

# The Shaping of the Brady Proposals

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## Ten Reasons for the Timing

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A variety of reasons have been advanced as to why the Brady proposals came when they did and why they incorporated for the first time official US backing for schemes of debt reduction that would involve enhancements from the international financial institutions.

First, the extant 'Baker Plan' strategy had run out of credibility. It is important to say that rather than that the plan had failed, because an accusation of failure involves an assumption about what the underlying objectives of the strategy actually were. Some blamed the failure of the commercial banks to come up with the amount of new funding which the strategy had required; some argued that the banks had done their bit but the response of the IFIs had fallen short;<sup>1</sup> some believed that the major part of the failure lay at the door of the LDC debtors themselves for not adjusting their internal policies rapidly and rigorously enough. But wherever the blame lay it was clear by mid-1988 that the strategy was not enabling most severely indebted countries to grow out of their problems and that the critical ratios of creditworthiness were not generally improving.

Second, the international financial system was no longer felt to be vulnerable to whatever actions the debtors might take or, by 1990, to a more radical approach to the entire problem than had been manifest in the previous procedures for repetitive reschedulings.

Third, most of the major lending banks had succeeded in making substantial provisions against loss of part of the principal owed or failure to receive prompt payment of interest as well as in strengthening their capital ratios.

Fourth, the performance of the secondary market where LDC loans were being traded at deep and generally growing discounts was assuming increasing significance — debtors were asking 'why are we attempting to service our loans in full when the market considers them to be worth less than half their face value?' and 'what can be done to enable us to capture the discounts?'

Fifth, a sense of the lack of parity of sacrifice between creditor banks and the populations of debtor countries in the treatment of the problem since 1982 was spreading; this uneven impact of the prevailing strategy was even causing disquiet amongst some of the staff of the IFIs.

Sixth, contributing to that feeling of disquiet was the evidence that IFI-designed structural adjustment programmes had much less chance of working if resources needed for investment had to be continually diverted fully to service the ever growing burden of commercial bank debt.

Seventh, in a period of high interest rates and weak commodity prices the underlying quality of IMF advances and of World Bank loans might themselves be damaged unless the burgeoning and ultimately competing claims of the commercial banks could be reduced.

Eighth, certain political considerations had assumed more immediate importance for the US administration, for example the need to come to terms with a new President of Mexico as orthodox in his financial policies as any Mexican President was likely to be; the desire to preserve democracy in Argentina; the need to respond to the anti-debt, anti-adjustment riots in Venezuela; and the wish to bolster Mrs. Cory Aquino's popularity in the Philippines.

Ninth, the possibility of getting the IFIs and the Japanese Government indirectly to help out the more exposed US banks (and the US Treasury) was not in itself unattractive.

Tenth and finally, Mr. Brady's installation as US Secretary of the Treasury gave his Assistant Secretary scope to introduce a new policy that would differentiate him from his predecessor and at the same time fit in with the more comprehensive and flexible approach to the countries of Latin America favoured by President Bush.

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## Similarities and Differences

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The announcement of a new policy, like a death in the family, however expected it may be always comes as a bit of a shock when it actually happens. The contents of the Brady proposals, as presented on March 10 1989 should not however have occasioned any great surprise. They had been circulated in draft form and

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<sup>1</sup> See William Cline 'From Baker to Brady: Managing International Debt', Amex Bank Review, Marjolin Prize Essays, 1989.

subjected to considerable criticism including some from institutions which found it necessary to welcome the proposals when they later became official US policy. All the main ingredients in the Brady mixture can be found in earlier publications or statements by commentators on the Third World debt situation. Amongst the most influential of these were 'Voluntary Approaches to Debt Relief' by John Williamson,<sup>2</sup> 'Six Principles for a Revitalised Debt Strategy' by Moeen Qureshi,<sup>3</sup> and the statement put out by Horst Schulmann of the Institute of International Finance (IIF).<sup>4</sup>

It can thus be argued that one part of the impact of the Brady proposals was mainly psychological — the explicit recognition that the external debt of many developing countries had grown so large that it could not possibly be fully serviced and that forms of debt relief were therefore unavoidable. It was not the truth of this proposition, which had been evident to many people for a considerable time, that mattered; it was the significance of a Secretary of the US Treasury for the first time publicly acknowledging it.

US Government officials like to refer to the Brady proposals as 'the strengthened strategy' for dealing with LDC debt and it is a useful touchstone for seeing whether individuals (or institutions) feel themselves beholden to US influence to detect whether or not they use this same nomenclature. In this article it is suggested that there are four significant similarities between the Baker and the Brady strategies and four significant points of difference.

The similarities are these:

1. The Case-by-Case approach in dealing with individual sovereign debtors is to be preserved although within a different framework of options.
2. Agreement by the debtor to a programme of adjustment with the IMF remains a pre-condition of eligibility for the new facilities and full conditionalities are to be maintained.
3. Participation by commercial banks in one or other of the options is to remain on a supposedly voluntary basis, the use of the word 'voluntary' in this context not being intended to inhibit government authorities from a certain amount of necessary 'arm-twisting'.
4. As with earlier phases of the strategy, the proposals were worked out and introduced by US officials and were heavily influenced by regional geo-political considerations.<sup>5</sup>

<sup>2</sup> John Williamson 'Voluntary Approaches to Debt Relief', Institute for International Economics, September, 1988.

<sup>3</sup> Moeen Qureshi 'Six Principles for a Revitalised Debt Strategy' in Adrian Hewitt and Bowen Wells 'Growing Out of Debt' published by the Overseas Development Institute for the All Party Parliamentary Group on Overseas Development, 1989.

<sup>4</sup> H. Schulmann 'The Way Forward for the Middle-Income Countries', IIF, Washington DC, January, 1989.

The differences are these:

1. The negative pledge and sharing clauses in the original syndicated loan agreements should be waived so as to allow different banks to select different options in converting out of those loans.
2. Governments are urged to induce their tax and regulatory authorities to amend or to interpret their tax treatment and banking regulations so as to facilitate (or even encourage) the participation of banks in schemes of debt or interest rate reduction.
3. The IMF and the World Bank would henceforth be willing to disburse their advances and loans in certain circumstances even if the sovereign debtor concerned had not reached a conclusive agreement with its commercial bank creditors — thus of course weakening the power of those creditors in holding out for what they would regard as an appropriate rescheduling deal.
4. Finance would be made available by the IFIs and, it was hoped, by other sympathetic agencies (especially from the balance of payments surplus countries) to fund schemes of debt and debt service reduction.

It was this last measure, the instrumentation for which will be described next, which has attracted most of the attention. But the other three differences in their own way could be just as important in determining the actual impact of the new strategy.

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## The Meaning of 'Credit Enhancement'

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The most spectacular innovation in Brady was the proposal for debt reduction to be achieved within a framework of voluntary actions by the commercial banks. The key that was to make such voluntary lowering of their claims acceptable to the banks was the prospect of 'credit enhancement' which would mean that a lower nominal claim against a debtor could be of equal or greater value than the previous higher claim because it would be collateralised or guaranteed with the money for the guarantees and the collateralisation or, in some cases, to finance debtor government buy-backs of their loans for cash, coming from the IMF, the World Bank and other well disposed governments.

It has been argued, most cogently by Lomax,<sup>6</sup> that it is an anachronism to include within the same scheme for a single country proposals for debt and debt service reduction with proposals that some banks should

<sup>5</sup> This part of the analysis draws heavily on Robert Devlin 'The New International Management of the Latin American Debt Problem', a paper prepared for the seminar 'Raul Prebisch's Intellectual Heritage and the Development Problems of Latin America', Santa Fe, Argentina, June 1989.

<sup>6</sup> See D. F. Lomax 'International Monetary Arrangements — Recent Proposals for Third World Debt', a paper submitted in evidence to the House of Commons Treasury and Civil Service Committee, July 1989.

simultaneously supply what is euphemistically called 'new money'.<sup>7</sup> Either a country should be regarded as insolvent, the argument goes, in which case it requires debt or debt service reduction, or it is only temporarily illiquid, in which case its need is for 'new money' (or temporary capitalisation of part of the interest due) until it can get over a short- to medium-term difficulty in its balance of payments. A view needs to be taken as to whether or not the country should be regarded as effectively insolvent; if it is not, debt reduction is inappropriate and, if it is, 'new money' will simply make the position worse.

Whatever sympathy one may feel for this line of argument, it is clear that those who designed the Brady proposals could not afford to admit its logic. The reason they could not do so was because it was not anticipated that sufficient financing would be available to fund schemes of debt reduction and/or that the discounts achieved in a voluntary negotiation between debtor governments and bank advisory committees would be sufficiently deep to offer the required balance of payments relief unless a proportion of commercial bank creditors were willing and indeed preferred to increase their exposure to the sovereign debtor by the provision of 'new money'. There may also have been an apprehension that some banks, particularly in the US, still could not afford to take some of the losses resulting from taking one of the debt reduction options even by the year 1990.

This diagnosis, if correct, would explain the emergence of the three main options between which creditor banks would be expected to choose in their next rescheduling negotiations with eligible sovereign debtors. The three options are by now famous but will be summarised here. They were: (1) a given bank could commit itself to a 'new money' package that would involve re-lending a proportion of the interest due on its existing loans thus increasing its exposure to the country by an agreed proportion over an agreed number of years; or (2) it could convert its existing loans into bonds that would have a lower face value but the same rate of interest; or (3) it could convert its existing loans into bonds that would have the same face value but a lower rate of interest. In the event of the bank selecting either the new reduced face value or reduced interest bonds it would benefit from the fact that the eventual repayment of the principal would be collateralised and the interest payments would be secured for a certain period of time on a roll-forward basis by one of the international financial institutions.

It should be stressed that these three options were still to be accompanied by other measures such as 'cash buy-backs up to a maximum amount', 'viable debt-equity swap programmes', provisions that would

encourage domestic nationals to repatriate their flight capital, 'concerted lending, club loans by a group of banks, or a range of trade, investment or other credits from individual banks'.<sup>8</sup>

The role of the IMF and the World Bank, in the view of the US Treasury, would continue to be to encourage and require debtor policy reforms, to supply finance for stabilisation and adjustment programmes and to catalyse other forms of financial support. But under the new strategy they would also be asked to 'redirect and increase resources to support debt and debt service reduction transactions agreed upon by commercial banks and debtor nations as an additional spur to growth in debtor nations'.<sup>9</sup>

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## The Size of the Initiative

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It is a feature of the Brady proposals that the quantum of debt and debt service reduction that will result from their implementation is unknown and unknowable. It is unknowable because neither the amount of resources to be devoted to debt reduction, nor the distribution of their application between different forms of debt reduction, nor the outcome of deals to be struck between individual debtors and their creditors can be known. Furthermore there are a variety of different ways in which the extent of debt relief can be measured. In these circumstances it is hardly surprising that estimates range from the optimistic to the pessimistic with any individual position in that range being determined by factors as diverse as a personal interest in the scheme's success, the effect of the proposals on a bank's declared profits, or animosity toward some officials at the US Treasury.

Most commentators however seem to be agreed on three things. First, that the psychological climate in which future debt rescheduling negotiations will be conducted has been profoundly changed; second, that the scheme will have a significant effect in some countries in bringing about debt service relief; and third, that the proposals by themselves with their present level of funding will not get rid of more than part of the debt overhang.

What is the anticipated level of funding? Early indications were that the IMF and World Bank were each thinking in terms of \$12 bn or so per institution over the first three years. Of that total of \$24 bn, roughly \$10 bn would be additional resources with the remaining \$14 bn being detoured from already programmed policy lending. Another \$4.5 bn in parallel lending for import support has been programmed by Japan.

Robert Devlin has commented:

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<sup>8</sup> David C. Mulford 'The Brady Plan: strengthening the current international debt strategy' in *Third World Debt: Managing the Consequences* edited by S. Griffith-Jones, IFR Books, 1989.

<sup>9</sup> *ibid.*

<sup>7</sup> For an investigation of the use and abuse of language in the Third World debt debate, see Mike Faber 'Beware of Debtspeak' IDS Discussion Paper, No. 251.

'By just taking into account the Baker 17 countries, where there is some \$375 bn of obligations with commercial creditors, it is clear that the \$29 bn already committed to the Brady Plan could support no more than a very partial reduction on the debt overhang. For example if used in straight buy-back of the Baker 17 debt at April's weighted average secondary market price of 36 cents, the above mentioned public funding could reduce commercial debt by some \$80 bn. Even this magnitude of debt reduction — which incidentally is highly improbable in a voluntary scheme because it assumes no rise in secondary market prices — would bring a fall in the interest payments on the commercial debt of these countries of only 21 per cent; meanwhile, the reduction in total interest payments would be just 16 per cent.'<sup>10</sup>

Devlin also points out that to the extent that debt reduction is financed through new loans, cash flow relief will be less than the reduction in interest payments to the banks. Indeed loans from the IFIs or for that matter grants from bilaterals that are used to reduce or extinguish debt but which otherwise would have been available for general balance of payments support will have a strongly negative foreign exchange flow impact in the initial year followed by a positive

net foreign exchange flow impact in all subsequent years. To that extent, as I have argued elsewhere, debt reduction expenditures can be subjected to a form of cost benefit analysis and their projected rates of return compared with what could be anticipated by alternative aid-financed projects.

Devlin concludes 'In any event, the resources committed to the Brady Plan suggest a debt reduction that will be piecemeal and which will fall far short of achieving the 50 per cent or greater cut in interest burdens that many heavily indebted countries seem to feel they need now to begin to grow and develop. Indeed, even the Plan's illustrative example of achieving a 20 per cent reduction in the interest burden of 39 developing countries over the next three years would seem to require more resources than are currently available. Moreover such a modest reduction would not even compensate for the 40 per cent rise in LIBOR over the last 18 months.'<sup>11</sup>

### The Evolving Composition of LDC Debt

However successful the Brady strategy turns out to be, it must still be set within the organic composition of LDC indebtedness as a whole. The structure of

<sup>10</sup> R. Devlin, *ibid.*

<sup>11</sup> *ibid.*

Table 1

**Long-Term Debt Outstanding**  
All Severely Indebted Developing Countries, except lines 8 and 10  
(all figures and calculations based on US\$, current)

	1970	1982	1988
1. Long-term External Debt (\$bn)	31.2	313.5	529.0
2. Average annual increase, 1970-1982		+21.25%	
3. Average annual increase, 1982-1988			+9.00% <sup>b</sup>
4. Percentage public and publicly guaranteed	61.3%	78.5%	93.1%
5. Percentage owed to multilaterals	10.1%	8.5%	14.0% <sup>a</sup>
6. Percentage owed to bilaterals	23.2%	14.6%	23.7% <sup>a</sup>
7. Percentage all official creditors	33.3%	23.3%	37.7% <sup>a</sup>
8. Line 7 for <i>all</i> developing countries	n.a.	35.4%	45.2% <sup>a</sup>
9. Percentage of both public and private debt owed to commercial banks	48.4%	62.9%	50.5% <sup>b</sup>
10. Line 9 for <i>all</i> developing countries	31.6%	50.4%	40.4% <sup>b</sup>

Sources: WB World Debt Tables 1989-90, Vol 1, pp 122-3 and 78-9.

Notes: a These figures will continue to rise

b These figures will continue to fall

creditors is dynamic and changing quite rapidly and yet much less attention is normally paid to it than to the list of debtors and the extent of their individual indebtedness. Table 1 illustrates what is meant by 'the evolving composition of LDC Debt'; several points that emerge from it deserve comment.

Lines 1, 2 and 3 show the long-term external debt of all severely indebted developing countries expanding at a compound rate of 21.25 per cent a year over the 12 year period terminating in 1982, and at a rate of 9 per cent in the six years following. Of that earlier period, one is tempted to ask 'What *did* the bankers think they were doing?' Part of the answer is 'They did not know'. Or rather, each knew how fast his own business was expanding but was unaware that borrowing from others was expanding even faster. If the Brady proposals succeed and interest rates fall, we may postulate that the successor figure to that in line 3 for the period 1988-1994 may indeed become negative.

Line 4 demonstrates how, partly on the insistence of creditors, a higher and higher portion of each country's indebtedness has either become government debt, or has had to be guaranteed by government.

Lines 5, 6 and 7 show how quickly the proportion of Severely Indebted Countries' debt owed to the multilaterals (IFIs) and bilaterally to other governments has been increasing — namely by more than 2 per cent a year as a percentage of all such debt since 1982. The reasons for this are clear. While most

commercial banks have been doing all that they can to reduce their exposure to LDC debtors, the World Bank has continued to make positive net transfers and the Paris Club has continued to do the equivalent of advancing 'new money' through its own extensive rescheduling arrangements. But the implications of this process continuing should be equally clear. Already, as line 8 and 10 show, all developing countries together owe more medium- and long-term debt to the bilaterals and to the IFIs than they do to the commercial banks. If the Brady proposals succeed this trend can do nothing but accelerate so that by 1994 it is quite conceivable that up to three-quarters of all medium- and long-term sovereign debt of all developing countries will be owed to official creditors.

A number of disturbing conclusions follow from that prediction, of which I shall mention just three: First conclusion: it is clear that the debt overhang cannot be removed simply by reducing LDC indebtedness to the commercial banks however large the discount they can be induced to accept in loan-bond conversions. Second conclusion (vide line 6): an early priority is going to be a solution to 'the Free-Rider Problem between Governments' which at the moment is gravely impeding the introduction of significant debt reduction to the proceedings of the Paris Club. Third conclusion: The next plan after Brady is going to have to incorporate more extensive and more open procedures for those whose indebtedness to the IFIs themselves (including arrears) has grown to a size that clearly cannot be serviced on the original contractual terms.