The Paris Club and International Debt Relief

name redacted
Analyst in International Trade and Finance

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Summary

The Paris Club is a voluntary, informal group of creditor nations who meet approximately 10 times per year, to provide debt relief to developing countries. Members of the Paris Club agree to renegotiate and/or reduce official debt owed to them on a case-by-case basis.

The United States is a key Paris Club Member and Congress has an active role in both Paris Club operations and U.S. policy regarding debt relief overall. The Federal Credit Reform Act of 1990 stipulates that Congress must be involved in any official foreign country debt relief and notified of any debt reduction and debt renegotiation.

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Introduction

The Paris Club is the major forum where creditor countries renegotiate official sector debts. Official sector debts are those that have been either issued, insured, or guaranteed by creditor governments. A Paris Club 'treatment' refers to either a reduction and/or renegotiation of a developing country's Paris Club debts. The Paris Club includes the United States and 18 other permanent members, the major international creditor governments. Besides the United States, the permanent membership is composed of Austria, Australia, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Netherlands, Norway, Russia, Spain, Sweden, Switzerland, and the United Kingdom. Other creditors are allowed to participate in negotiations on an ad-hoc basis.

By contrast, the London Club, a parallel, informal group of private firms, meets in London to renegotiate commercial bank debt. Unlike the Paris Club, there is no permanent London Club membership. At a debtor nation's request, a London Club meeting of its creditors may be formed, and the Club is subsequently dissolved after a restructuring is in place.

The Paris Club does not exist as a formal institution. It is rather a set of rules and principles for debt relief that have been agreed on by its members. To facilitate Paris Club operations, the French Treasury provides a small secretariat, and a senior official of the French Treasury is appointed chairman. The current Paris Club chairman is Jean-Pierre Jouyet, Under-Secretary of the French Treasury. In addition to representatives from the creditor and debtor nations, officials from the international financial institutions (IFIs) and the regional development banks are represented at Paris Club discussions. The IFIs present their assessment of the debtor country's economic situation to the Paris Club. To date (December 2013), the Paris Club has reached 429 agreements with 90 debtor countries. Since 1983, the total amount of debt covered in Paris Club agreements—rescheduled or reduced—is approximately $573 billion.

As several emerging economies including Brazil, China, and India developed robust aid foreign loan programs, concerns have been raised that many low-income countries in South Asia and su-Saharan Africa that reduced their bilateral and multilateral debts may slide again into indebtedness due to cheap loans. In October 2013, Paris Club officials met with representatives from emerging creditor nations to begin an effort to harmonize approaches to lending and restructuring.[1] The meeting included China, India, Mexico, Turkey and Gulf Arab countries, with the 19 Paris Club members.

Background

Since the first debt restructuring took place in 1956, the terms, rules, and principles of the Paris Club have evolved to their current shape. This evolution occurred primarily through the G7/8 Summits.[2] Five 'principles' and four 'rules' currently govern Paris Club treatments. Any country

[1] Hugh Carnegy, "'Rich Country' creditors seek emerging markets lender accord," *Financial Times*, October 233, 2013.

[2] The G8 Summit brings together the leaders of Canada, France, Germany, Italy, Japan, Russia, the United Kingdom, and the United States, annually, to discuss a wide range of political, social, and economic issues.

that accepts the rules and principles may, in principle, become a member of the Paris Club. Yet since the Paris Club permanent members are the major international creditor countries, they determine its practices.

The five Paris Club 'principles' stipulate the general terms of all Paris Club treatments. They are: (1) Paris Club decisions are made on a *case-by-case* basis; (2) all decisions are reached by full *consensus* among creditor nations; (3) debt renegotiations are applied only for countries that clearly need debt relief, as evidenced by implementing an International Monetary Fund (IMF) program and its requisite economic policy *conditionality*; (4) *solidarity* is required in that all creditors will implement the terms agreed in the context of the renegotiations; and (5) the Paris Club preserves the *comparability of treatment* between different creditors. This means that a creditor country cannot grant to a debtor country a treatment on more favorable terms than the consensus reached by Paris Club members.[3]

While Paris Club 'principles' are general in nature, its 'rules' specify the technical details of Paris Club treatments. The 'rules' detail (1) the types of debt covered - Paris Club arrangements cover only medium and long-term public sector debt and credits issued prior to a specified "cut-off" date; (2) the flow and stock treatment;[4] (3) the payment terms resulting from Paris Club agreements; and (4) provisions for debt swaps.[5]

Since the Paris Club is an informal institution, the outcome of a Paris Club meeting is not a legal agreement between the debtor and the individual creditor countries. Creditor countries that participate in the negotiation sign a so-called 'Agreed Minute.' The Agreed Minute recommends that creditor nations collectively sign bilateral agreements with the debtor nation, giving effect to the multilateral Paris Club agreement. By recommending that the United States renegotiate or reduce debts owed to it, congressional involvement is necessary to implement any Paris Club agreement.

Paris Club Terms

There are four types of Paris Club treatments depending on the economic circumstances of the distressed country. They are, in increasing degree of concessionality: **Classic Terms**, the standard terms available to any country eligible for Paris Club relief; **Houston Terms**, for highly-indebted lower to middle-income countries; **Naples Terms**, for highly-indebted poor countries; and **Cologne Terms**, for countries eligible for the IMF and World Bank's Highly Indebted Poor Countries Initiative (HIPC). Classic and Houston terms offer debt rescheduling while Naples and Cologne terms provide debt reduction.

[3] For more information on Paris Club principles and rules, see http://www.clubdeparis.org.

[4] The flow treatment provides a method for the debtor country to progress through temporary balance of payments difficulties. Stock treatment specifies what portion of a country's 'stock' of debt is covered by the Paris Club agreement.

[5] A debt swap is a transaction in which a company, or in the case of the Paris Club, a country, exchanges debt for other assets, such as foreign aid, equity, or local currency debt.

Classic Terms

Classic terms are the standard terms for countries seeking Paris Club assistance. They are the least concessional of all Paris Club terms. Debts are rescheduled at an appropriate market rate.

Houston Terms

Houston terms were created at the 1990 G-7 meeting in Houston, Texas so the Paris Club could better accommodate the needs of lower middle-income countries. Houston terms offer longer grace and repayment periods on development assistance than do Classic terms.

Naples Terms

Naples Terms, designed at the December 1994 G-7 meeting in Naples, Italy, are the Paris Club's terms for cancelling and rescheduling the debts of very poor countries. Countries may receive Naples terms treatment if they are eligible to receive loans from the World Bank's concessional facility, the International Development Agency (IDA). A country is eligible for IDA loans if it has a per-capita GDP of less than $755. According to Naples Terms, between 50% and 67% of eligible debt may be cancelled. The Paris Club offers two methods for countries to implement the debt reduction. Countries can either completely cancel the eligible amount, and reschedule the remaining debts at appropriate market rates (with up to 23-year repayment period and a six-year grace period); or they can reschedule their total eligible debt at a reduced interest rate and with longer repayment terms (33 years).

Cologne Terms

Cologne terms were created at the June 1999, G-8 Summit in Cologne, Germany.[6] Cologne terms were created for countries that are eligible for the World Bank and IMF 1996 Highly Indebted Poor Countries Initiative (HIPC).[7] They allow for higher levels of debt cancellation than Naples Terms. Under Cologne terms, 90% of eligible debts can be cancelled.

The Evian Approach

On October 8, 2003, Paris Club members announced a new approach that would allow the Paris Club to provide debt cancellation to a broader group of countries. The new approach, named the "Evian Approach" introduces a new strategy for determining Paris Club debt relief levels that is more flexible and can provide debt cancellation to a greater number of countries than was available under prior Paris Club rules. Prior to the Evian Approach's introduction, debt cancellation was restricted to countries eligible for IDA loans from the World Bank under Naples Terms or HIPC countries under Cologne terms. Many observers believe that strong U.S. support for Iraq debt relief was an impetus for the creation of the new approach.

[6] A list of all Paris Club debt reductions under Cologne Terms can be found online at http://www.clubdeparis.org/en/countries/countries.php?TYPE_TRT=CO.

[7] CRS Report RL33073, *Debt Relief for Heavily Indebted Poor Countries: Issues for Congress*, by (name redacted); and CRS Report RS22534, *The Multilateral Debt Relief Initiative*, by (name redacted).

Instead of using economic indicators to determine eligibility for debt relief, all potential debt relief cases are now divided into two groups: HIPC and non-HIPC countries. HIPC countries will continue to receive assistance under Cologne terms, which sanction up to 90% debt cancellation. (The United States and several other countries routinely provide 100% bilateral debt cancellation.) Non-HIPC countries are assessed on a case-by-case basis.

Non-HIPC countries seeking debt relief first undergo an IMF debt sustainability analysis. This analysis determines whether the country suffers from a liquidity problem, a debt sustainability problem, or both. If the IMF determines that the country suffers from a temporary liquidity problem, its debts are rescheduled until a later date. If the country is also determined to suffer from debt sustainability problems, where it lacks the long-term resources to meet its debt obligations and the amount of debt adversely affects its future ability to pay, the country is eligible for debt cancellation.

U.S. Participation

The United States began participating in Paris Club debt forgiveness in 1994, under authority granted by Congress in 1993 (Foreign Operations Appropriations, §570, P.L. 103-87). Annually reenacted since 1993, this authority allows the Administration to cancel various loans made by the United States. These can include U.S. Agency for International Development (USAID) loans, military aid loans, Export-Import Bank loans and guarantees, and agricultural credits guaranteed by the Commodity Credit Corporation.

The procedure for budgeting and accounting for any U.S. debt relief is based on the method used to value U.S. loans and guarantees provided in the Federal Credit Reform Act of 1990.[8] The Act, among other things, provides for new budgetary treatment of and establishes new budgetary requirements for direct loan obligations.

Since passage of the act, U.S. government agencies are required to value U.S. loans, such as bilateral debt owed to the United States, on a net present value basis rather than at their face value, and an appropriation by Congress of the estimated amount of debt relief is required in advance of any debt relief taking place. Prior to the passage of the act, neither budget authority nor appropriations were required for official debt relief and bilateral debt (and other federal commitments) were accounted for on a cash-flow basis, which credits income as it is received and expenses as they are paid.

Determining the net present value is a complex calculation involving several factors, including the terms of loan (whether it is concessional or at market rates), as well as the financial solvency of the debtor and their likelihood of repayment. Following the passage of the act, a working group of executive branch agencies, the Inter-Agency Country Risk Assessment System (ICRAS), was created to maintain consistent assessments of country risk across the many U.S. agencies that make foreign loans. ICRAS operates as a working group. The Office of Management and Budget

[8] CRS Report 91-381, *Statutory Authorities Related to Official Debt Relief*, by (name redacted) (archived CRS Report, available from author). See also, "Appendix IX: How the United States Budgets and Accounts for Debt Relief," in U.S. General Accounting Office, *DEVELOPING COUNTRIES: Debt Relief for the Poorest*, GAO/NSAID-00-161, June 1, 2000, pp. 128-142.

chairs ICRAS.[9] The U.S. Export-Import Bank provides country risk assessments and risk rating recommendations, which must be agreed on by all the ICRAS agencies. OMB is then responsible for determining the expected loss rates associated with each ICRAS risk rating and maturity level. Each sovereign borrower or guarantor is rated on an 11-category scale, ranging from A to F-.

Some analysts, including the Government Accountability Office (GAO), raise concerns about the official process for estimating the cost of foreign loans to the United States, and thus the cost needed to forgive U.S. debt.[10] OMB's current methodology uses rating agency corporate default data and interest rate spreads in a model it developed to estimate default probabilities and makes assumptions about recoveries after default to estimate expected loss rates. According to GAO, the method that OMB employs may calculate lower loss rates than may be justified for the sovereign debt of emerging economies.

In 2004, GAO recommended that the Director of OMB provide affected U.S. agencies and Congress with technical descriptions of its current expected loss methodology and update this information when there are changes. GAO also recommended that the OMB Director arrange for independent review of the methodology and ask U.S. international credit agencies for their most complete, reliable data on default and repayment histories, so that the validity of the data on which the methodology is based can be assessed over time. In their response, OMB made no commitment to increase transparency or engage the private sector rating community.

Author Contact Information

(name redacted)
Analyst in International Trade and Finance
/redacted/@crs.loc.gov, 7-....

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[9] For more information on ICRAS, see, "Appendix IV: Interagency Country Risk Assessment System," in U.S. Government Accountability Office, *EXPORT-IMPORT BANK: OMB's Method for Estimating Bank's Loss Rates Involves Challenges and Lacks Transparency*, GAO-O4-531, September 2004, pp. 76-78.

[10] U.S. Government Accountability Office, *EXPORT-IMPORT BANK: OMB's Method for Estimating Bank's Loss Rates Involves Challenges and Lacks Transparency*, GAO-O4-531, September 2004.