OPPORTUNITIES FOR THE APPLICATION OF EXTERNAL DEBT RESTRUCTURING MECHANISMS FOR DEVELOPING COUNTRIES

Grigor NAZARYAN,
PhD in Economics, Associated Professor, ASUE
Suren MINASYAN
PhD Student, Institute of Economics and Business, RAU

Key words: foreign debt, debt restructuring, debt forgiveness, paris club, the Brady plan, G20, common framework

Introduction. The application of debt restructuring mechanisms for developing countries with heavy debt has a history of decades, but these mechanisms have been taken on a new meaning since the outbreak of COVID-19. According to the World Bank (WB), the total global debt reached 263% of world GDP in 2020, while the debt of both the public and private sectors, as well as advanced and developing countries increased [WB, 2021]. Nevertheless, the most problematic was the public debt of developing countries, which increased by 9 percentage points in 2020 alone, accounting for 63% of the total GDP of those countries [WB, 2021]. The conditional liabilities of these governments are expected to increase due to loans and guarantees provided to companies, while the debt generated by SOEs will also increase [Melecky, 2021, p. 3].

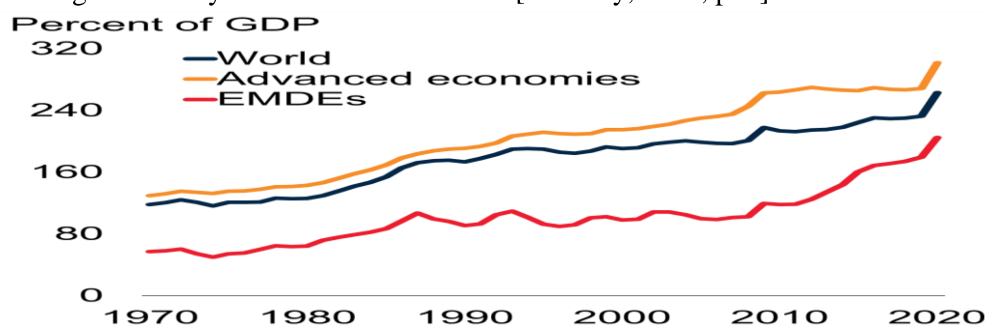

Figure 1. Total debt/GDP ratio for the world: developed, developing nations [source: WB]

In the current situation, leading international financial institutions (IFIs) and advanced countries started to develop new mechanisms for debt restructuring to apply for countries with debt management issues, recognizing that existing tools are not capable of helping to solve the issues of debtor countries. However, what were those restrictions and why could the debt of developing countries not be restructured within existing mechanisms? In order to answer the question, this article intends to analyze and assess various tools applied by advanced countries and IFIs since the middle of the 20th century to restructure the external debt of developing countries.

Methodology. The methodological basis for conducting the research is the use of secondary information collection tools. The collection of secondary information will be

based on works of leading economists and publications of academic and financial organizations (like WB and IMF), as well as the foundations of classical and modern economic theories. The comparative method was used in the article as well to identify the main similarities and differences between the various debt restructuring mechanisms.

Literature Review. Along with the continuous growth of sovereign debt, theorists focused on the economic development of countries with large volume of debt. Myers (1977) was one of the first theorists to discuss the sovereign debt issues and called such a case debt overhang, a situation where the high level of debt distorts the possibilities for borrowers to make optimal future investment decisions. The concept of debt overhang was further used in the macro literature where the debt overhang has been analyzed mainly in the context of sovereign-debt crises. Indeed, due to the debt crises in the 80s and 90s, this theory has been extended in a sovereign context with the aim to explain the effects that the high debt had produced on the level of investment in the "less developed countries" [Picarelly, 2016, p. 4]. In general, debt studies can be divided into two main groups: the studies of the first group are focused on the effects on investments (Deshpande (1997)), while the others go further and examine the direct effects on GDP growth [Clements et al., 2003]. Since the 1980s, in parallel with the development of debt restructuring initiatives, researchers have focused on these mechanisms and their potential impact on beneficiary countries. Moreover, some researchers (Arslanalp and Henry 2004) referred to the positive consequences both creditor and debtor countries. The early researches included comparative analysis of several restructuring episodes occurred between 1950 and 1980. In this researches in particular, some differences between the restructuring processes implemented by haircut and processes implemented by lengthening maturities are highlighted. Others analyze the different consequences produced by restructuring processes implemented via haircut or via lengthening maturities. They show that the debtor countries' conditions improve significantly just in case of debt write-offs. Different form of debt reliefs instead, such as lengthening of maturities, are not generally followed by such results. [Picarelly, 2016, p. 5].However, given the emergence of new debt restructuring mechanisms and the aggravation of debt management issues around the world, the topic requires ongoing research. While available literature mainly refers to the historical debt relief mechanisms, this article covers information of two latest debt relief initiatives as well - the Debt Service Suspension Initiative and the Common Framework, presenting them in comparison with existing mechanisms.

Analysis. Historically, the first of the debt restructuring mechanisms was the *Paris Club*, founded in 1956 as a non-formal organization of major lender countries, with the aim of developing systemic solutions for borrowers with debt issues. The first beneficiary of the Paris Club was Argentina, whose debt of USD 500 million to 11 countries was restructured in accordance with the Club's basic conditions. Similar to the Paris Club, the

London Club was created as an informal association of private lenders, with the aim of restructuring the debt of borrowers with debt issues. The club was founded in 1976 and the first deal was the debt restructuring of the Republic of Zaire (currently, the Democratic Republic of the Congo).The *Brady plan* was proposed by the US Treasury Secretary in 1989 to address the volatile sovereign debt issues of Latin American countries lent by US private financial institutions in the 1970s and 1980s. Concerns over US financial stability were also at the heart of the Brady plan. The latter called for more than 100 private-sector lenders to reduce the debt stock of 17 debtor countries by 37% of the NPV.

The *Heavily Indebted Poor Countries Initiative* was launched in 1996 by the WB, the International Monetary Fund (IMF) and other multilateral, bilateral and commercial lenders to address sovereign debt repayment related issues of low-income countries. The initiative determined the amount of debt write-off that the country would need to get out of its volatile debt level permanently. Meanwhile, debt restructuring was ensured only when the borrowing country was implementing major structural and social development reforms. The initiative was complemented in 2005 by the *Multilateral Debt Relief Initiative*, which offered a full debt forgiveness from the WB, the IMF, the Inter-American Development Bank and the African Development Bank. Currently, 37 countries are among the beneficiaries of these initiatives, in which debt forgiveness of about USD 100 billion has been implemented. All of these initiatives set themselves the task of developing common principles that would be applied to a large number of borrowing countries. However, each borrower's debt restructuring process was viewed in its own way (“case by case” approach), which sometimes led to inconsistencies in different processses, reducing the transparency and credibility of the process. These initiatives had much in common (significant reduction in debt stock, broad participation of borrower countries, protracted debt restructuring processes, replacement of less ambitious debt repayment efforts by debt restructuring/forgiveness), as well as a number of differences: they differed in their structure and basic principles, with the participation of private creditors, as well as the accessibility of borrowing countries to participate in the process. It should be noted that all these tools have always been sharply criticized, and the subject of criticism has been not only the lack of transparency and credibility of the process, but also the challenges that have arisen as a result of debt restructuring to borrowers. At first glance, debt service deferral may provide financial opportunities for borrowers in the short term, but critics argue that debt restructuring creates a "decade of lost economic growth" for the borrower, as the process did not involve structural reforms.

As noted, debt restructuring tools have gained new relevance in the wake of the COVID-19 epidemic as a number of poor developing countries face serious debt service difficulties. As a result, in 2020, the G20 proposed the *Debt Service Suspension Initiative (DSSI)*, which aims to suspend sovereign debt service for poor countries creating a

fiscal space to increase social, health or economic spending in response to the crisis. The DSSI, however, did not involve debt forgiveness and private lenders do not participate.

Later, the *Common Framework* was launched by the G20 to address the shortcomings in existing tools. It was essentially a platform to consider debt restructuring and forgiveness opportunities for DSSI beneficiaries and to offer systemic solutions using lessons learned from previous tools. The framework mainly envisages debt restructuring by extending the repayment period and/or reducing the interest rate, rather than reducing the nominal value. The option of canceling or writing off the debt is provided for in the "most difficult cases", which will be determined by a joint assessment of the WB and the IMF, as well as other creditors involved in the process. The framework does not yet have a final methodology for evaluating the process, but is currently used in three countries: Chad, Ethiopia and Zambia. The Common Framework, however, has some significant similarities with each of the previous initiatives, and it is inappropriate to state that it will effectively replace their implementation. Moreover, the implementation of the framework faces a number of old and new challenges, including lack of incentives for private lenders, expansion of borrower debt structure (complication of communication between large lenders) and diversification (including at the expense of private lenders, creditors whose distinction is not clear between private and public, such as the KfW). Despite the limited application of the debt restructuring process, it is, of course, inappropriate to state that limitation is due to shortcomings of tools. Obviously, it is impossible to cancel the accumulated debt indefinitely, as it is a successive chain of commitments on each side, but existing debt restructuring tools have essential limitations, in particular:

i. they are mainly used in low-income countries, while a number of middle-income countries also have difficulty in managing public debt, and these issues have been exacerbated especially after the outbreak of the COVID-19 epidemic, as governments' socio-economic measures were largely financed by external borrower financing as well [Kose, Ohnsorge and Sugawara, 2021, p. 9];

ii. it is debatable that the debt restructuring of developed countries and IFIs is based solely on economic reasons, and lenders do not pursue geopolitical goals to support or influence borrowers;

iii. debt restructuring significantly focuses on deferral and/or reduction of interest rates, while direct debt forgiveness is crucial for effective debt management. As a result, debt forgiveness is addressed by lenders only years after debt management issues arise and several failed restructuring attempts, when the borrower's debt service capacity has already been exhausted.

Conclusions. Effective application of debt restructuring mechanisms can have a positive impact on heavily indebted countries. However, there are some issues with the development and application of these mechanisms that hinder their widespread and

effective application. Thus, in the context of supporting countries with debt management issues, it is more expedient to expand the scope of debt restructuring tools, both from the point of view of the beneficiaries and the instruments used, giving priority to the possibility of direct debt forgiveness. Meanwhile, the debt forgiveness process needs to be linked to structural economic reforms, combining them wherever possible with the commitments made by developed countries and international organizations (including the EU) to combat climate change, protect the environment and support the developing world.

References:

1. Arslanalp, S., Henry P. B. 2004, Is debt relief effcient? Journal of Finance 60(2), 1017-1051;
2. Clements, B., Bhattacharya, R., Nguyen, T. Q. 2003, External debt, public investment, and growth in low-income countries. IMF WP/03/249;
3. Deshpande, A. 1997, The debt overhang and the disincentive to invest. Journal of Development Economics 52, 169-187;
4. Kose, M. Ohnsorge, and N. Sugawara. 2021. "A Mountain of Debt: Navigating the Legacy of the Pandemic." Policy Research Working Paper 9800, World Bank, Washington, DC;
5. Melecky, M. 2021. Hidden Debt: Solutions to Avert the Next Financial Crisis in South Asia. South Asia Development Matters. Washington, DC: World Bank;
6. Myers, S. 1977, Determinants of corporate borrowing. JFE 5, 147-175;
7. Picarelli, M. 2016, Debt Overhang and Sovereign Debt Restructuring, Sapienza University of Rome;
8. World Bank. 2021. Debt Transparency: Challenges and Reforms for Low-Income Developing Countries; Washington, DC;
9. World Bank. 2022, Global Economic Prospects, January, Washington, DC.

Grigor NAZARYAN, Suren MINASYAN

Opportunities for the Application of External Debt Restructuring Mechanisms for Developing Countries

Keywords: foreign debt, debt restructuring, debt forgiveness, Paris Club, The Brady plan, G20, Common framework

Since the second half of the 20th century, lending countries and organizations have undertaken a number of external debt restructuring/forgiveness processes, which, however, have had limited application. Moreover, in no case was it possible to present a complete methodology for the implementation of the process, the application of which would be universal in nature and would be free from substantial, justified criticism.
Since the outbreak of COVID-19, the world, including both advanced and developing countries, has faced serious challenges in raising large amounts of new debt and servicing it in the future. If debt service was not as risky in advanced countries, a number of developing countries have seen huge amounts of debt accrued, once again bringing the tools of debt restructuring (including debt forgiveness) to the forefront.
The author aims to study and summarize the various mechanisms and tools of debt restructuring developed by advanced countries and international financial institutions for borrowing countries. Meanwhile, the purpose of the article is to assess the opportunities and limitations of the existing mechanisms for developing countries.