, relying heavily on the rich countries' assistance. In this latter case indeed, debt restructuring becomes another name of aid assistance. The balance between loans, and the cost of refinancing them, and grants has become a critical issue.

According to the line of reasoning that was developed by the Meltzer commission, HIPC should obtain full debt relief, and simply stop borrowing afterwards, relying mostly on grants. This is a philosophy that has been endorsed by the US administration and roughly by the academic community at large. So far as the bilateral institutions are concerned, this is already reflected in the current trends.



Source: Cohen and Reisen (2006)

The argument in favour of grants over loans has been summarized by Bulow and Rogoff (BR) as follows. The poorest countries have no access to the financial markets for a good reason: they are unable to repay their debt. It is then hard to see on what premises foreign governments could expect to be better treated than private bankers (all the more so that they have to count with a public opinion increasingly hostile to debt) . If anything the HIPC makes that point forcefully.

How could one answer this simple and powerful argument? One line is the following. There are many other reasons than, say, bad governance which explain why poor countries have no access to world financial markets. Macroeconomic instability, driven by commodity shocks or natural disaster, is also a critical factor. For the poorest countries, the annual number of disasters between 1997 and 2001 has been one every 2.5 years. Commodity price shocks are also more severe for poor countries. Low income countries experienced this type of shock on average every 3.3 years. About 26 highly indebted countries have an export concentration of more than 50% in three or fewer commodities, while 62% of the total exports of the least developed countries are unprocessed primary commodities.

In most cases, such risks are a powerful factor of exclusion from private markets. Now let us consider, in view of these risks, the case of a public agency that hesitates between making grants and loans. Assume that there is a fifty percent chance that the country will fail to repay its debt out of this exogenous risk. The agency can either offer \$100 of grants, or make a loan with a 50% probability of repayment. If it is willing to take the risk, the agency can then make a loan worth $200. There is an interesting leverage which can increase the aid volume for a given ODA. This obviously requires to deal appropriately with exogenous shocks and to implement credible rules for debt reductions when they are needed: but contrary to the BR line of reasoning, it does not foreclose loans in the future[3]. This may explain why new bilateral credits, from China in particular, are offered.

Conclusion

The Paris Club had to address two major shifts to which it was initially ill-prepared. On the one hand, the rise of financial markets as a prime provider of finance for middle income debtors made old-styled liquidity problems obsolete. On the other hand, the political willingness to help poor countries has made debt forgiveness one key instrument for delivering aid. The future of the Club seems to be settled by the decline of loans originating from its original members. Either it will include new members such as China, or it will close. At any rate, whatever role remains will require a higher degree of coordination with the donor community. There may be room for both loans and grants, but not in isolation.

[3] In our contribution with Helmut Reisen (2006), we argue that development banks should make provisions against the risk of writing down the debt of the poorest countries. These provisions could be subsidized by grants, and be counted as ODA.

References

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