Resolving Nigeria's Paris Club Debt Problem:

A Case of Non-Performing Creditors

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August 1, 2005
[FINAL DRAFT]

FINALDRAFT:1Aug05

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EXECUTIVE SUMMARY

Intense domestic pressure has convinced Nigeria's President, Olusegun Obasanjo, to consider a deal that would eliminate the country's $31 billion of debt owed to the governments of the United Kingdom, France, and other aid-giving countries.

The creditor countries have proposed an unprecedented deal that would cancel all of Nigeria's debt to them in exchange for a cash payment of roughly $12 billion. Thus the write-off would amount to $18 billion or 60 percent of what Nigeria now owes them. The proposed deal is unprecedented because the Paris Club has never before agreed to a buyback of debt at a discount. (They only agreed to the first ever buybacks, at par, earlier this year.) The Paris Club, an informal mechanism for restructuring loans extended by bilateral official agencies, has carried out almost 400 debt-restructuring operations with debt-distressed countries over the past 50 years.

The creditor proposal is driven by UK Prime Minister Tony Blair's decision to make aid to Africa one of the centerpieces of the July 2005 G-8 Summit meeting at Gleneagles in Scotland. The Summit leaders agreed on this occasion to cancel the remaining debt of the Heavily-Indebted Poor Countries (HIPCs) owed to multilateral institutions (IMF, World Bank, and African Development Bank) under a program initiated in 1996. Although Nigeria is not a HIPC because of its oil revenues, the G-8 leaders could not ignore Nigeria because it is Africa's most populous country, has a democratic government in place after 16 years of military dictatorship, has followed enlightened economic policies for the past five years, and has an annual per capita income below the average of the HIPCs.

The proposed deal is being sharply criticized from both sides. In Nigeria, the President Obasanjo is accused of being hoodwinked by the Paris Club and using the country's valuable foreign exchange reserves to satisfy foreign creditors instead of alleviating poverty at home. In the creditor countries, governments are being accused of rewarding one of the most corrupt countries in the world for reneging on its contractual obligations when it has the capacity to meet these in full.

In contrast to commercial debt-restructuring operations, Paris Club operations are highly politicized. The deal on the table reflects heavy political baggage that burdens both parties. While it is possible to speculate on what a non-political deal would look like, this is an academic exercise. In the end, this was the only deal that was politically feasible for both sides.

The broader implications of the deal for the creditor countries are generally positive because they move the Paris Club toward greater flexibility after a period of five years in which inflexibility was raising the perceived risk of private sector lending to emerging market countries and therefore constraining access to international capital markets for this important group of countries as a whole.

The implications of the deal for Nigeria are harder to assess because debt relief buys nothing; it only formalizes past losses. The future economic prospects of Nigeria do not depend on whether Nigeria has zero, $3 billion, or $31 billion of Paris Club debt. It depends on the degree of social consensus in the country in support of wise economic policies and a long list of institutional improvements required to reduce corruption and foster job-creating productive investments.

The deal is not yet closed. Before Nigeria can sit down with the Paris Club creditors and hammer out the details, Nigeria will have to reach agreement with the IMF on an economic program to be supported by a new IMF facility to be created by September. The program will be based on Nigeria's "home grown" economic reform blueprint, the National Economic Empowerment and Development Strategy (NEEDS). After the Paris Club agreement has been signed, Nigeria will have to clear its end-2004 arrears with a cash payment of $6 billion, and pay any additional amounts agreed to.[1] Finally, Nigeria will have to meet the initial targets of its economic program that will be the basis for the buyback around March 2006 that will extinguish all of its remaining Paris Club debt. Passing these hurdles without stumbling will not be easy and will require exceptional patience and understanding on both sides.

[1] Paris Club agreements are framework agreements formalized in separate bilateral implementing agreements between the debtor country and each of its Paris Club creditors. One reason for this extra step is that Paris Club agreements leave open the interest rate to be charged on rescheduled or restructured debt so that different rates, reflecting the differing market rates for the various currencies involved, can be fixed in the bilateral agreements. In a departure from the normal practice, because no Paris Club debt will remain outstanding at the end of the operation, it appears that Nigeria will not have to negotiate separate bilateral agreements.

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I. A Problem Nobody Wanted

A. Four Steps to Today's Window of Opportunity

Nigeria's debt servicing problems began around 1985. At that point, the Nigerian government's total external debt to all creditors amounted to $19 billion. Since then, the government has paid them more than $35 billion while borrowing less than $15 billion. Nevertheless, its outstanding external debt at the end of 2004 grew to almost $36 billion.[2]

How is this possible? The short answer is because of compound interest. The long answer is because Nigeria's Paris Club creditors opted—for political reasons—not to restructure their claims on Nigeria in 1992 when Nigeria's commercial creditors agreed to do so. The ballooning of Nigeria's debt is related directly to and exclusively to this policy choice by the creditors. Over the past twenty years, Nigeria has met its debt service obligations to multilateral creditors (the World Bank and the African Development Bank) without any restructuring, to commercial creditors after negotiating a debt exchange at a 60 percent discount, and to non-Paris Club bilateral creditors with varying degrees of debt relief. In other words, except on its Paris Club debt, Nigeria has been a performing debtor. Nigeria's case is unique because it is essentially a case of non-performing creditors.

Before walking through the four steps that created today's situation, the raw numbers are presented in Table 1. Note in particular that Nigeria's debt to commercial creditors and to Paris Club creditors was the same in 1985: $7.8 billion each.[3]

Table 1: External Debt of the Nigerian Government
($ billions)

	1985	2004
Paris Club creditors	7.8	30.8
Other bilateral creditors	1.9	0.0
Commercial creditors	7.8	2.2
Multilateral creditors	1.3	2.8
TOTAL	18.9	35.9

[2] The figure for post-1985 borrowing is not firm. Nigeria's Debt Management Office is still trying to re-create Nigerian records that have been lost or destroyed to arrive at amounts that are consistent with creditor records.

[3] These numbers include short-term debt that is normally exempt from sovereign restructuring operations. Nigeria's short-term debt owed to or guaranteed by Paris Club creditors was $4.9 billion in 1985. These were incorporated in the 1986 Paris Club rescheduling. The amount of short-term debt owed to commercial creditors at that time was $4.8 billion.

1. <u>1973-1985: Boom and Bust</u>

The external debt of the Nigerian government was negligible in 1970. Three years later, the first OPEC-led oil shock put Nigerian on an economic roller coaster. Government revenue soared and spending rose just as quickly. The bust began in 1978 when oil prices slumped and accelerated in the early 1980s when monetary policy was tightened in the USA.

Nigeria's oil export earnings reached $25 billion in 1980. In 1982 they were down to $12 billion and they dropped to $6 billion in 1986. Spending meanwhile remained high, largely financed by external borrowing. Virtually all of this borrowing was on commercial or quasi-commercial terms. As an OPEC member, Nigeria was not eligible for the soft-loan financing provided by multilateral and bilateral aid agencies to other countries at this time. LIBOR, the benchmark inter-bank interest rate for international lending, rose from 3-4 percent per annum in the early 1980s to 13 percent in 1989.

Regrettably much of the government spending was on wasteful consumption, including quite a few "white elephant" projects. Corruption was rampant. A strategy of import substitution was followed. Hoping that oil prices would rebound, desirable macroeconomic policy adjustments were postponed. A study carried out in 1996 of 63 projects undertaken in the 1980s for which the country had borrowed $2.6 billion in hard currency found only one project that was functioning and had repaid its borrowing in full. In addition, more than $500 million was borrowed to purchase military equipment, including MIG 21 fighters from the Soviet Union.

By 1985, significant debt service arrears began to accumulate. The stage was set for Nigeria's first debt restructuring operations.

The political context for these events was distinctly unfavorable. Only six years after independence in 1960 a small group of army officers overthrew the federal government and assassinated the prime minister. A year later, in 1967, a civil war broke out that continued for three years. A bloodless military coup in 1975 ended a year later when the coup leader was assassinated, which set the stage for the first presidency of Olusegun Obasanjo who was chief of staff of the army at the time. Obasanjo set a timetable for the restoration of civilian rule and it was followed. A democratically elected president took office in 1979 but his re-election in 1983 was challenged for numerous irregularities and the military seized control at the end of that year. In 1985, a military coup brought to power the regime of General Ibrahim Babangida.

2. <u>1986-1992: Debt Rescheduling and Debt Reduction</u>

The political context during this period deteriorated significantly but not to the point of discouraging the Paris Club (and London Club) creditors from entering into debt relief agreements with the country. Nationalist sentiment was channeled into growing opposition to economic reforms supported by the IMF. Babangida reneged on the promise of a return to civilian rule by 1990. A coup plot in that year failed and the leaders were executed.

Nigeria's first trip to the Paris Club was in 1986. The creditor governments involved agreed to reschedule more than $7 billion of medium- and long-term debt in arrears at the time of the negotiations and falling due over the coming year. Sadly, the Nigeria's ability to service its debt did not improve as expected under the IMF-supported adjustment program adopted by the country as a condition of getting debt relief from the Paris Club. It went back to the Paris Club in 1989 to reschedule another $6 billion of arrears and future payments, and again in 1991 for a further $3 billion of relief.

These Paris Club operations were mirrored by two London Club operations to reschedule debt owed to commercial banks, the first in 1987 and the second in 1989. The rescheduling terms Nigeria received from both creditor groups were similar to those granted to several dozen other countries during the 1980s debt crisis.

Until 1989, both the official creditor agencies and the commercial banks refused to include an element of debt reduction in their debt relief operations. The strategy for overcoming the debt crisis adopted by the creditor countries, led by the USA, was to use financing from the International Monetary Fund (IMF) and the World Bank to help debtor countries implement economic reforms that would boost their economic growth and thereby restore their debt-servicing capacity. The strategy was only partially successful, however. The rescheduling process tended to increase debt-service obligations faster than GDP was growing.

The turning point in resolving the 1980s debt crisis came in 1989 when the Brady Plan was adopted to support debt reduction operations with commercial banks. These were innovative exercises in burden sharing that combined stronger economic adjustment measures by the debtor countries with exceptional financing from the IMF, the multilateral development banks, and bilateral donor agencies. They also eliminated most of the debt owed to commercial banks by converting it into marketable bonds at a substantial discount. Nigeria's turn for a Brady bond exchange came in 1992 when it exchanged $5.6 billion of commercial bank debt for $2.1 billion of Par Bonds, a discount of roughly 60 percent.[4]

1992 is the year when the Paris Club made a critical choice that turned Nigeria's problem into a Paris Club problem. A window of opportunity had opened up at the end of 1990 when the first in a series of elections to restore civilian rule was held. This made it possible for the Paris Club creditors to conclude their third debt rescheduling deal with Nigeria in January 1991. This deal covered payments due through the end of the first

[4] This was one of the biggest discounts received in a Brady Plan operation up to this point. The first Brady Plan operation, with Mexico, involved a discount of around 20 percent. Nigeria, however, had concluded a benchmark debt reduction operation before the Brady Plan was introduced, not for commercial bank debt but for supplier credits in arrears and not guaranteed by creditor country export credit agencies. It began restructuring these credits as tradable Promissory Notes in 1983 and it completed the restructuring in 1988 with a fresh issue of Promissory Notes with a face value of $4.8 billion.

quarter of 1992. Since Nigeria was still experiencing debt-servicing difficulties in March 1992, a new debt relief arrangement with the Paris Club should have been concluded that year. Moreover, with the Brady Plan debt reduction deal wrapped up with the London Club in January 1992, there were strong technical arguments for a Paris Club deal that would allow Nigeria to exit from the cycle of repeated reschedulings of a growing mountain of debt by including a substantial element of debt reduction.

The Paris Club deal that should have been done in 1992 never happened because politics intruded in the form economic mismanagement by the Nigerian government and Paris Club rules.

Nigeria's economic policies. From the first operation with Argentina in 1956, consistently through the 390-odd operations it has concluded since then, the Paris Club has conditioned its debt relief on a formal economic program meeting the standards of the IMF. The simple and justifiable reason for this rule is that the creditors want some assurance that the debtor country's ability to service its external debt (creditworthiness) will improve so they will not have to continue rescheduling indefinitely. In other words, the first step in getting debt relief from the Paris Club is to reach agreement with the IMF on a one-year stand-by arrangement or a multi-year extended arrangement that provides IMF resources in periodic disbursements linked to meeting quantitative performance targets and to implementing specific policy reforms spelled out in the arrangement.

Nigeria met this requirement for the Paris Club debt relief operations it concluded in 1986, 1989, and 1991. But there was a problem in 1992. Nigeria's policies fell well short of the standard required for IMF support. The key question here is why the commercial banks were able to conclude a debt reduction deal in 1992 despite Nigeria's poor policies. The short answer is that they were treating Nigeria like other Brady Plan countries and were already committed in principle to a debt reduction deal at the beginning of 1991 when Nigeria had an IMF-approved arrangement in place to support the Paris Club's deal. The parameters of the Brady Plan deal that was formalized in January 1992 had been set months earlier. The commercial banks could have pulled the plug on the deal on the grounds that Nigeria was out of compliance with its IMF-approved program, but this was not their style. They were anxious to close the deal and move on.

Paris Club rules. These few paragraphs focus on the crux of the problem. As of 1992, the Paris Club had only included debt reduction in its debt relief operations with low-income, IDA-eligible countries.[5] Importantly, the Paris Club had started to include debt reduction in operations with these countries in 1988 when a pattern of serial reschedulings produced a snowballing of debt that was becoming increasingly and

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[5] The International Development Association (IDA) is the soft-loan window of the World Bank. It provides loans on very long terms and very low interest rates that are funded by grants from the donor countries rather than the capital market borrowing used to fund the World Bank's ordinary loans. The per capita annual income ceiling for IDA-only eligibility in 1993 was $610. Nigeria's per capita annual income at that time was only $270, but oil-producing countries were ineligible because their oil earnings put them in a strong balance-of-payments position.

obviously unsustainable. The political will to take this step was generated at the G-7 Summit in Toronto in 1988 when a "menu" approach to Paris Club operations with low-income countries was endorsed.[6] In other words in the 1989-1995 period when commercial banks were concluding Brady Plan deals with major borrowing countries such as Mexico and Brazil involving billions of dollars of debt reduction, the Paris Club creditors continued to reschedule but refused to consider debt reduction.

A good question is why the commercial banks accepted this lack of burden sharing? The short answer is that it was part of the overall Brady Plan deal. In return for debt reduction by the commercial banks, the Paris Club creditors (dominated by the G-7 countries of the USA, the UK, Germany, France, Italy, Canada, and Japan) used their voice and vote in the IMF and the multilateral development banks to provide modest amounts of official financing to help close the deals and facilitate the conversion of bank debt into bond debt.[7] Most of the creditor governments were carrying loans to Nigeria and other non-performing debtors at face value on their books. They were not ready to deal with the budget implications of writing down these debts, which were substantial in the case of countries such as Brazil and Mexico.

It was clear to some debt experts at the time that the Paris Club's insistence on limiting debt reduction to low-income countries would be difficult to sustain. It took the Paris Club another ten years to reach this conclusion.

The numbers. By 1991, the year before Nigeria's Brady Bond exchange, the government's external debt had already ballooned from $19 billion in 1985 to $34 billion, close to where it stands today. Two-thirds of the increase was in Paris Club debt and the rest was split between multilateral creditors and commercial creditors.

The increase in Nigeria's debt to Paris Club creditors by 130 percent in only six years, while debt to commercial creditors rose only 35 percent, is a result of two factors: new borrowing and arrears. New borrowing from the Paris Club creditors was just under $6 billion.[8] The remaining $4 billion of the $10 billion increase reflects interest arrears, late interest charges, and penalty charges in a high interest rate environment. (See Table 2.)

[6] One of the menu options was debt forgiveness of up to 33 percent on payments falling due in a one-year "consolidation period". At the G-7 Summit in London in 1991, a more generous formula was endorsed, opening the door to 50 percent stock reduction on a Net Present Value basis. This limit was further raised to 67 percent at the G-7 Summit in Naples in 1994.

[7] The long answer can be found in *Sovereign Debt Restructuring: the Case for Ad Hoc Machinery*, published by this author in 2003 (Brookings Institution Press). This authoritative book examines the origins and evolution of the Paris Club and London Club process for restructuring sovereign debt and explores the issue of why similar machinery for restructuring bond debt did not exist at the time of Argentina's historic default at the end of 2001.

[8] Japan provided a bit more than 60 percent of this new financing and the US provided almost 20 percent. France and Germany together provided another 15 percent, while Italy and the UK provided about 5 percent.

Table 2: External Debt of the Nigerian Government
($ billions)

	1985	**1991**	2004
Paris Club creditors	**7.8**	**17.8**	30.8
Other bilateral creditors	**1.9**	**1.4**	0.0
Commercial creditors	**7.8**	**10.5**	2.2
Multilateral creditors	**1.3**	**4.0**	2.8
TOTAL	**18.9**	**33.7**	35.9

3. 1993-1998: The Debt Snowball

The political context during this period could hardly have been worse. The elections to restore civilian government, originally due to be held in 1990, were finally carried out in mid-1993 and were remarkably fair. Two weeks later, however, Babangida annulled the results. The country slid into chaos and Defense Minister Sani Abacha took power at the end of the year. When the election results were annulled, the United States and other major creditor countries began imposing economic sanctions on Nigeria, including the suspension of arms sales and military assistance. The sanctions killed the remaining chances for a Paris Club restructuring of any kind. Other episodes of poor governance occurred over the next six years. In 1995, Abacha announced a plan for a 3-year transition to civilian rule. Local and state elections held in late 1997 and early 1998, however, were rigged to produce a landslide for Abacha in national elections, but he died in mid-1998 before these took place.

While the position of the Paris Club creditors not to enter into debt restructuring negotiations with the Abacha government is easy to justify on political grounds, it had the effect of exacerbating Nigeria's debt servicing difficulties. In the face of sanctions, General Abacha could not justify paying billions of dollars every year to these creditors and arrears started piling up, compounded by interest charges on overdue interest and penalty charges.

Over the next six years, the share of Nigeria's total external debt owed to Paris Club creditors jumped from 53 percent to 72 percent as Nigeria met its payment obligations to other creditor groups.

- After a substantial payment in 1992 related to its 1991 Paris Club deal, Nigeria's payments to Paris Club creditors dropped well below the scheduled amounts and arrears accumulated rapidly. It was during this period that Nigeria began discriminating among creditors, paying some while not paying others. This discrimination has complicated the restructuring of Nigeria's debt, requiring special "leveling up" arrangements to reverse the discrimination. During this period, the Paris Club creditors extended essentially no new credit to Nigeria so the increase in their claims by $4 billion reflects the accumulation of arrears.

- Nigeria met most of its obligations to non-Paris Club bilateral creditors, often in return for concessions including partial forgiveness/reduction. With no new financing coming from these creditors, this portion of Nigeria's debt fell to below $100 million.

- After its 1992 Brady Plan deal, Nigeria was reasonably punctual in meeting its payment obligations to commercial creditors even though they were providing no new financing. As a result, this portion of its debt declined steadily from $5.4 billion to $3.6 billion.

- To maintain their preferred creditor status and avoid arrears, the multilateral creditors continued to make new loans to Nigeria and Nigeria continued to meet its payments obligations.[9] In fact, during the 1993-1998 period, Nigeria paid its multilateral creditors $4.5 billion dollars while it paid it Paris Club creditors—with claims 4-5 times larger—only $1.5 billion. The gamesmanship behind this pattern is quite interesting but beyond the scope of this paper.

Table 3 highlights these changes during the 1993-1998 period.

Table 3: External Debt of the Nigerian Government
($ billions)

	1985	1991	**1992**	**1998**	2004
Paris Club creditors	7.8	17.8	**16.4**	**20.8**	30.8
Other bilateral creditors	1.9	1.4	**1.2**	**0.1**	0.0
Commercial creditors	7.8	10.5	**5.4**	**3.6**	2.2
Multilateral creditors	1.3	4.0	**4.5**	**4.2**	2.8
TOTAL	18.9	33.7	**27.6**	**28.8**	35.9

4. 1999-2005: Setting the Stage for Paris Club Reduction

General Abdulsalam Abubakar, the transitional president after the death of Abacha, appointed an independent national election commission to conduct new and open elections. The winner of the presidential contest was former president (1976-1979) Obasanjo, and democratic rule returned to Nigeria in May 1999 when he was sworn in. The political climate for a Paris Club deal has improved steadily since then. Democratic practices improved markedly and human rights abuses diminished. Economic management became much more disciplined under Finance Minister Ngozi Okonjo-Iweala who had gained valuable experience and an excellent reputation as a senior manager at the World Bank. President Obasanjo was re-elected for a second term in 2003 in respectable national vote. Nevertheless, deeply rooted problems continued to plague the country, including endemic corruption and pervasive ethnic tensions. Nigeria

[9] Technical arrears to the World Bank emerged occasionally during the 1985 to 2000 period, but they never got out of control as they did in a number of other countries such as Sudan and Zaire.

remains today as a troubled country universally known for its financial scams and widely regarded as a poor place to invest or visit.

On the creditor side, there were also several critical developments favoring a deal to normalize relations with Nigeria. In particular, Argentina's massive bond default at the end of 2001 and its decision to impose unprecedented losses on its bondholders forced the major creditors to reconsider their policy toward Paris Club debt reduction for middle-income countries. The challenge of restructuring Iraq's debt after the military intervention to remove the Saddam Hussein regime also required more flexibility in dealing with oil-exporting countries.

In 2003, the G-7 Finance Ministers agreed that the time had come to open the door to debt reduction for middle-income and oil-producing countries. The G-7 decision was highlighted at the G-8 Summit hosted by France in Evian and codified by the Paris Club a few months later in the form of "the Evian Approach". Under this new policy, when the alternative of rescheduling was not viable, the Paris Club would engage in "staged" debt reduction for middle-income debtors. This means that instead of a straight-forward reduction, the preferred approach of commercial creditors, Paris Club debt reduction would be implemented in two or more steps, with the initial reduction occurring at the time of agreement and subsequent reductions linked to satisfactory implementation of an IMF-supported (or monitored) economic adjustment program. The first Evian operation was done with Iraq in November 2004.

In another important breakthrough, the Paris Club creditors bowed to pressure from debtors that wanted to buy back their relatively expensive Paris Club obligations and concluded formal buyback deals with Russia and Peru in 2005.

Meanwhile, Nigeria's payments to the Paris Club creditors more than doubled in 1999 to $644 million from $229 million the year before in an effort by the new government to show good will in resolving the problem that had developed and normalizing financial relations with these important countries. In 2000, Nigeria entered into intensive negotiations with the IMF on an economic reform program that could meet the Paris Club's standard of conditionality. Reaching agreement was fraught with difficulty. On the Nigerian side, there were strong vested interests opposed to specific reforms and intense domestic pressures to avoid becoming beholden to the "colonialist" dictates of the IMF. On the IMF side, there was the standard of uniform treatment of its members that required a package of reforms exceeding the implementation capacity of this untested democratically elected government.

In the end an unsatisfactory compromise was reached. To meet the Paris Club's conditionality requirement, a strong reform program supported by a one-year IMF stand-by arrangement was adopted, even though the odds of achieving the objectives of the program were low. To give the appearance of not being under the thumb of the IMF, Nigeria agreed not to use any of the IMF financing to which it was entitled. With this fig leaf in place, the Paris Club agreed to a generous rescheduling of Nigeria's arrears but refused to commit to any debt reduction. Instead it agreed in principle to negotiate a debt reduction agreement in 2001 after a full year of satisfactory implementation by Nigeria of its reform program.

The inevitable happened. Slippages in the government's program emerged quickly and by the middle of 2001 the program was seriously off track. Consequently the Paris Club was off the hook in terms of doing a debt reduction deal, but the Nigeria's mountain of Paris Club debt swelled to new heights. Under the 2000 Paris Club deal, Nigeria was due to pay these creditors nearly $3 billion per year in the 2001-2005 period. The government was only able to get budget authority from the parliament for paying around $1 billion each year. Furthermore, a Supreme Court decision in 2002 disrupted payments by shifting the burden of debt service from the Federal government to the States. Another factor that contributed significantly to the mushrooming of Nigeria's Paris Club debt in the 1999-2004 period was the depreciation of the U.S. dollar relative to the Euro. The numbers reflecting these changes are highlighted in Table 3. Since Nigeria met its payment obligations to other creditor groups, the share of Paris Club debt in the country's total external debt jumped up further to 86 percent (see Table 4.)

Table 4: External Debt of the Nigerian Government
($ billions)

	1985	1992	**1998**	**2004**
Paris Club creditors	7.8	16.4	**20.8**	**30.8**
Other bilateral creditors	1.9	1.2	**0.1**	**0.0**
Commercial creditors	7.8	5.4	**3.6**	**2.2**
Multilateral creditors	1.3	4.5	**4.2**	**2.8**
TOTAL	18.9	27.6	**28.8**	**35.9**

5. Wrap-up

The key points in this lengthy historical review are the following:

- Except for its Paris Club debt, Nigeria has been meeting its debt-service obligations in a credible manner since 1992. The multilateral creditors have protected their exemption from debt restructuring operations by continuing to extend new loans, but their exposure has fallen steadily. The commercial creditors agreed to a 60 percent reduction of their claims in 1992 and since then have seen their exposure decline by 60 percent as Nigeria met its scheduled principal and interest payments and no new loans were made. The non-Paris Club bilateral creditors have effectively exited, as no new loans were extended but Nigeria made payments in return for partial cancellation or other considerations. In other words, except for it Paris Club debt, Nigeria has been a performing debtor.

- Most of Nigeria's $31 billion of debt currently owed to Paris Club creditors represents interest arrears, interest charged on the interest arrears, and penalty charges. The original loans contracted by the Nigerian government prior to1992, add up to around $19 billion.[10] No loans were made after 1992. Since 1985, Nigeria has paid the Paris Club creditors almost $11 billion and yet the country still owes $31 billion to these creditors.

- A window of opportunity opened up in 1991-1992. If the Paris Club had agreed to a 60 percent debt reduction deal at that time instead of another rescheduling, both Nigeria and the Paris Club creditors would be better off today. The Paris Club's claims of $17.8 billion at the end of 1991 would have been reduced to $7.1 billion at the end of 1992. If the repayment terms on the remaining amount had been comparable to those granted in the 2000 rescheduling operation, then Nigeria's annual payments to Paris Club creditors after 1992 would have been under $1 billion per year, a financially and politically feasible amount.

- Political factors, essentially beyond the control of both parties, made it impossible to conclude a debt reduction deal in 1991 or 1992. On one side, Nigeria was stuck with a military dictatorship pursuing unsustainable policies. On the other side, the Paris Club creditors were stuck with their rule of not offering debt reduction to oil-exporting countries, despite the very low probability that Nigeria would ever be able to fully meet its contractual obligations to these creditors.

- A new window of opportunity has opened up. The Nigerian government has demonstrated a capacity to implement reasonably strong fiscal and monetary policies. The Paris Club has opened the door to doing debt reduction deals with countries like Nigeria, and to buybacks.

II. A Good Deal from a Non-political Perspective

What would a good deal, or a fair deal, look like and how does that compare with the deal that the Paris Club is now offering to Nigeria?

A. Relevant Political Factors in the Nigerian Case

A lot of political baggage is having an impact on the restructuring of Nigeria's Paris Club debt. Some helps Nigeria and some hurts it.

1. Aid to Africa

The UK government decided to make aid to Africa (together with global warming) a centerpiece of the G-8 Summit in Gleneagles in early July of this year. The headline commitment to demonstrate G-8 solidarity in helping Africa was "finishing" the process of debt reduction for Heavily-Indebted Poor Countries (HIPCs) that began in 1996 and involved a large number of African countries. After the Gleneagles

[10] As noted earlier, this figure is not firm because of the loss or destruction of Nigerian records related to borrowing in the 1970s and 1980s.

commitment has been fully implemented, the debt of these countries both to multilateral institutions (primarily the IMF, the World Bank, and the African Development Bank) will have been reduced to zero. Taking this step while leaving Nigeria twisting in the wind with $31 billion of Paris Club debt was politically intolerable considering that Nigeria is Africa's biggest country by population (130 million), has a level of annual per capita income ($300 in 2002) below the average for the HIPCs, and has a democratic government. The position of the U.K. on this issue is also critical because it has the largest exposure to Nigeria among the Paris Club creditors, accounting for about 26 percent of the total. The UK's focus on aid to Africa is the main driver of the deal that was announced in June and it works in Nigeria's favor.

2. Governance and failed states

Economic progress in Africa is widely believed to depend on improving the quality of governance throughout the continent, especially in failed and failing states. With the election of President Obasanjo in 1999, Nigeria took a giant step in the direction of better governance. Just as importantly, however, Nigeria has been playing a major role in peacekeeping operations on the continent. These factors work in Nigeria's favor.

3. Terrorism

The war on terrorism is a smaller but significant part of the baggage. It is the front burner issue for the G-8 countries that together account for 90 percent of Nigeria's Paris Club debt. The leaders of this war, the United States and the United Kingdom, place a high importance on the support other countries are providing for this effort. For the past four years, Nigeria has been a strong and consistent supporter. The G-8 countries see a Paris Club deal in part as a reward for Nigeria's support.

4. Oil prices

Another big piece of the baggage is oil politics. Nigeria is an OPEC member and important supplier of oil and gas to the USA and Europe. With benchmark oil prices rising above $60 per barrel, Nigeria's oil revenues have been far above the amounts assumed in its recent budgets. To the immense credit of its President and Finance Minister, Nigeria has been setting aside the excess revenue in a stabilization fund—the Excess Crude Account created in 2004—instead of spending it as was done in the past. However, it is hard to sell debt reduction for an OPEC country when it is sitting on reserves of $23 billion (at the end of May 2005) that are growing rapidly.

5. Budget rules

The most surprising piece of political baggage is that most of the Paris Club creditors are facing fiscal strains and a deal with Nigeria could ease these strains. How can debt reduction become a budget receipt? The answer is that by the rules of budget accounting in most of the countries concerned, non-performing debt has to be written down in their financial accounts. When a restructuring of non-performing debt is concluded, to the extent that amounts received are in excess of the expected value they can be counted as a budget receipt. Conversely, to the extent that amounts received are below the expected value they get scored as a budget expenditure. The budget impact can be especially great in the case of buy-back operations as opposed to rescheduling. In the case of the USA, the issue is further complicated because a deal at below the expected value requires prior appropriations by the Congress. Moreover, some of the budget accounting rules may make the situation more complicated by scoring a buyback payment as a budget receipt but not a payment of arrears. The impact of this budget accounting factor is compounded by the progress made over the past 20 years by the OECD member countries in harmonizing their export credit terms. Thus the Paris Club creditors appear to have discounted their claims on Nigeria to roughly the same degree. It defies credulity, but there is evidence that these budget considerations are having a major influence over the detailed terms of the imminent Paris Club deal.[11]

6. Intra-creditor relations

Part of the drama of this case is the tension between the G-8 members of the Paris Club and the non-G-8 members. Largely for practical reasons, the G-8 members reached agreement among themselves first on a “comprehensive” approach to Nigeria’s Paris Club debt and then sat down with the non-G-8 members (including the Netherlands, Belgium, Denmark, and Austria) to convince them of the merits of their approach. Already miffed because a similar process was used to get their support for the G-8 initiative on HIPC debt reduction, the non-G-8 creditors were in a position to hold up the deal the Nigeria case because the Paris Club operates by consensus,. This piece of political baggage clearly works against Nigeria’s interests and it may dominate the final stage of negotiations.

7. Odious debt

An easily overlooked but far from negligible piece of political baggage comes out of a segment of the NGO community that has been campaigning for more than a decade to cancel the debt of low-income countries.[12] This community played a key role in the World Bank’s initiative in 1996 to launch the HIPC debt reduction program, because it depended critically on channeling more money from the donor countries to the multilateral lending institutions to make them whole as they cancelled their claims on the low-income countries. The Jubilee 2000 coalition was especially effective at the beginning of the new millennium in making the HIPC program more generous. One of the rallying points of the anti-debt campaigners has been the concept of “odious debt”.

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[11] A net financial flow from Nigeria to its creditors would be part of the prevailing global pattern that has emerging market countries (notably China) financing the current account deficit, and indirectly the fiscal deficit, of the USA.

[12] There is a broader segment of the NGO community that is campaigning to alleviate poverty in developing countries by working to achieve the United Nations’ Millennium Development Goals. Supporters of this campaign and others have argued that the resources used by Nigeria to pay its Paris Club creditors should instead be used to invest in health and education and a broad range of other activities. This piece of political baggage is beyond the scope of this study, which treats Nigeria’s Paris Club debt as a financial issue rather than an aid issue.

Their position is that countries should not be required to repay international debt contracted by tyrannical regimes that borrowed to line their pockets rather than advance the welfare of their citizens. Without a doubt, a good portion of Nigeria's debt to Paris Club creditors has odious characteristics, but there is no consensus among the creditor-country governments on either how to define odious debt or whether it makes sense to do so. It can even be argued that the Paris Club has often used the flexibility it has in setting restructuring terms to reflect the dubious nature of some of its claims. Thus the odious debt issue weighs in the balance in favor of Nigeria, but not too heavily.

8. Anti-IMF sentiment

All of the above factors are external to Nigeria. Two major pieces of political baggage, however, are internal: anti-IMF sentiment and anti-debt sentiment. For a variety of reasons, anti-IMF sentiment has been especially virulent in Nigeria for a long time. For each of the last three Paris Club operations (2000, 1991, and 1989), the sentiment was so strong that the Nigerian government was able to convince the Paris Club to reschedule as an exception to Paris Club rules on the basis of an IMF arrangement that involved no borrowing from the IMF, and therefore no debt to the IMF. The sentiment remains so strong that all the players take for granted that Nigeria will not borrow from the IMF in connection with its upcoming Paris Club deal. Moreover, the Nigeria case figures prominently in recent deliberations in the IMF to create a new non-lending arrangement currently labeled a "Policy Support Instrument (PSI)". It is anticipated that the IMF will establish this new instrument by September and that Nigeria will be one of the first, if not the first, country to avail itself of the instrument.

This baggage weighs in the balance heavily against Nigeria's interests for reasons of precedent. If the Paris Club is going to provide a country with exceptionally generous debt relief then it would like to see an exceptionally strong adjustment program being implemented by the debtor country. This is how the Brady Plan worked and the main beneficiary of a stronger program would be the Nigerian population. It's paradoxical that a stronger program would elicit more generous relief, because a strong program implies a greater capacity to service external debt, but this is how politics impacts on debt restructuring at the sovereign level.

9. Anti-debt sentiment

The anti-debt sentiment is more irrational than the anti-IMF sentiment. Some senior officials in the Nigerian government seem to understand that the country's future creditworthiness would be enhanced by eliminating most but not all of its Paris Club debt. Specifically, leaving a modest amount of debt to be serviced would underscore Nigeria's status as a performing debtor and help to distinguish Nigeria from the HIPCs that are viewed in the international financial community as "basket cases". Domestic pressure in favor of eliminating all of Nigeria's Paris Club debt is so strong, however, that the government appears willing to spend the money required to wipe out entirely this portion of its external debt. Given the risk of political turmoil over a deal that leaves the country beholden to the Paris Club, the government's position appears reasonable.

B. The parameters of a non-political restructuring

There is no accepted standard for a non-political restructuring of any country's debt, but it is possible to arrive at a commercial standard for restructuring that is largely non-political. The commercial standard can be approached from two directions: the 1992 Brady Plan restructuring of Nigeria's commercial bank debt and the recently agreed "Principles for Stable Capital Flows and Fair Debt Restructuring".

Nigeria benefited from being one of the last countries to implement a Brady Plan debt exchange because the commercial banks were not overly concerned at that point about creating a precedent that would undermine their negotiating objectives in workouts with larger debtors such as Mexico and Brazil. After lengthy negotiations similar to those with other debtor countries, the commercial banks offered an exchange of their claims into bonds at a discount of 60 percent. This figure was close to the prevailing market price for non-performing Nigerian debt and therefore it is possible to say the deal was largely free of any political factors. Moreover, the Steering Committee that was negotiating with the Nigerian government had to produce a deal that would be acceptable to banks holding a "critical mass" (on the order of 95 percent) of Nigeria's debt. This also helped to ensure that the deal was market driven and not political.

Is there any reason for thinking that the Paris Club creditors should have gotten a better deal from Nigeria at the same time? There is a yes answer and a no answer. Yes, if the Paris Club creditors had at the same time resumed lending to Nigeria, because the commercial banks were obviously exiting from Nigeria and had no intention to extend further credit to the country in the foreseeable future. No, however, because in fact the Paris Club creditors were adamantly opposed to any new lending to Nigeria because of their dislike of the Abacha regime.

Is there any reason for thinking that the Paris Club creditors should have gotten a worse deal? Yes, because they were making loans for unproductive purposes such as military hardware, because many of their loans were in effect subsidies for their exporters, and because historically Paris Club terms have been slightly more generous than London Club restructuring terms to compensate for the political nature of the Paris Club credits. Thus, instead of a 60 percent discount, it could be argued that a comparable discount for restructuring Paris Club debt would have been on the order of 65 percent.

Taking the other tack, under the leadership of the Institute of International Finance (an association representing the global financial industry), a set of "Principles for Stable Capital Flows and Fair Debt Restructuring" was hammered out at the beginning of 2004 between the industry and a group of major emerging market borrowing countries (including Brazil, Mexico and Turkey). The proximate motivation for negotiating these principles was Argentina's confrontational approach to restructuring the $90+ billion of bonds that were outstanding when it defaulted at the end of 2001. To help avoid other messes of this kind in the future, the industry and the issuers were able to agree on some guidelines both for avoiding default and for speedy restructuring in those rare cases when default could not be avoided.

The Principles do not define "fair" in quantitative terms but rather sketch out procedures to ensure that the interests of both creditors and debtors will be respected. By this standard, the deal put forward by the G-8 for Nigeria looks more like the kind of unilateral offer made by Argentina than the kind of consensual deal envisioned in the Principles, except that the unilateral offer is coming from the creditor side rather than the debtor side. Rather than settling on a deal based on a technical evaluation at the expert level, the deal on the table today seems to have grown out of discussions at the highest political levels on both sides.

Clearly in a commercial debt restructuring negotiation, the creditors are trying to maximize their recovery from the debtor. But there is another important motivation that seems absent in quite a few Paris Club deals with non-HIPCs over the past 15 years: restoring the debtor country's access to international capital markets. One gets the sense that at the margin the commercial creditors are more willing to reduce their cash recovery in order to improve the chances of being able to do business in the future with a performing debtor. Because they are commercial entities, the benefits of resuming normal business seem to shape the terms of the deal more than is the case for the Paris Club creditors. Commercial creditors have a strong aversion to repeat restructurings of debt when assumptions about the debtor country's future debt-servicing capacity turn out to be unduly optimistic. Commercial creditors prefer a one-off deal and would object strongly to staging debt reduction with some portion of the reduction linked to future economic performance.

Using these alternative approaches as guideposts, a non-political restructuring of Nigeria's Paris Club debt might have the following parameters:

- A write-down of the entire stock of debt by 60 percent, matching the 60 percent reduction Nigeria obtained from its commercial bank creditors in 1992. This would reduce Nigeria's Paris Club debt from $31 billion to $12.4 billion.

- A buyback of three-quarters ($9.3 billion) of the remaining debt at a discount of 33 percent, paid in full at the time of settlement rather than being phased with a portion linked to future economic performance.

- Rescheduling the $3.1 billion of debt remaining after the buyback over a period of 10 years with no grace period at the current market rate for 10-year dollar borrowing (4.2 percent). This would leave Nigeria with roughly $450 million of principal and interest to pay in the first year after the closing, with steadily declining amounts in the subsequent nine years.

III. The Deal on the Table

The Paris Club creditors have never accepted commercial standards as a basis for a debt restructuring operation. They have their own standards, which are largely based on precedents. In the case of Nigeria, there are three relevant precedents: the HIPC debt forgiveness program, the debt reduction operation for Iraq in November 2004, and a number of recent buy-back operations, notably with Russia and Poland. After looking at these precedents, the proposed deal is described and the reactions in the creditor countries and in Nigeria are noted.

A. The Precedents

1. The HIPC precedent.

Initially for low-income countries and subsequently for HIPCs, the Paris Club creditors began in 1988 to offer debt reduction of up to 33 percent of payments falling due a year at a time. The ceiling on the debt reduction component of Paris Club deals was raised gradually until it reached 90 percent at the Cologne Summit in 1999. More recently, several individual donors decided unilaterally to forgive 100 percent of their remaining claims on the HIPC countries, and at the Gleneagles Summit in July 2005, the G-8 countries agreed to forgive 100 percent of both multilateral and bilateral debt owed by these countries.

Nigeria has never been a HIPC country and 100 percent forgiveness was never considered to be a serious option simply because Nigeria is member of the OPEC cartel and has large oil export earnings relative to its GDP. Another reason for ruling out such treatment was Nigeria's poor track record of implementing economic reforms. A wholesale write-off of Nigerian debt could only be viewed as an incentive for other debtor countries to mismanage their economies and make it hard for the Paris Club to deny equally generous terms to other countries doing a better job of economic management.

Nigeria, however, was not far from being a HIPC for three reasons. First, it easily qualified on annual per capita income grounds. Second, under heavy pressure from development-oriented NGOs, the World Bank decided in June 2005 to re-categorize Nigeria from being an "IDA blend" country to being an "IDA only" country, on the basis of the widespread poverty of the country's population. Third, Nigeria's Paris Club debt was large enough to be viewed technically as unsustainable. Although the IMF carried out a sustainability analysis in 2002 that found Nigeria's overall external debt burden to be financially sustainable, the margin of sustainability was small and clearly it was politically infeasible to allocate the budget resources required to fully meet the country's scheduled payments to Paris Club creditors.

Heading into the Gleneagles Summit, there was considerable support among the G-8 countries for reducing Nigeria's debt by 67 percent, the percentage associated with the Paris Club's "Naples terms" adopted in 1994 for low-income countries. The intellectual case for debt reduction of this magnitude was reinforced by work carried out at the Center for Global Development.[13]

2. Debt reduction for Iraq

In November 2004, the Paris Club agreed to write off roughly 80 percent of its claims ($37 billion before restructuring) over a period of three years, with the remaining 20 percent rescheduled over 23 years with a grace period of six years. Three features of the Iraq case echoed features of the Nigerian case: the total amount of Paris Club debt was the same order of magnitude; much of the outstanding debt had been contracted by an undemocratic regime that was committing gross human rights violations, and the country was a major oil exporter.

Why then didn't Nigeria get the same 80 percent reduction or close to it? Two reasons are obvious. First, some of the Paris Club creditors are pouring money into Iraq for security and reconstruction. Asking Iraq to pay more in debt service simply means they have to give more money to Iraq to offset this expenditure. Deep debt reduction is also a way of getting some of the creditors to contribute to the costs of reconstruction without having to contribute new money. Second, when the Paris Club concluded its operation with Iraq In November 2004, Iraq's foreign exchange reserves were negligible and the prospects for accumulating reserves were highly uncertain. By contrast, Nigeria's reserves were more than $23 billion at the end of May 2005, roughly 80 percent of the Paris Club's claims, and growing visibly. Iraq did not have the resources to undertake a buyback. Nigeria does.

3. Buybacks of Paris Club debt

Following several bilateral debt buybacks that involved fiscal benefits for the creditor countries involved but were not welcomed by other Paris Club creditors, the Paris Club agreed to an unprecedented Club-wide buyback for Russia's debt in May 2005. Russia bought back $15 billion of Paris Club debt at par (no discount) leaving $25 billion outstanding and available for additional buybacks in the future. In June 2005, the Paris Club agreed to a $2 billion buyback of Peru's debt, leaving $2.2 billion outstanding.

These operations opened the door to a buyback with Nigeria, although some creditors were uncomfortable with engaging in buybacks at a discount, especially a deep discount of the kind that might be acceptable to the government of Nigeria.

B. "A fair and sustainable solution"

In the run-up to Gleneagles, the G-8 Finance Ministers met in London on June 10-11. The communiqué issued at the end of their meeting devoted a paragraph to Nigeria. The operative sentence was: "We are prepared to provide a fair and sustainable solution to Nigeria's debt problems in 2005, within the Paris Club." At this point, the

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[13] See Moss (2004). Work done by the Center for Global Development was also helpful in getting the World Bank to make Nigeria an IDA-only borrower. See Moss, Standley, and Birdsall (2004).

main parameters of a deal appear to have been agreed upon at the head of government level.

On June 29, a special session of the Paris Club was held to present the deal to the non-G-8 Paris Club creditors, notably Netherlands, Belgium, Denmark, and Austria, and seek their concurrence. At the end of this session, the Paris Club issued a statement saying it was ready to negotiate a "comprehensive debt treatment". The statement went on to say:

> Creditors welcomed Nigeria's willingness to conclude a Policy Support Instrument (PSI) as soon as this instrument is approved by the board of the IMF, to pay all its arrears towards Paris Club creditors and treat them equitably. On this basis, the debt treatment would include debt reduction up to Naples terms on eligible debts and a buy back at a market related discount on the remaining eligible debts after reduction. This Agreement would be phased in relation with appropriate IMF review under the PSI.

In subsequent announcements and press briefings, President Obasanjo and Finance Minister Ngozi Okonjo-Iweala added the following details:

- The government of Nigeria expects to have a PSI with the IMF in place in September and within the same month negotiate a Memorandum of Understanding with the Paris Club creditors to formalize the deal.[14]

- Nigeria will clear its current arrears—amounting to $6 billion—by a cash payment in September.

- Nigeria will buy back the remaining debt after "Naples" reduction of 67 percent by making a cash payment of another roughly $6 billion, a few months after the first one. Thus, to eliminate $30 billion of Paris Club debt, the creditors will write off $18 billion and Nigeria will pay $12 billion.

Creditor-country officials have confirmed these details in conversations with the author. From the Paris Club's perspective, Nigeria is clearing its arrears of $6 billion with a down payment, leaving roughly $24 billion outstanding. The Paris Club is then canceling 67 percent of this amount, or $16 billion, leaving $8 billion. Nigeria will then buy back this $8 billion at a "market related discount" of 25 percent, or $2 billion. Thus, in return for writing off $18 billion of debt, the creditors will receive $12 billion. The division of the debt into arrears, Naples reduction, and buyback tranches is a bit of sophistry, however. The deal pure and simple is a buyback of $30 billion of debt for $12 billion, which represents a discount of 60 percent.

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[14] Normally the Paris Club's "umbrella" (framework) agreements are implemented by means of separate bilateral agreements with each creditor country, and different interest rates are set at the bilateral level to reflect the different currencies involved. In an interesting departure from normal practice, because there will be no remaining debt on which to charge interest, it appears that Nigeria will be able to skip the sometimes troublesome step of negotiating bilateral implementing agreements.

Reading between the lines of the available information, there appear to be two significant details that remain unsettled: the precise amount to be paid in September and the timing of the second payment.

- While the total payment of around $12 billion seems firm, apparently some creditors are taking the position that Nigeria should pay in September not only the $6 billion in arrears (as of the end of 2004), but also certain "leveling up" payments plus all of the scheduled payments under the 2000 Paris Club agreement due up to the month in which the Memorandum of Understanding is signed. These additional amounts could be sizeable.

- The final payment, to buyback the debt remaining after 67 percent reduction, will presumably be made around March 2006 and will be tied to a review of Nigeria's performance under its PSI with the IMF. This is reasonable under the Paris Club's "Evian approach" but it introduces some risks. It is possible that the review will not be completed on schedule because the reform program is off track due to domestic developments or external events beyond the control of the government.

1. <u>Reaction in the creditor countries</u>

The general reaction has been favorable, but not universally. In some countries there are concerns about being generous to a country that is regarded as one of the most corrupt in the world. In some of the smaller creditor countries, there has been grumbling about having a G-8 deal rammed down their throats. In the USA, some members of Congress seem adamantly opposed to any debt relief for Nigeria before it turns over Charles Taylor, the former leader of Liberia now in exile in Nigeria, to the Special Court for Sierra Leone, which has indicted him for war crimes and other offenses.

2. <u>Reaction in Nigeria</u>

The reaction in Nigeria has been mixed. The President and the Finance Minister have stressed the unprecedented action by the Paris Club, which is undeniable. It is the first ever Paris Club buyback at a discount, which has the potential of being a costly precedent in future Paris Club operations with other countries. They have pointed out that the deal will free up $1 billion in budget resources, which will be used to finance investments that will directly improve the welfare of the population, and they have committed to establishing an innovative mechanism to track the use of these resources. The President has scheduled an early meeting of the National State Council to sort out the details, which will have an important impact on the budgets of Nigeria's 36 states plus the Federal Capital Territory that currently share national oil revenues and debt-service payments with the Federal government.

The deal has been sharply criticized by some politicians and commentators, using statements such as “the rip-off of the century”, “creditors are taking advantage of us”, and “there are better uses for $12 billion, such as critical infrastructure investments”.

IV. Implications for the International Financial System

Political deals as well as commercial deals always involve compromises. Neither side gets everything they want. Both sides are usually criticized by outsiders for making unwarranted concessions. Arguments can go on endlessly over whether a different deal would have been better, and it’s impossible to prove the case because history cannot be rewound.

Nigeria’s Paris Club debt deal, assuming it is completed as announced by the middle of next year, will share these same characteristics. It is without question a political deal and the debate over which side got the better deal is likely to go on forever. Or the ultimate assessment will turn on an event that was unpredictable at the time the deal was made such as a collapse of world oil prices. What is clear is that it’s a very political deal and it’s a stretch for both sides.

A. Implications for Creditors

The Paris Club is a process more than an institution. It has no formal charter and its membership is fluid. Since the first Paris Club operation in 1956, its informal “rules” have been constantly changing as it adapts to a changing world. Proposals to incorporate the Paris Club into a formal international bankruptcy process—treating commercial bank debt, bond debt, and multilateral institution debt together—have been advanced repeatedly. In 2001, these took the form of a proposal from the IMF to create a Sovereign Debt Restructuring Mechanism (SDRM). The SDRM proposal foundered for the same reason earlier proposals did: it was unnecessary and politically infeasible.[15]

The Paris Club started out by limiting debt relief operations strictly to the rescheduling of principal and interest payments falling due in “consolidation periods” of 12-18 months.[16] At the end of the 1980s, it began to include partial debt reduction in operations with heavily-indebted low-income countries. Not until 2003 did the Paris Club open the door to debt reduction for middle-income (and oil-producing) countries. Not until 2005 did it entertain requests for buybacks. In each instance, the added flexibility was sensible and in most instances overdue. One positive implication is that the Nigeria case once again demonstrates the ability of the Paris Club to modify its rules when the reasons to do so become compelling.

[15] Rieffel (2003) describes in considerable detail the origins and evolution of the Paris Club and London Club processes, the debate over the SDRM in the 2001-2003 period, and other basic information about sovereign debt restructuring.

[16] This is not strictly true. In 1970, the Paris Club agreed to a long-term rescheduling of Indonesia’s debt on such favorable terms that it clearly involved a substantial element of debt reduction. Two or three other countries in the 1970s also obtained exceptionally generous terms in the 1970s.

The deal with Nigeria takes the Paris Club into uncharted waters, however. Every generous deal becomes a precedent that reduces the Paris Club's leverage in what is often seen as a zero-sum game. The Paris Club may find it impossible to resist the political pressure to do similar deals in other cases where the technical arguments are not quite as strong. It is even possible that some debtor countries will deliberately pursue policies that aggravate their debt-servicing difficulties in anticipation of getting Nigeria-type relief from the Paris Club. This is a negative implication but not one to be given great weight. The side effects of poor policies are too risky for most political leaders.

Perhaps the most important consequence of the Nigeria case is the potential for greater use of buybacks. Making official debt more like commercial debt is healthy for the international financial system. Making it more like a commodity and less political is useful and a logical result of assigning recovery values to these claims in the budget procedures of the creditor countries. Of course this option is useless for countries with no cash to finance a buyback. It is conceivable, however, that private creditors would finance a buyback of official debt at a discount, shifting the risk from taxpayers to private investors. That would be beneficial because it would depoliticize debt to official creditors and could provide the basis for more efficient restructuring operations.

Another potentially important consequence of the Nigeria case is the more relaxed position the Paris Club seems to be taking on "comparable treatment". Comparable treatment is the Paris Club rule that a country to which it grants debt relief must seek equivalent relief from its commercial creditors. From the mid-1950s to the mid-1990s, the Paris Club applied this rule in a flexible manner that facilitated debt relief negotiations between debtor countries and their commercial creditors (generally banks). In the late-1990s, however, the Paris Club began applying comparable treatment in a rigid fashion that became increasingly problematical in cases involving bond debt. It is significant that the Paris Club does not appear to be making an issue of comparable treatment in Nigeria's comprehensive deal. It could have required the Nigerian government to carry out an Argentina-style exchange of its outstanding Par Bond and Promissory Note debt at a discount. The technical grounds for doing so would have been extremely weak, because these obligations represent debt that has already been reduced. Furthermore, requiring new relief on its commercial debt would have damaged Nigeria's access to future commercial borrowing, which would be inconsistent with the broad objective of the deal. Requiring more relief from commercial creditors could also impact adversely on capital market access for all emerging market borrowers.

B. Implications for Debtors

On a political level, the Nigeria deal is bad news because it provides ammunition to populists who sing the siren song of debt relief. It is easy to hate creditors. Anyone who has ever been it debt—for college tuition, a home mortgage, a new card, a family business—has wished that his or her debts would disappear or be assumed by someone else. Politicians who advocate debt relief are always popular and almost always wrong.

The fundamental truth about technically sound debt relief is that it buys nothing. It simply recognizes a loss that has been incurred in the past. Debt relief cannot build roads, improve health, or create sustainable employment. Only sound economic management can deliver these kinds of outcomes. Debt relief cannot make a country grow. Economic growth depends on disciplined monetary and fiscal policies, a never-ending process of institutional reform, and wise use of the scarce resources that governments obtain domestically and abroad.

One of the myths in the business of debt relief at the international level is that creditor countries will use every trick in the book to take advantage of debtor countries. Populists view the conditions attached to debt relief as onerous and unwarranted intrusions. The reality is that doing business with a country in default is not attractive. When a debtor country gets into debt-servicing difficulties, it is in the interest of the creditors to restructure the country's debt as quickly as possible—on a sustainable basis—so that they can resume doing business with it.

These considerations point to the major weakness in the Nigeria's Paris Club deal: totally eliminating the country's Paris Club debt rather than leaving a modest amount to be serviced normally. The creditors did not ask for this; the Nigerian government asked for it to appease populist sentiment within the country. In terms of the country's future economic development, a deal that left $3-5 billion of Paris Club debt would have been a better deal. It would have reinforced perceptions of Nigeria's creditworthiness in the international financial community. It would have helped Nigeria distinguish itself from the "basket case" HIPCs. It would have made foreign borrowing less expensive for the private Nigerian companies that offer the best hope for more job opportunities for the Nigerian people.

C. The Bottom Line

It is not the purpose of this study to decide whether the deal that has been struck in principle between Nigeria and its Paris Club creditors is a good deal or a bad deal. Instead the purpose is to highlight the exceptional circumstances that created the window of opportunity for reaching agreement and the numerous political factors that affected the terms of the deal.

Like all deals, it will leave some people unhappy and some people convinced that a better deal could have been struck. Little satisfaction will come from listening to or repeating the arguments advanced by these people.

Can it be true that a billion dollars here or a billion dollars there doesn't matter? For the Paris Club creditors as a group, a billion dollars is small beer. But the answer is also yes for Nigeria. Nigeria is a big country and the future welfare of its people depends much more on how wisely the government invests its future oil revenues than how much of its existing foreign exchange reserves are used now to resolve its Paris Club debt problem, which represents one of the biggest clouds hanging over the country today.

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