Is the Brady Plan an Effective Approach to Debt Management?

Stephany Griffith Jones[1]

1. Introduction

Recently, we have seen a move towards the general acceptance that there is a need for some kind of debt/debt service reduction for heavily indebted middle-income countries, the so-called HICs. This was first reflected in the 1988 French and Japanese initiatives, but became broadly accepted when US Treasury Secretary Brady announced his plan in early 1989. The recognition that the debt problem is not just a liquidity, but also a solvency problem is an important step forward in dealing with the debt overhang, which at least in Latin America, was broadly viewed as the key obstacle to development in the 1980s.

The initial debt management strategy (1982-85) had assumed that the debt crises were temporary, and that with much adjustment on the part of the debtors and some 'involuntary lending' from the banks, the problem would be overcome. It was insistently argued that voluntary lending and LDC growth would return to the 1970s pattern. At that time, those who argued for debt reduction were treated as unnecessarily radical.

By 1985, the desired results were clearly not achieved and debtors were increasingly organised, as well as beginning to take unilateral action to limit debt service payments. The Baker Plan was introduced. Its rhetoric was new — it argued for adjustment *with* growth — and the conditionality on new lending was expanded to include long-term structural reforms, such as trade liberalisation and privatisation.

Though the latter was linked to increased lending by the World Bank — and other multilateral bodies — the basic financing modality to handle the debt overhang was not modified. Under Baker, countries were still being lent more money so that they could get out of debt! Debt reduction was still officially unacceptable, though it began to be introduced informally in 1987 and 1988 (the Mexican Aztec bonds, and the donor funded Bolivian buy backs being the precedents).

However, it was only with the Brady Plan — in early 1989 — that debt reduction finally became an acceptable modality to deal with the debt overhang.

Before analysing the features of the new stage, it seems worthwhile to examine the reasons which made the previously almost taboo subject of debt reduction become almost universally acceptable in 1989, and which led to it becoming a key element in the US Treasury's new debt strategy.

Firstly, in debtor nations, impatience with adjustment and negative net transfer burdens has clearly spread from relatively limited circles of intellectuals to strongly influence the political process, as parties supporting a more radical stance on debt gained many votes (e.g. in Mexico) or power (e.g. in Argentina). More dramatically, the riots in Venezuela in February 1989, in which so many people were killed due to protests against adjustment measures, illustrated the deep resistance to cuts in living standards among the poorer people in Latin America. In political and popular circles in highly indebted countries massive net transfers, linked to a large debt overhang, are seen as a major cause for declining or stagnant living standards and investment levels since 1982. Increasingly these concerns are shared by representatives of industrial governments, international organisations, international banks and by public opinion in industrial countries. The need to sustain fragile and young democracies and the need to provide some hope for a better future to people in highly indebted countries are often quoted as reasons for the need for a new debt strategy.

A strong intellectual case was made by influential economists in the industrialised world, such as Paul Krugman, John Williamson and Jeffrey Sachs, that debt relief was in the economic interest of both debtors and creditors. They — and others — argued that excessive debt burdens act as a disincentive for debtor countries (and governments) to take painful or politically unpopular adjustment or stabilisation measures, as the potential fruits or those measures (e.g. as reflected in higher exports) will go in excessive proportion to the creditors. Secondly, they pointed out that attempts to extract full contractual debt service risk provoking the debtors into a confrontation, from which both they and the creditors will lose. Furthermore, excessive debt burdens not only have direct negative effects on the local economy, particularly via lower investment, higher taxation and/or higher inflation but also indirect ones, for example, by discouraging capital flight repatriation. Furthermore, it has been argued increasingly that by

[1] I thank Andrew Briggs for his assistance.

forgiving part of a country's debt creditors may increase adjustment and desirable structural reforms, which will increase future debt service capacity.

Finally, the need for debt/debt service reduction as a key mechanism to reduce net transfer of financial resources from highly indebted developing countries to the industrial world is based on increased evidence that there has been, and will be, very little new general purpose bank lending to those countries.

The Brady Plan includes a number of innovative elements. The first is that it *explicitly* recognises the need for debt reduction and for reducing debt service. (In fact, several debt reduction exercises had already taken place when the Brady Plan was announced, with explicit or implicit industrial government support.) The second important element in the Brady initiative is that the IMF and World Bank funds (as well as contributions by governments, notably that of the Japanese) will be made available to support debt reduction operations. The mechanisms through which this will be done include providing collateral for discounted debt/bond exchange transactions and replenishment of debtor resources cash buy-backs. It is important to stress that both the funding and the support of international financial institutions are backing debt reduction; this is particularly interesting because in the previous phases of the debt problem, these institutions had — on the contrary — exerted pressure on debtor governments to service their debts in full. In fact, a third innovative element of the Brady plan de-links disbursements of IMF and World Bank programmes from agreements being reached with — and debt being serviced to — private creditor banks.

2. Potential Problems with the Brady Plan

An important potential problem with the Brady Plan is that banks are expected to participate voluntarily in debt reduction or new money arrangements. Ultimately, it may prove difficult or even impossible to persuade a sufficient number of banks voluntarily to reduce their aggregate claims on particular debtor countries to levels that are sustainable — that is, fully serviceable without compromising growth objectives.

When US Treasury Secretary Brady launched his plan in March 1989 he argued that 'creditor governments should also consider how to reduce regulatory, accounting or tax impediments to aid debt reduction, where they exist'.

However, changes in regulatory or fiscal aspects have been promoted very slowly, particularly in Europe. This may in part reflect the normal time lag between political changes, policy formulation and implementation, particularly relevant in the context of such a complex technical issue, which furthermore involves important differences between countries. However, it may reflect also to an important extent the differences in objectives between those pursuing the reformulation of the debt management strategy with a view to focusing far more on debt/debt service reduction (e.g. debtor governments and some part of the creditor governments) and those in charge of banking regulation supervision and taxation. This tension of objectives emerged particularly clearly in a series of interviews with European bank regulators, several of whom argued that:

(i) the main concern of bank regulators and supervisors is not to pursue the objective of the Brady Plan, to facilitate debt and interest reduction, but to safeguard the interest of the depositors by defending the solvency of banking institutions;

(ii) particularly as regards possible changes in fiscal aspects, modifications suggested to encourage debt/interest reduction are seen by regulators as undesirable, not necessarily in the context of Third World debt itself, but because it could set a precedent for other (domestic) debtors.

The latter argument seems weakened by the fact that special regulatory treatment has, for example, been given already to a specific category of loans, without this having a contagious effect. This occurred, for example, in the US, where certain banks were in 1987 given preferential treatment on their agricultural loan losses, without this serving as a precedent for other cases.

Tax Incentives

As Brady stressed, the degree of success of his plan could depend in part on incentives that governments provide creditors with, to reduce their claims on developing country debt. From recent statements it would seem that US authorities are willing to be quite flexible, compared to European ones, so as to aid the implementation of the Brady Plan.

Perhaps the common regulatory feature in Europe and Canada (as opposed to the US or Japan) is the favourable attitude of the authorities to encouraging loan loss provisions in general, and, in particular, through tax deductability of such provisions.

US tax policy with respect to provisioning is the most stringent, as only a small proportion of reserves against LDC risk is currently tax deductible. It is now clearly established that the decision of US banks to make fairly large provisions in May 1987 was made independently of any tax advantages.

As regards the tax advantages given to the European banks to encourage their provisioning, there are two schools of thought:

(i) Regulators in European countries and banking analysts believe that the tax incentives provided

to banks have performed a positive role in the international debt crisis management strategy, mainly because (together with other factors) it strengthened the banks against risk of insolvency in case of Third World default or debt service limitation. When pressed on the issue of debt/debt service reduction, they argue that the existence of large provisions makes feasible debt/debt service reduction.

(ii) There is a second school of thought, which convincingly argues that in fact the structure of incentives in Europe discourages debt/debt service reduction. Bouchet and May (1989) thus emphasise that:

> where banks are able to deduct loan loss reserves from taxes there is little or no tax benefit to recognising losses upon restructuring debt. Where loan loss provisions are not tax deductible, banks may have an incentive to accept instruments that involve the recognition of loss in order to receive the corresponding tax deductions.

Furthermore, they argue that:

> one way to structure a policy environment that encourages market-based debt reduction would be not to allow banks to recognise tax losses for provisioning or for secondary market transactions which do not result in a realistic restructuring of a debtor country's obligations (and, thus some benefit for the debtor country).

Capital Requirements and Loan Loss Reserves

Tax treatment of loan loss provisions and of actual losses due to debt/debt service reduction seem to be the most crucial elements in determining banks' attitudes to debt/debt service reduction. However, another factor of importance is the link between loan loss provisions and capital. This is being modified in the context of convergence towards a common measurement of capital adequacy within the new Basle Agreement [Rodriguez 1989].

In countries, such as France, where reserves are included in regulatory capital, banks are unlikely to want to take losses and write down reserves. Accounting conventions will require that losses be recognised (though timing could be modified); as Bouchet and Hay (1989) point out, encouraging losses by writing down assets against provisions has a capital cost for banks where reserves (as in France, and in the US for general reserves) are included in regulatory capital. The situation is different where (in countries like the UK, Germany and Switzerland) loan loss reserves are already excluded from capital, and thus banks recognise no further capital loss when assets are written off against reserves; these banks may not have the disincentive to participate in voluntary debt reduction that is present where loan loss reserves are included in regulatory capital.

The problem will be reduced as the Basle Agreement will impose near uniformity of treatment of loan loss reserves by the end of 1990, the time at which, for banks of all nationalities, loan loss reserves in excess of 1.5 per cent of risk-weighted assets will be excluded from capital. Thus, at the end of 1990, French (and US) banks would consider additions to loan loss reserves to be a capital loss, in similar ways that a British or German bank would. As a result, there would be a more neutral impact on the willingness of these banks to recognise limited losses, and the distinction will tend to lose its importance for debt/debt service reduction schemes, though it will not disappear altogether.

3. Suggested Improvements to Support the Brady Plan

In order to encourage banks to participate in the Brady Plan it would be desirable for regulators in the US to allow more favourable levels of provisioning for participants of the Brady Plan.

As we have established, in Europe and Canada, although there may be tax incentives at the time of provisioning, there are no tax incentives to accept debt or debt service reduction; there seems to be a strong case that the high provisioning could in fact discourage debt/debt service reduction.

It would seem desirable to design a tax policy for Europe and Canada so as to **ensure that sufficient (but not excessive) levels of provisioning are maintained; however, when a certain level of debt/debt service reduction was agreed as desirable between a country and the IMF/World Bank, banks could only maintain their tax concessions if they participated in the debt/debt service reduction exercise (or in equivalent contributions).** Such a policy would have several advantages: (i) provisioning would still be encouraged by taxation policy; (ii) at the same time debt reduction would also be encouraged, as tax concessions could only be maintained if banks participated in debt reduction schemes; (iii) debt reduction would be conditional on adjustment programmes agreed with the IMF (a condition which would make it attractive to the industrial governments).

If such a line were to be taken by tax authorities, it would be particularly valuable if the position were made clear and public, to provide signals to the banks. Lack of knowledge and clarity about the future reaction of tax authorities to changes in debt management policies may inhibit the search for innovative solutions, as bankers are less willing to be innovative if they are unsure of the implications of their actions.

Other Improvements

Regulatory bodies in different countries are very diverse. Some European countries require provisions against trade credits even when those credits are being serviced.

Trade credit constitutes an essential lubricant in the process of international trade. Having to reserve against trade loans discourages banks from providing essential short term financial flows even if they are fairly secure.

Especially given the dramatic decrease in new lending to the developing countries over recent years, trade credit should be isolated from the international debt problem. This is justified by the fact that short term trade credit is provided through different institutional modalities than other credits; furthermore, most countries make a special effort to continue servicing these short-term credits, even if they are unable or unwilling to service the rest of their debts. In short, trade credit is less risky than other forms of developing country debt. Ideally, trade credits should not have to be provisioned against unless there were strong evidence that a country was unable or unwilling to service them.

4. Conclusion

Changes in regulatory, fiscal and accounting policies in creditor nations are particularly relevant in the context of the Brady Plan, which stresses officially supported, market based, voluntary debt reduction. Regulatory and fiscal changes fit well as part of a strategy in which industrial governments induce, encourage and nudge private banks towards some debt/debt service reduction. In the context of the Brady Plan it seems particularly essential to integrate far more clearly than has been done until now, discussions between regulators, fiscal authorities and policy makers of different creditor nations to make more consistent their policy objectives and measures.

As the Brady Plan is voluntary, it is most important that countries' governments and authorities take the initiative in encouraging their banks to participate, rather than hope the banks will take part on their own initiative. The Brady Plan is innovative, but it is questionable whether it can ensure enough debt reduction to have a significant effect.

One could argue that the Brady Plan would have been more successful if it were more mandatory, forcing banks to accept official decisions on the magnitude of debt reduction. That issue will probably be examined again in a couple of years. At present, it seems more positive to suggest changes that might help the Brady Plan work. One such change in the European context, is the suggested modification of fiscal treatment of provisions.

References

Bouchet, M. and Hay, J. 1989, 'Survey of banking regulations in the OECD countries relating to market-based debt reduction', World Bank, Washington DC, April 1, mimeo

Rodriguez, E., 1989, 'The political economy of banking regulations', paper presented at IDRC workshop, held at ODC Washington, 5-7 September