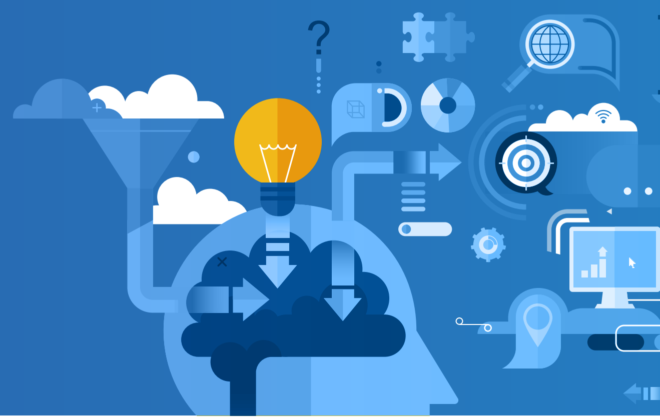
RESEARCH INSIGHTS



Why Are Preferred Creditors Preferred?

- If sovereign borrowers restructure commercial debts, they are still expected to repay preferred creditors such as the IMF, IDB and the other main multilateral development banks (MDBs) in full.
- Surprisingly, while this status is almost always respected, it is a market custom and does not appear in legal documents. Moreover, existing scholarly work does not provide a justification for why it is so enduring.
- We found that private and preferred lending can coexist and that it can be in the interest of countries to always repay preferred lenders, as the benefit of future access to credit outweighs the cost of repayment. This explains the persistence of the preferred status.

CONTEXT

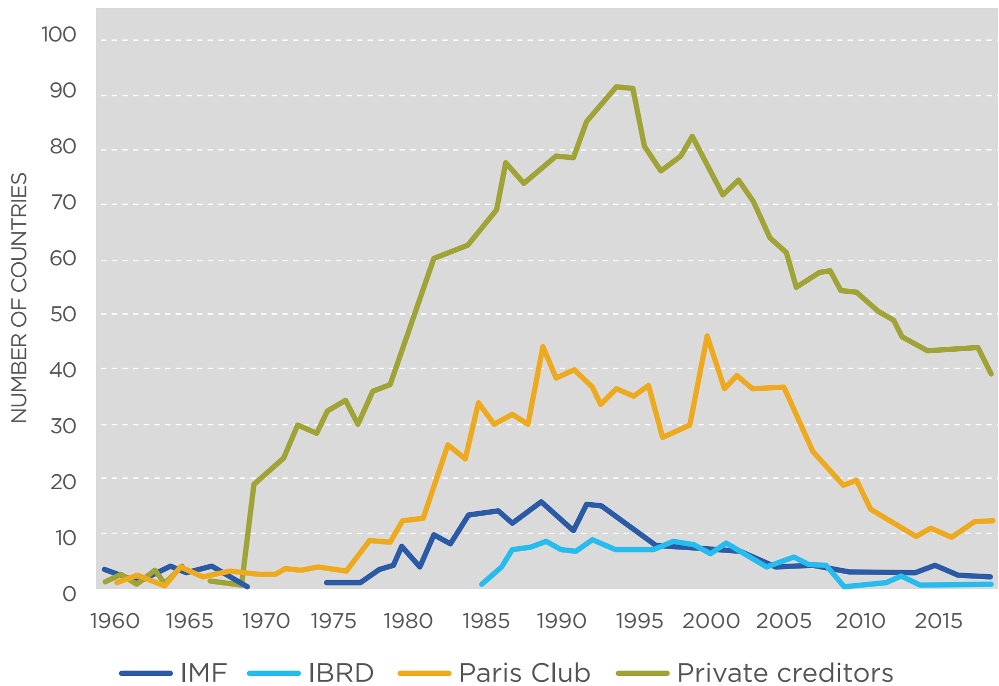
Argentina fell into default with commercial creditors in 2002. Some accepted an offer of partial repayment in 2005 and 93% accepted further offers in 2010. Many legal cases challenged these agreements, but there was no real attempt to disrupt operations with preferred creditors. All parties implicitly accepted their preferred status. More generally, significantly fewer countries default on the IMF, the IBRD (International Bank of Reconstruction and Development, the non-concessional part of the World Bank Group), and other MDBs than on private creditors, including banks and bondholders, or bilateral creditors such as member countries of the so-called *Paris Club* (see Figure 1).

THE PROJECT

We developed a theoretical model that included both commercial and preferred creditors to demonstrate that both can coexist and that their existence benefits countries. Despite the long-standing puzzle of preferred creditors, we could not find academic papers that attempted this challenge. Most scholarly work on sovereign debt simply ignores the existence of preferred creditors and, when it acknowledges them, the authors do not show how they are able to maintain their preferred status.

In our model, the cost of borrowing from commercial creditors might be high, reflecting the risk of a default in bad times. However, the country always repays a preferred creditor who can then lend at a low interest rate. Unlike many small private lenders, a preferred lender can limit the amount lent to ensure that the benefit of repayment always exceeds the costs.

Figure 1: Number of Countries in "Default" with Different Creditors in Each Year



RESULTS

Our work demonstrates that commercial and preferred lenders can coexist and that access to both types of lending may be beneficial to countries. We also showed that if a preferred creditor lends at low interest rates and restricts lending volumes, its preferred status will be respected. This explains why the preferred status persists as a market norm rather than being included in legal contracts. We also found that having both types of lenders can be better for countries, as they are able to borrow using two types of contracts if they wish.

Still, the lending volumes from the market and from the preferred lender may be constrained—a country may be able to borrow less than it would like to. Also, the more the country can receive from one type of lender, the less it will be able to borrow from the other, as access to one type of lender becomes less valuable if the country can borrow more from the other. These conclusions stem from our *willingness to pay* approach.

Interestingly, we found that a country is better off if we impose an assumption that it only has access to preferred lending if it repays private lenders when times are good. This rules out what has been termed an "inexcusable default." The assumption provides greater incentives for the country to repay the private lender in good times, as it can borrow more in emergency situations.

Key Concept

SOVEREIGN DEFAULT

Sovereign default is not always transparent as payments may be delayed or debt can be renegotiated without missing a payment. Rating agencies tend to place sovereigns in default if creditors accept a reduction in the value of payments but sometimes this is a judgement call.

Key Concept

WILLINGNESS TO PAY

Since it is difficult to penalize countries in default (there is no bankruptcy court for sovereigns), economic analysis of sovereign debt normally focuses on *willingness to pay*, rather than *ability to pay* used for households and firms that can be taken to national courts.

POLICY IMPLICATIONS

Our work shows that preferred creditors can lend in bad times and expect to be repaid, and that their existence may make countries better off. This justifies preferred creditor status as a market custom.

However, preferred creditors cannot lend unlimited amounts. Our analysis suggests they should restrict lending volumes so that countries retain the incentive to repay.

Preferred lenders add value because they offer a different contract. If a preferred lender charged higher rates to countries perceived as being riskier, their incentive to repay in bad times would diminish. Taken to an extreme, preferred lenders might become just like an additional private lender, losing their value added.

Given high debt levels and the financial pressure many countries are under due to Covid-19, there have been calls for debt reductions. Our results suggest that this may well be appropriate for private creditors that charge interest rates related to risk, but not necessarily for preferred creditors. Arguably, it is better to ensure preferred lenders remain preferred and find ways for them to provide more low-cost, long-term financing, rather than reducing their lending power.

A necessary caveat to our analysis is that it was developed through an economic model with a set of assumptions. These should be taken into account when considering the implications of our work.

FULL STUDY

Cordella, T., and A. Powell. 2019. "*Preferred and Non-Preferred Creditors.*" Policy Research Working Paper Series 8941. World Bank.

DEPARTMENT OF RESEARCH AND CHIEF ECONOMIST

The Department of Research and Chief Economist generates new ideas to enrich the knowledge base that supports the policy agenda of the Inter-American Development Bank (IDB) and its member countries for achieving sustainable and equitable development in the region. To maximize the impact of its research, the Research Department carries out activities that serve as inputs to other IDB departments, governments, the academic community and public opinion in the region.