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Nigeria's Paris Club Debt Problem

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Intense domestic pressure has convinced Nigerian President Olusegun Obasanjo to seek a deal that would eliminate the country's $31 billion of debt owed to the governments of the U.K., France, and other aid-giving countries that use the Paris Club process to restructure debt that countries cannot repay.

The Paris Club creditors have proposed an unprecedented operation—its first-ever buyback at a discount—that would cancel all of Nigeria's debt to them in exchange for a cash payment of roughly $12 billion.

But sharp criticism, directed at both parties, has accompanied the proposed deal. In contrast to commercial debt-restructuring operations, Paris Club operations are highly politicized, and the pending deal reflects heavy political baggage burdening the two parties. Despite this, the Paris Club offer remains the only feasible option for both sides.

The deal is not yet closed, however. Nigeria must first obtain IMF approval of its economic reform program under a facility to be created by September; then it must hammer out the remaining details of the Paris Club deal. Passing these hurdles without stumbling will not be easy and will require exceptional patience and understanding on both sides.

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Nigeria's debt servicing problems began around 1985, when the Nigerian government's total external debt to all creditors amounted to $19 billion. Since then, the government has paid creditors 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.

How is this possible? The short answer is compound interest; the long answer is that 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 relates directly and exclusively to this policy choice by creditors.

During the past twenty years, Nigeria has met debt service obligations to its multilateral creditors (the World Bank and the African Development Bank) without any restructuring; to its commercial creditors after negotiating an exchange of bank debt at a 60 percent discount; and to its non-Paris Club bilateral creditors in return for varying degrees of debt relief. (Table 1 details Nigeria's external debt amounts; note that Nigeria's debt to commercial creditors and to Paris Club creditors was the same in 1985: $7.8 billion each.)

Except on its Paris Club debt, Nigeria has in fact been a performing debtor. This is a unique case of non-performing creditors.

FOUR STEPS TO A MEGA-PROBLEM

So what accounts for this curious situation? Nigeria's Paris Club problem derives from four fundamental facts:

- First, most of the $31 billion of debt currently owed by Nigeria to Paris Club creditors consists of interest arrears, interest charged on the interest arrears, and penalty charges. These charges have accumulated faster than Nigeria's ability to pay.

- Second, if the Paris Club had agreed to a 60 percent debt reduction deal in 1992, as commercial bank creditors did, this situation would not have developed.

- Third, political factors, essentially beyond the control of both parties, stood in the way of concluding a debt reduction deal in 1992.

- Fourth, a window of opportunity opened up in 2005, so it now appears feasible for Nigeria to buy back, with a large cash payment, all of its Paris Club debt at a deep discount.

Table 1
External Debt of the Nigerian Government
(billions of U.S. dollars)

	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**

1973–1985: Boom and Bust

In 1970, the external debt of the Nigerian government was negligible. Only three years later, the first OPEC-led oil shock sent Nigeria on an economic roller coaster; government revenue and spending soared.

Nigeria's oil export earnings peaked at $25 billion in 1980 but were down to $6 billion by 1986. Spending meanwhile remained high, largely financed by external borrowing at market interest rates. Regrettably, the government wasted much of its oil earnings on unproductive consumption. By 1985, significant debt service arrears began to accumulate, setting the stage for Nigeria's first debt restructuring operations.

Nigeria's debt accumulation occurred within a volatile political context, during a time when Nigeria experienced the assassination of its prime minister, the outbreak of civil war, a brief period of democratically elected government, and military coups.

1986–1992: Debt Rescheduling and Debt Reduction

While the political context in the late-1980s continued to deteriorate, the Paris Club (government creditors) and the London Club (commercial bank creditors) were able to conclude debt relief agreements with Nigeria. However, President Ibrahim Babangida reneged on his promise to return to civilian rule by 1990, which made Nigeria's relations with the major donor countries much more strained.

Nigeria first went to the Paris Club in 1986. Sadly, its ability to service its debt did not improve as expected, and it returned to the Paris Club in 1989 and again in 1991. London Club operations in 1987 and 1989 mirrored these Paris Club operations. The rescheduling terms Nigeria received from both creditor groups were similar to those granted to other debt-distressed countries during the 1980s debt crisis.

After the Brady Plan was adopted in 1989 to support debt reduction operations with commercial banks, the 1980s debt crisis was resolved on a case-by-case basis. In 1992, under a Brady Plan deal, Nigeria exchanged $5.6 billion of commercial bank debt for $2.1 billion of Par Bonds, a discount of roughly 60 percent.

At the same moment, the Paris Club made a critical choice that turned Nigeria's problem into a Paris Club problem. The first in a series of elections to restore civilian rule had opened up a window of opportunity for more Nigerian debt restructuring at the end of 1990. This had resulted in Nigeria's third Paris Club rescheduling, covering payments due through the end of the first quarter of 1992. Since Nigeria was still experiencing debt-servicing difficulties in early 1992, a new debt relief arrangement with the Paris Club should have been concluded then. Moreover, strong technical arguments existed for a deal that would include substantial debt reduction. But the Paris Club deal that should have been completed in 1992 never happened because of Nigeria's economic policies and Paris Club rules.

Nigeria's economic policies. Since its creation, the Paris Club has conditioned its debt relief on a formal economic program that meets IMF standards. Nigeria could not meet this requirement in 1992, thereby closing the door to Paris

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Club negotiations. By contrast, the London Club was able to conclude a debt reduction deal that year because it had committed in principle to a debt reduction deal a year earlier when Nigeria had an IMF-approved program in place. The commercial banks could have balked—as the Paris Club did—but lacking a political agenda, they were anxious to close the deal and move on.

Paris Club rules. The Paris Club started to include debt reduction in operations with low-income, oil-importing countries in 1988. It was already clear to some experts at the time that the Paris Club's insistence on limiting debt reduction to this group of countries would be difficult to sustain. It took the Paris Club another ten years to reach this conclusion.

By 1991, the year before Nigeria's Brady Bond exchange, the government's external debt had ballooned from $19 billion in 1985 to $34 billion, close to where it stands today. Paris Club debt represented two-thirds of the increase.

1993–1998: The Debt Snowball

The political context during this period could hardly have been worse; long-delayed elections to restore civilian government were finally carried out, only to see the results annulled. In response, the United States and other major creditor countries imposed economic sanctions on Nigeria, thereby killing any remaining chances for a Paris Club deal of any kind.

While the decision not to enter into debt restructuring negotiations with the Nigerian government was easy to justify on political grounds, it exacerbated Nigeria's debt servicing difficulties. In the face of sanctions, the Nigerian leadership under General Abacha decided not to pay billions of dollars every year to the creditors imposing sanctions. Arrears piled up, compounded by interest charges on overdue interest and penalty charges.

During 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.

1999–2005: Setting the Stage for Paris Club Reduction

After the death of Abacha, Nigeria restored democratic rule, and the second presidency of Olusegun Obasanjo began in May 1999. The political climate for a Paris Club deal improved steadily under Obasanjo. Nevertheless, deeply rooted problems continue to plague the country, including endemic corruption and ethnic tensions.

In an effort by the new government to show its good will, Nigeria's payments to Paris Club creditors more than doubled in 1999 to $644 million from $229 million the year before. In 2000, Nigeria entered into intensive negotiations with the IMF on an economic reform program to meet the Paris Club's conditionality requirement. An unsatisfactory compromise was eventually reached. With the fig leaf of an IMF-supported program in place, the Paris Club agreed to a generous rescheduling of Nigeria's arrears but refused to grant any debt reduction. Instead, it agreed in principle to negotiate a debt reduction agreement in 2001 after a year of satisfactory program implementation.

The inevitable happened. The program went off track, the creditors stepped back from doing a debt reduction deal, and Nigeria's mountain of Paris Club debt swelled to new heights as fresh arrears accumulated.

POLITICAL IMPERATIVES

An exceptional number of political factors are shaping the Paris Club buyback deal being offered to Nigeria:

Aid to Africa. The U.K. government highlighted aid to Africa as the centerpiece of the G-8 Summit in July 2005. The G-8 countries made a headline commitment to "finish" the process of debt reduction for Heavily-Indebted Poor Countries (HIPCs) that began in 1996 and involved a large number of African countries. Taking this step—while ignoring Nigeria's $31 billion Paris Club debt problem—was politically intolerable, and the U.K., as the largest of Nigeria's Paris Club creditors, used its position to drive a deal home.

Governance, failed states, and terrorism. With the election of President Obasanjo in 1999, Nigeria took a giant step in the direction of better governance. Furthermore, Nigeria has been playing a major role in peacekeeping operations in Africa and has also been a strong supporter of the war on terrorism. The Paris Club offer can be seen through this lens as a reward for Nigeria's efforts in these areas.

Oil prices. With benchmark oil prices in the range of $60 per barrel, Nigeria's oil revenues have been far above the amounts assumed in its recent budgets. Selling debt reduction for an OPEC country that sits on foreign exchange reserves that are worth more than $23 billion (and growing rapidly) remains politically problematic.

Budget rules. Surprisingly, the deal offered to Nigeria could ease the budget strains most Paris Club creditors are currently experiencing because Nigeria's cash payments would be scored as budget receipts. A deal involving significant budget costs would have been a political nonstarter.

Intra-creditor relations. The G-8 members of the Paris Club reached an internal agreement among themselves on a "comprehensive" approach to Nigeria's debt. But the non-G-8 creditors—already miffed because a similar exclusionary process was used to garner their support for HIPC debt reduction—appear to be demanding further concessions by Nigeria even though they hold only a small share of the debt.

Odious debt. A segment of the NGO community has campaigned for more than a decade to cancel the debt of low-income countries. One of the rallying points has been the concept of "odious debt": the notion that creditors should not require countries to repay international debt contracted by tyrannical regimes. Much of Nigeria's debt to Paris Club creditors exhibits odious characteristics.

Anti-IMF sentiment. Public antipathy toward the IMF has been exceptionally virulent in Nigeria. For each of the last three Paris Club operations (2000, 1991, and 1989), the Nigerian government was only able to reschedule its debt on the basis of "loose" arrangements with the IMF.

Anti-debt sentiment. Ideally, leaving a modest amount of Paris Club debt to be

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serviced after the buyback would underscore Nigeria's status as a performing debtor and help to distinguish Nigeria from the HIPC "basket cases." But domestic pressure within Nigeria to eliminate 100 percent of Paris Club debt has been so strong that this financially desirable objective remains politically infeasible.

A NON-POLITICAL RESTRUCTURING

No accepted standard for a non-political restructuring of sovereign debt exists, but it is worthwhile to approximate the parameters of a restructuring that would meet commercial standards.

One approach—starting with the deal the commercial banks accepted in 1992—involves a write-down of 60 percent. In the past, the Paris Club creditors often justified better treatment than commercial banks because they were willing to extend new loans to the debtor country, unlike the banks. But in Nigeria's case, the Paris Club creditors adamantly opposed new lending for political reasons.

Another approach uses the "Principles for Stable Capital Flows and Fair Debt Restructuring" agreed at the beginning of 2004 between the global financial industry and a group of major emerging market borrowing countries.[1] 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, a Nigeria debt deal would rest on a technical analysis at the expert level rather than a bargain made at the highest political level.

Using both approaches as guideposts, a non-political restructuring of Nigeria's Paris Club debt might include the following features:

- A write-down of the entire stock of debt ($31 billion) by 60 percent, matching the 60 percent reduction Nigeria obtained from its commercial bank creditors in 1992.

- 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.

Rescheduling the debt remaining after the buyback ($3.1 billion) over a period of 10 years, with no grace period at the current market interest rate.

THE DEAL ON THE TABLE

In practice, Paris Club creditors have never accepted commercial standards as a basis for their debt restructuring operations. They employ their own standards, which are largely based on precedents. For Nigeria now, three relevant precedents apply: HIPC debt forgiveness, debt reduction for Iraq, and buy-back operations with Russia and Peru.

The HIPC precedent. Initially for low-income countries and subsequently for HIPCs, the Paris Club creditors began in 1988 to offer debt reduction on payments falling due a year at a time. The ceiling on debt reduction for deals with these countries gradually rose until it reached 90 percent at the Cologne Summit in 1999 and finally 100 percent at the Gleneagles Summit in July 2005. Nigeria has never been a HIPC country, and 100 percent forgiveness has never been a serious option simply because Nigeria has large oil export earnings. However, Nigeria has never been far from being a

HIPC because of its low per capita income, its status as an "IDA-eligible" country, and its "unsustainable" debt burden. Heading into the Gleneagles Summit, considerable support existed among the G-8 countries for reducing Nigeria's debt by 67 percent.

Debt reduction for Iraq. In 2003, the G-7 Finance Ministers opened the door to debt reduction for middle-income and oil-producing countries by agreeing on the "Evian Approach," under which the Paris Club agreed to consider "staged" debt reduction. Instead of a straight-forward reduction (the preferred approach of commercial creditors), Paris Club reduction would be implemented in two or more stages. Iraq was the first country to obtain Evian terms. In November 2004, the Paris Club agreed to write off roughly 80 percent of its claims on Iraq over a period of three years. Similar treatment for Nigeria was a non-starter because the creditors were pouring money into Iraq for reconstruction and Iraq's foreign exchange reserves were close to zero. By contrast, Nigeria was sitting on reserves at the end of May 2005 of $23 billion, which were roughly 80 percent of the Paris Club's claims and growing visibly.

Buybacks. This year, the Paris Club agreed to an unprecedented buyback of $15 billion of Russia's debt and $2 billion of Peru's debt. These operations opened the door to a buyback with Nigeria, even though some creditors were uncomfortable with setting a precedent for buybacks at a discount.

The Paris Club Offer

At the end of a pre-Summit meeting in June, the G-8 Finance Ministers announced, "We are prepared to provide a fair and sustainable solution to Nigeria's debt problems in 2005, within the Paris Club." A special meeting of Paris Club creditors was held on June 29 to persuade the non-G-8 Paris Club creditors to embrace the G-8 proposal. The Paris Club offer contains three main components:

- Nigeria will reach agreement with the IMF in September on its economic objectives and policies for the coming year and immediately thereafter will negotiate a Memorandum of Understanding with the Paris Club to formalize the restructuring.

- 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, approximately six months after the first payment.

Thus, to eliminate $31 billion of Paris Club debt, the creditors will write off about $18 billion, and Nigeria will pay about $12 billion. Two significant details apparently remain unsettled: the precise amount to be paid in September and the timing of the second payment. Both are potentially problematic.

Reactions in the creditor countries and in Nigeria. The Paris Club creditors have received criticism for being generous to a country that is regarded as one of the most corrupt in the world. In Nigeria, the President and the Finance Minister have stressed the Paris Club's unprecedented action, which

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is undeniable; indeed, the Nigerian deal is the first ever Paris Club buyback at a discount. At the same time, prominent Nigerian politicians and commentators have criticized the deal with statements such as “creditors are taking advantage of us” and “there are better uses for $12 billion.”

Political deals as well as commercial deals always involve compromises. And both sides are often criticized for making unwarranted concessions. But while these arguments can go on endlessly over whether a different deal could have been structured better, it is impossible to prove the case either way 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 the quintessential political deal, and the debate over which side won is likely to go on forever. What is obvious at this stage is that the deal is a stretch for both sides.

THE BOTTOM LINE

A fundamental truth is that debt relief buys nothing. It simply recognizes a loss 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.

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1 Institute of International Finance, 2005. http://iif.com/data/public/principles-final_0305.pdf

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