Preferred and Non-Preferred Creditors

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ABCDE

June 17-18, 2019
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
## Number of defaults years to IMF and/or IBRD, by country

<table>
<thead>
<tr>
<th>Countries</th>
<th>IMF</th>
<th>IBRD</th>
<th>IMF&amp;IBRD</th>
<th>Countries</th>
<th>IMF</th>
<th>IBRD</th>
<th>IMF&amp;IBRD</th>
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<td>0</td>
<td>Zimbabwe</td>
<td>16</td>
<td>17</td>
<td>16</td>
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</tbody>
</table>

Total (56 countries) 325 171 109
### Lending Rates for IBRD Flexible Loans with a Variable Spread (1) (Effective July 1, 2018) (2)(4)

<table>
<thead>
<tr>
<th>Average Maturity (years)(5)</th>
<th>8 years and below</th>
<th>Greater than 8 to 10</th>
<th>Greater than 10 to 12</th>
<th>Greater than 12 to 15</th>
<th>Greater than 15 to 18</th>
<th>Greater than 18 to 20</th>
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</thead>
<tbody>
<tr>
<td><strong>Group A</strong></td>
<td>LIBOR +0.48%</td>
<td>LIBOR +0.58%</td>
<td>LIBOR +0.68%</td>
<td>LIBOR +0.78%</td>
<td>LIBOR +0.88%</td>
<td>LIBOR +0.98%</td>
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<td><strong>Group B</strong></td>
<td>LIBOR +0.48%</td>
<td>LIBOR +0.58%</td>
<td>LIBOR +0.73%</td>
<td>LIBOR +0.88%</td>
<td>LIBOR +1.03%</td>
<td>LIBOR +1.18%</td>
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<td><strong>Group C</strong></td>
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<td>LIBOR +0.78%</td>
<td>LIBOR +0.98%</td>
<td>LIBOR +1.18%</td>
<td>LIBOR +1.38%</td>
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<td><strong>Group D</strong></td>
<td>LIBOR +0.53%</td>
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<td>LIBOR +0.88%</td>
<td>LIBOR +1.13%</td>
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<tr>
<td><strong>Front-End Fee (7)</strong></td>
<td>0.25%</td>
<td>0.25%</td>
<td>0.25%</td>
<td>0.25%</td>
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<tr>
<td><strong>Commitment Fee (8)</strong></td>
<td>0.25%</td>
<td>0.25%</td>
<td>0.25%</td>
<td>0.25%</td>
<td>0.25%</td>
<td>0.25%</td>
</tr>
</tbody>
</table>
Another one (not in this paper)
Sovereign borrowing and willingness to pay literature does not address PCT


PCT literature does not address willingness to pay senior creditors, it assumes it

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 $\rho$

- 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
\( L^* \)
\( \bar{\rho}_I \quad \hat{\rho}_I \quad L_I \)

4b. Value of Lending Relationship
\( V^* \cdot \frac{\rho \leq 1 - \rho}{1 - \rho} \)
\( V_I \)
Market lending

4a: Lending Volumes
\( (\alpha=0, \pi=0.6, k=3.25) \)

\[ L^* \]

\[ \bar{\rho}_M, \bar{\rho}_M, \rho^C \]

\[ L_N \]

4b: Value of Lending Relationship

\[ V^* + \frac{\bar{y}}{1-p} \]

\[ V_M \]

\[ 0.2, 0.4, 0.6, 0.8 \]
Optimal IFI and market lending

4a: Lending Volumes
(a=8, π=6, k=3.25)

4b: Value of Lending Relationship

No  Market  IFI
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?
How valuable is official and market lending?
Summing up

- Market access is more valuable for low values of $\rho$

- IFI lending is more valuable for intermediate values of $\rho$

- 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

The graph shows the relationship between $L_1|\rho$ and $\rho$ for different values of $E$: $E=10$, $E=30$, and $E=40$ (Unconst.). The curves indicate how capital allocation changes as the parameter $\rho$ varies.
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.
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!