Preferred and Non-Preferred Creditors

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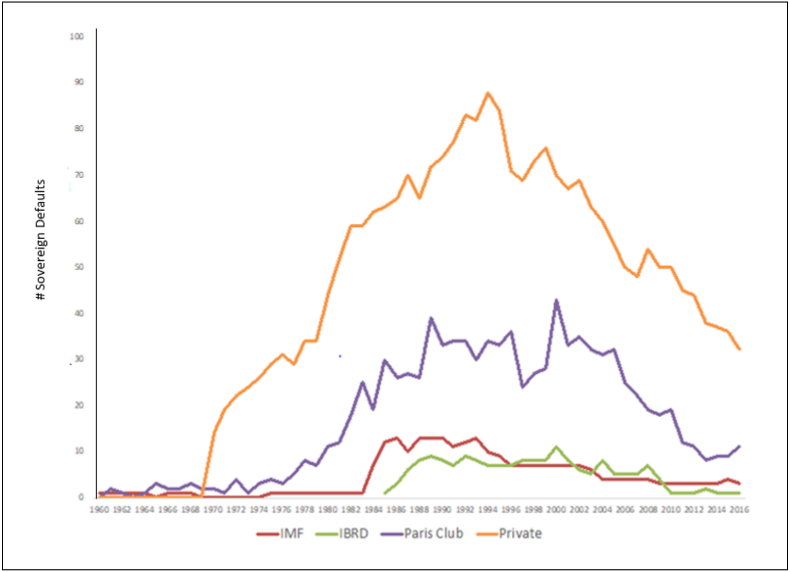
What is the PCT?

- The preferred creditor treatment **is not** a legal status or a legal obligation on governments to give the World Bank, the IDB, the IMF, or other IFIs, priority over other lenders

- "**It is** the practice (or custom) of borrowing member countries of continuing to service their loans from the Bank during periods when they are unable to service all their external debts in accordance with their terms, which other creditors have acquiesced in this practice"

PCT is a common practice



Name and Shame

Number of defaults years to IMF and/or IBRD, by country

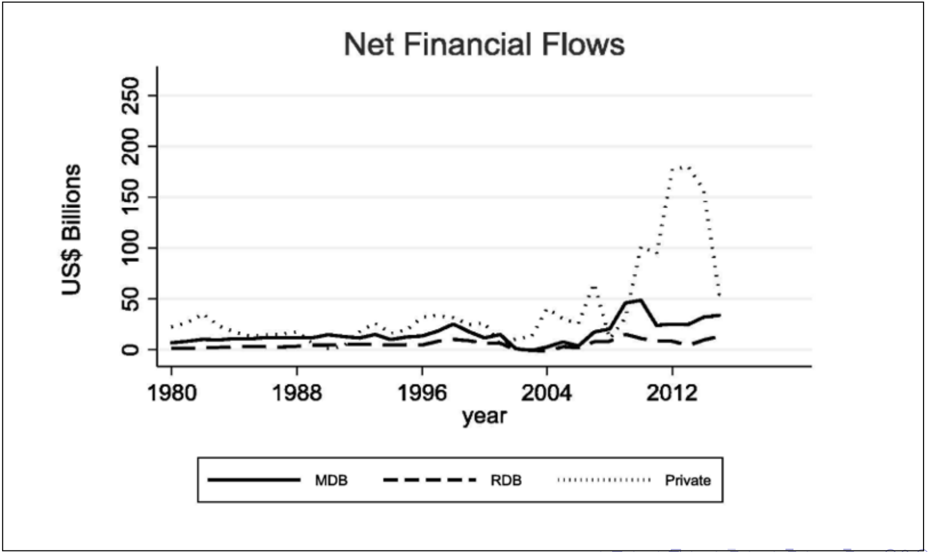
Countries	IMF	IBRD	IMF&IBRD	Countries	IMF	IBRD	IMF&IBRD
Afghanistan	9	1	1	Laos	1	0	0
Argentina	4	2	1	Lebanon	0	1	0
Bolivia	2	0	0	Liberia	25	23	23
Bosnia & Herzegovina	3	5	0	Macedonia	0	1	0
Brazil	4	0	0	Myanmar	0	4	0
Cambodia	19	0	0	Nicaragua	4	7	2
Central African Republic	9	0	0	Pakistan	2	0	0
Chad	1	0	0	Panama	5	4	4
Chile	2	0	0	Peru	9	5	5
Comoros	1	1	0	Rep. Of Congo (Brazzaville)	0	6	0
Côte d'Ivoire	0	5	0	Romania	4	1	1
Cuba	5	0	0	Rwanda	1	0	0
Dem. Rep. of Congo (Kinshasa)	18	9	9	Samoa	0	1	0
Dominican Republic	1	0	0	Serbia	9	11	9
El Salvador	1	0	0	Seychelles	0	5	0
Equatorial Guinea	3	0	0	Sierra Leone	12	4	4
Gambia	3	0	0	Somalia	34	4	4
Ghana	1	0	0	St. Lucia	3	0	0
Greece	1	0	0	Sudan	37	9	9
Guatemala	0	2	0	Suriname	1	0	0
Guinea-Bissau	3	0	0	Syria	1	16	0
Guyana	10	3	3	Tanzania	3	0	0
Haiti	7	2	1	Togo	0	2	0
Honduras	3	1	1	Uruguay	1	0	0
India	0	1	0	Vietnam	14	0	0
Iran	0	1	0	Yugoslavia	2	0	0
Iraq	14	14	13	Zambia	12	3	3
Jamaica	5	0	0	Zimbabwe	16	17	16
				Total (56 countries)	**325**	**171**	**109**

One possible reason

Lending Rates for IBRD Flexible Loans with a Variable Spread (1) (Effective July 1, 2018) (2)(4)

Average Maturity (years)(5)	8 years and below	Greater than 8 to 10	Greater than 10 to 12	Greater than 12 to 15	Greater than 15 to 18	Greater than 18 to 20
Group A	LIBOR +0.48%	LIBOR +0.58%	LIBOR +0.68%	LIBOR +0.78%	LIBOR +0.88%	LIBOR +0.98%
Group B	LIBOR +0.48%	LIBOR +0.58%	LIBOR +0.73%	LIBOR +0.88%	LIBOR +1.03%	LIBOR +1.18%
Group C	LIBOR +0.48%	LIBOR +0.58%	LIBOR +0.78%	LIBOR +0.98%	LIBOR +1.18%	LIBOR +1.38%
Group D	LIBOR +0.53%	LIBOR +0.63%	LIBOR +0.88%	LIBOR +1.13%	LIBOR +1.38%	LIBOR +1.63%
Front-End Fee (7)	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%
Commitment Fee (8)	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%

Another one (not in this paper)



Literature

- Sovereign borrowing and willingness to pay literature does not address PCT
  - e.g., Eaton and Gersowitz (1981), Kletzer and Wright (2000), Arellano (2008), Aguilar and Amador (2013)
- PCT literature does not address willingness to pay senior creditors, it assumes it
  - e.g., Bolton and Jeanne (2009), Boz (2011), Chaterterjee and Eyigungor (2015), Fink and Sholl (2016), Hatcheondo et al (2017)

Questions

- Can the PCT be sustained as an equilibrium outcome?
- Are there limits to the amount of “safe” IFI lending?
- Do such limits depend on the characteristics of a country?
- What is the optimal amount of IFI (preferred) lending?
- How should IFIs allocate their capital if it is limited?

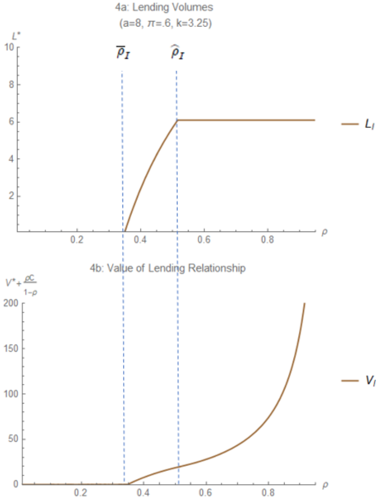
The model (i)

- We develop a very simple (infinite-horizon discrete-time) model of emergency lending
- Where a country is hit by a shock with probability ρ
- And to cope with the consequences of the shock it can borrow
  - from an IFI, which is willing to lend only if it can lend at the risk-free rate and be always repaid
  - or from the market, which charges a rate that prices in the expected probability of default

The model (ii)

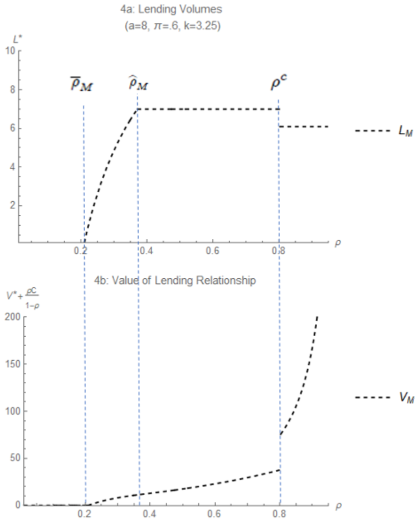
- Loans are short term and are due at the end of each period
- The cost of repaying the debt can be either
  - low
  - or high
- If the country defaults,
  - on the IFI
    - it is excluded from official lending until it fully repays its arrears
  - on the market
    - it is excluded forever

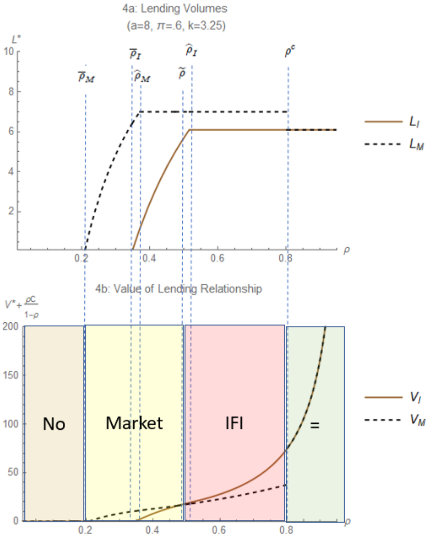
IFI lending



4a: Lending Volumes
(a=8, π=.6, k=3.25)
L*
10
8
6
4
2
0.2
0.4
0.6
0.8
ρ
L_I
4b: Value of Lending Relationship
200
150
100
50
0
0.2
0.4
0.6
0.8
ρ
V_I

Market lending

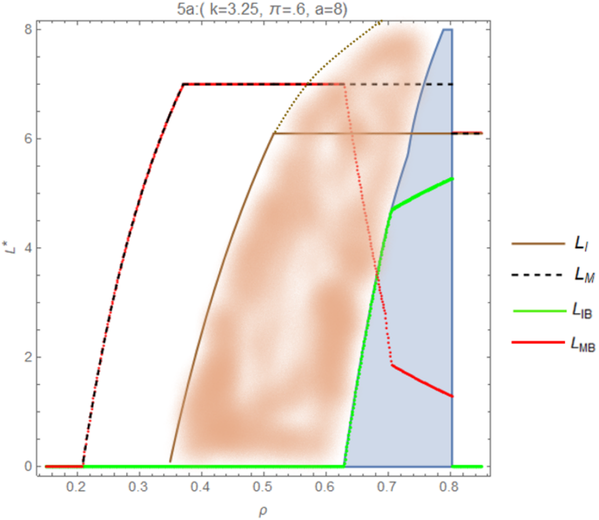



4a: Lending Volumes
(a=8, π=.6, k=3.25)
L^*
$\bar{\rho}_M$
$\bar{\rho}_I$
$\hat{\rho}_M$
$\tilde{\rho}$
$\hat{\rho}_I$
ρ^c
L_I
L_M
ρ
4b: Value of Lending Relationship
$V^* + \frac{\rho C}{1-\rho}$
No
Market
IFI
=
V_I
V_M

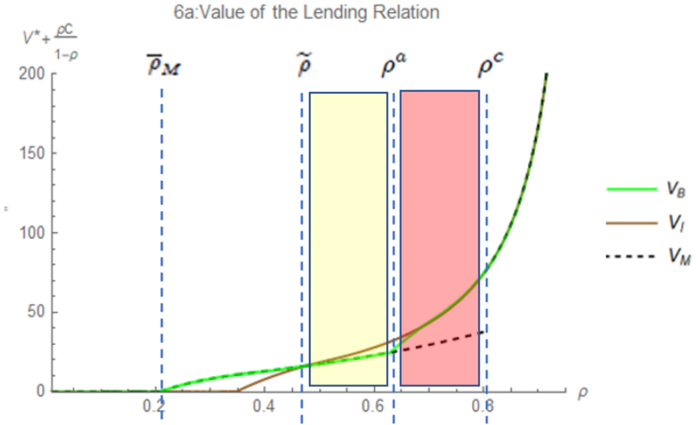
Blended case

- To solve for the blended case we assume that the (benevolent) IFI moves first
- And chooses the optimal amount of (safe) lending
- Anticipating what the country will borrow from the market and can default in the high-repayment-cost state

Solving for the blended case



How valuable is official and market lending?



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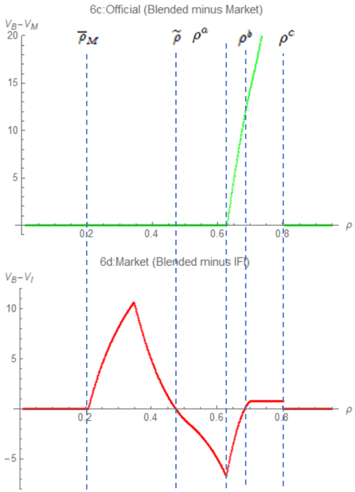
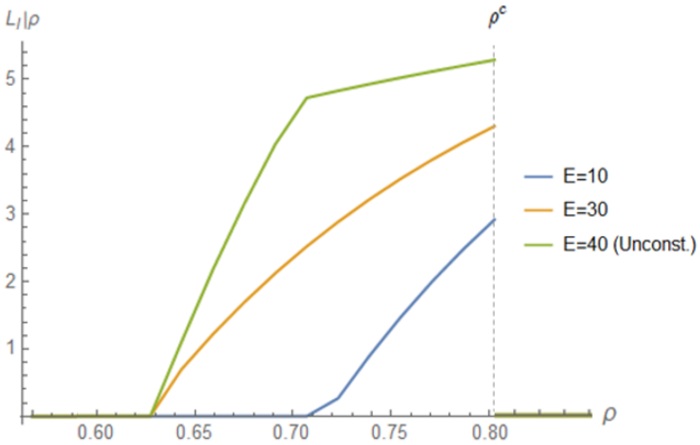


Summing up

- Market access is more valuable for low values of ρ
- IFI lending is more valuable for intermediate values of ρ
- When this is the case, market borrowing crowds out more efficient official lending
- Hence, it would be optimal to ban it (no non-concessional lending clause)
- When shocks are recurrent, it is optimal to have both official and market lending
- But when they are "the norm" the market can offer risk-free loans

Optimal capital allocation



Conclusions (i)

- IFIs are valuable because they can commit to lend a specified amount that will be repaid
- Markets seldom can do that (multiple equilibria/dilution problem)
- It may be welfare improving for IFIs to lend conditionally on countries not borrowing from the market

Conclusions (ii)

- PCT allows the official sector to lend more when the risk for commercial lenders is relatively high
- This means that IFIs should not allocate capital according to commercial lenders' risk measures
- Actually, they should be allowed to lend proportionally more to countries that have no or little market access
- This not only for development reasons, but also for safeguarding their resources

Conclusions (iii)

- Official lenders can help countries cope with major shocks, but there is a limit to the amount they can lend while maintaining PCT
  - Greece repaid private lenders while on default with the IMF, but may not repay...others official creditors
  - Argentina received a relatively small IMF package in 2001 and repaid in full and early
  - But now it borrowed a lot...
  - Italy?
- Asking IFIs to "share the burden" in a debt restructuring operation, would destroy their ability of lending risk free, and thus their value added
- Bottom line: PCT lenders are different, the difference should be exploited not diminished

And...

Thank You!