The Brady Plan and Market-Based Solutions to Debt Crises

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At the end of the 1980s—the so-called "lost decade" in Latin America—the incoming Bush administration devised the Brady Plan, a new U.S. strategy that emphasized debt-forgiveness for highly indebted developing countries. The debt crisis that had erupted in 1982 with Mexico's announcement that it could not honor its debt obligations had gone through two distinct phases. By the end of the decade it was widely accepted that those phases represented failed attempts to resolve the sovereign debt problem.

During the first phase, from 1982 to 1985, developed nations responded to the possibility of default by Third World countries by providing new loans to those countries through commercial banks, the International Monetary Fund (IMF), and other multilateral lending agencies. The crisis was treated as one of liquidity and not of solvency. Thus, the goal of new lending was to give the indebted countries time to put their finances back in order to again repay their debts within a few years. Developing nations followed IMF-sponsored adjustment measures that included raising taxes, raising tariffs, devaluing the currency, and, in many cases, reducing government expenditures (structural adjustments were not seriously considered because the fundamental problem was thought to be temporary illiquidity).

The second phase came with the Baker Plan when it became evident that developing countries were not growing out of their debt and in fact were becoming more indebted. The new plan, introduced by U.S. Treasury Secretary James A. Baker in 1985, emphasized new lending to the highly indebted countries based on market conditionality. Thus, the proposal promised $9 billion from the multilateral agencies and $20 billion from commercial banks in exchange for market-oriented reforms in recipient countries—for example, tax reductions,

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privatization of state-owned enterprises, reduction of trade barriers, and investment liberalization.

By 1987–88, it became apparent that the Baker Plan too had been unsuccessful at either reducing debt or allowing the target countries to grow their way out of debt as had been intended. Like the strategy before it, the Baker Plan was unable to provide the proper incentives for developing countries to introduce consistent market reforms, or for banks to supply new money that would finance such reforms. From the end of 1985 to the end of 1988, net lending from the public sector to the Baker Plan countries amounted to $15.7 billion, while new money from private banks amounted to $12.8 billion (Cline 1995: 210). Paul Krugman (1994: 700) showed that the stock of official creditor loans to the Baker countries rose from $50 billion to $120 billion from 1982 to 1987, while that of bank loans remained at $250 billion from 1982 to 1987, then fell to $225 billion in 1988. It appeared that as commercial banks decreased their debt stock in the Baker countries, the official lenders increased theirs.[1] In short, a slow transfer of private debt to public debt was occurring without a corresponding resolution to the underlying debt crisis.

When the Bush administration assumed office in 1989, the new Secretary of the Treasury, Nicholas Brady, announced that the only way to address the sovereign debt crisis was to encourage the banks to engage in "voluntary" debt-reduction schemes. Countries were to implement market liberalizations in exchange for a reduction of the commercial bank debt, and, in many cases, new money from commercial banks and multilateral agencies. Initial skepticism abounded and much remained into the early 1990s. One observer noted that the plan could be "compared to an offer to sell fire insurance at bargain rates in a town where half the people are arsonists" (Meltzer 1989: 71).

However, the current prevailing view sees the Brady Plan as a success.[2] Since 1989, Latin American nations (the main targets of the plan) have moved aggressively toward the free market, introducing far-ranging reforms, and have begun attracting impressive levels of finance again from the international capital markets. Many analysts believe that in a number of important countries the debt problems

[1]Cline (1995: 229, 230) uses different data on the stock of private and official creditor loans that make it look "less like the banks were being bailed out." He concludes, nevertheless, that "it is a matter of value judgment whether the rising public-sector share over the 1980s represented bailing out the banks or restoring more balance to the lending shares."

[2]See Cline (1995), for example, and Roett (1992: 132) who explained that "By the end of 1991 it was clear that the Brady Plan . . . was the only feasible policy response for dealing with the outstanding stock of debt."

of the 1980s have been overcome; debt remains, but it is manageable under the dramatically changed conditions of the early to mid-1990s.

How the Brady Plan Works

The Brady Plan was intended to be more flexible than previous plans in dealing with individual countries' characteristics and creditors' desires. To understand how the plan worked, it is useful to examine the first of such deals reached in principle with Mexico in 1989. Although William Rhodes, a top Citicorp executive, proclaimed, "I would not say that Mexico is going to be a cookie cutter for others," Mexico indeed proved to serve as the prototype of Brady deals with other countries.[3]

An advisory committee, consisting of the Mexican government and representatives of more than 500 banks, negotiated a "menu," or set of conditions that banks could choose from to reduce or increase their exposure. Three options were on the menu. Existing loans could be swapped for 30-year debt-reduction bonds that would provide a discount of 35 percent of face value (the bonds would have an interest of 13/16 percentage point above the London Interbank Offer Rate, LIBOR). Existing loans could also be swapped for 30-year par bonds that would effectively reduce Mexico's debt service on those loans through a below-market interest rate of 6.25 percent. Banks could also provide new loans at market interest rates over a four-year period of up to 25 percent of their 1989 exposure, taking into account any discount or par bonds obtained. The three options allowed creditor banks to set their exposure to anywhere between 65 to 125 percent of its pre-Brady level (Unal, Demirguc-Kunt, and Leung 1992: 3).

In the Mexican deal, banks chose to swap 49 percent of their loans for discount bonds, 41 percent for par bonds, and 10 percent to provide new money. Commercial debt worth $48.9 billion (medium- and long-term) was covered under the deal. In exchange for forgiving part of Mexico's debt, the principal and interest of the new bonds banks received were securitized by U.S. Treasury bonds, which were in turn financed by the international financial organizations (ibid.: 2, 4).

The general structure of subsequent Brady deals was based on the Mexican arrangement; differences came up mostly in regard to percentages of debt reduction or new money provisions, interest rates, and final bank preferences. Among the countries that followed Mexico in arranging Brady deals were Costa Rica (1989), Venezuela (1990), Uruguay (1991), Argentina (1992), and Brazil (1992). By May 1994,

[3]Quoted in Bartlett (1989).

18 countries had agreed to Brady deals forgiving $60 billion of debt and representing about $190 billion in bank claims (long term). Under the plan, the World Bank and the IMF would provide $12 billion each, and the Japanese Import-Export Bank would provide about $8 billion for securitization; most of that money has already been committed for that purpose. The typical deal led to about 30 to 35 percent forgiveness of a country's debt (Cline 1995: 17).

Criticisms

Early criticisms of the Brady Plan were mainly of two sorts. Many complained that the plan did not provide enough debt-forgiveness to benefit the countries in question, and that the commercial banks were not burdening their fair share. Jeffrey Sachs (1989), for example, believed that at least 40 percent debt reduction was needed for the Brady Plan to work because anything less would not restore a country's creditworthiness. Kenneth Rogoff (1993: 753) argued that banks benefited at the expense of developing countries because debt forgiveness improved the creditworthiness of borrowers, thus pushing up the value of the remaining debt and the amount banks could be expected to receive.

Others complained that not enough money was being provided by official lenders. One banker protested, "They ask us to cancel 50 percent of our loans, and then expect us to put in new money with no guarantees. That's crazy!"[4] Rhodes (1990), Citicorp's chief debt negotiator, called for more money to be provided by the IMF and the World Bank as part of the debt negotiations, and suggested, "Public sector resources to support debt reduction are failing to meet the expectations of some countries."

The tensions between those who wanted to force banks into more debt reduction and those who thought taxpayers should ultimately help reduce the debt arose in large part because the Brady Plan was driven by political, not market, considerations. Washington saw the issue as a security and geopolitical concern. Whether to pursue the Brady strategy or not was to "choose democracy or debt." Indeed, the bloody riots in Caracas, Venezuela, in early 1989 reinforced the view that adjustment by highly indebted countries would be destabilizing without an active debt reduction strategy.

Nor can the Brady Plan be described as "voluntary," despite official use of the term. Officials used various techniques to pressure banks into Brady deals. In early 1989, for example, the Treasury Department

[4]Quoted in Rowen (1989a).

eliminated some tax advantages of recognizing losses on foreign loans and added that banks may see that those advantages lessen in the future (Saunders 1989: 144). Additionally, during their meeting in July 1989, leaders of the G-7 industrialized countries released a communique specifying, "Banks should increasingly focus on voluntary, market-based debt and debt-service reduction operations, as a complement to new lending."[5] Architects of the Brady Plan, however, had more than friendly advice in mind in encouraging such an outcome. Specifically, the World Bank and the IMF, contrary to past practice, could now begin lending to nations that had not in fact reached binding agreements on past debt problems with their commercial bank creditors (Kampffmeyer 1989: 9).

The politicization of commercial bank lending practices under the Brady Plan was consistent with past U.S. policies. During the 1970s, for instance, U.S. officials praised banks for recycling petrodollars to the developing world. They also allowed banks to avoid complying with laws that limited a bank's loans to a borrower to 15 percent of the bank's capital. Thus loans to an assortment of state institutions owned by a foreign government were all treated as individual loans until regulators enforced the lending limits after the outbreak of the debt crisis (Schwartz 1989: 15 and Monteagudo 1994: 75).

Of course, truly market-based approaches to resolving the debt crisis would involve no taxpayer guarantees for debt-reduction and in the 1980s might even have meant that debt forgiveness would be greater than it was under the Brady Plan. That point was implicitly acknowledged by one of the critics of the banks, who urged a coercive debt reduction strategy: "Somebody somewhere has to say to the banks, 'An agreement will be reached and everyone will sign it, or you will all have to write down the value of your loans to their market value.' "[6]

For highly indebted developing countries having trouble honoring their debt obligations, market-based initiatives to reduce debt, including debt buybacks and debt-equity swaps, have proved to be effective. Indeed, both debtors and creditors stand to benefit from such schemes if the revenue streams from debt repayments are not kept up because of debtor inability to do so. That appears to have been the case with many Baker and Brady Plan countries.

Krugman (1989: 263–66) explains that if the debt overhang is too large, it behaves as a tax on a developing country's investment and growth. Under such conditions, the ability to service debt diminishes.

[5]Quoted in Rowen (1989b).

[6]Quoted in Bartlett (1989).

The "debt Laffer curve" Krugman describes suggests that if a country is on the wrong side of the curve, (i.e., it has too much debt), creditors' expected claims will be lower than if a country were on the correct side of the curve (i.e., it has a manageable amount of debt that does not depress investment). Thus, a creditor will benefit by forgiving some debt if a country is deemed to be on the wrong side of the curve. The difficulty, of course, is determining what side of the debt Laffer curve a country is on.

That evaluation, however, should be left up to market participants. Creditors, after all, will be most sensitive to a country's candidacy for debt forgiveness. However, countries whose debts are not forgiven may choose to buy back their debt on the secondary market, thus granting themselves effective debt forgiveness. If a country's debt trades at a considerable discount in the secondary market, the amount forgiven can be substantial. Barry Eichengreen and Richard Portes (1989: 82) indicate that many Latin American countries benefited from such schemes in the 1930s. In this way, Bolivia retired 5 percent of its debt at 16 cents on the dollar, Colombia retired 22 percent at 22 cents, Chile 18 percent at 59, and Peru 31 percent at 21.

Naturally, such a course of action may disturb creditors because borrowers are using reserves to lower their own debt rather than honor the senior debts owed to the creditors. The predictable effect is to dampen future access to the capital markets. A developing country, therefore, is not automatically inclined to follow that approach and indeed often has strong reputational incentives to negotiate debt payments with creditors.[7]

For countries that have little or no hard currency reserves to repurchase debt or remain current on debt payments, debt-equity swaps are a viable option. Under that scheme, debtor governments buy bank claims at a discount in local currency (or other financial instruments) to be used to purchase equity in the debtor countries (Monteagudo 1994: 69).

The market-based solutions described above are often supplanted because of politicization or concerns that they are inadequate in addressing sovereign debt issues. The most frequent charge by supporters of government-sponsored debt-reduction schemes is that although creditors may benefit from debt forgiveness, they individually face incentives not to forgive debt since forgiveness by one creditor will benefit all others. The "free rider" phenomena, it is said, prevents

[7]For a discussion of the importance of sovereign-government reputation in the capital market under market conditions (i.e., no official coercion to settle debts), see English (1996: 259–75).

a market solution from occurring. As Roland Vaubel (1983: 299) explains, "This problem, however, has often been solved: the creditors either combine in consortia (clubs) or individual creditors make their offers conditional on the conclusion of similar contracts with other creditors. It is conceivable that creditors would ask the Fund to act as their coordinating agent in such negotiations, but this does not mean that the IMF itself should lend." One could replace the "IMF" in Vaubel's sentence with the Treasury Department, the World Bank or any other government agency.

But the Brady Plan did interject taxpayers into the debt workouts. The plan's immediate effect appeared to be detrimental. In 1989, the Institute of International Finance (IIF) correctly complained that expectations about debt-forgiveness under the Brady Plan had led countries to build up payments arrears to commercial banks. The IIF also charged that the Brady Plan encouraged the slowing down of voluntary debt reductions from $18.3 billion in 1988 to $11.3 billion in 1989 (Fidler 1990: 3).

Melanie Tammen (1990: 260) also noted that debt equity swaps, which had been increasingly popular in the years previous to the Brady Plan, diminished upon its announcement. By 1989, Brazil, Argentina, the Philippines, and Ecuador suspended or significantly reduced debt-equity auctions. Indeed, as Table 1 shows, total debt conversions fell significantly in 1989.

While the Baker Plan failed to mobilize significant new lending on the part of the banks, the banks were undertaking market-based debt reduction schemes of their own. From the end of 1985 to the end of 1988, for example, banks retired $26 billion worth of debt through debt-equity swaps, exit bonds, debt-buybacks, and discount restructurings (Cline 1995: 210).

In addition, as a response to the Brazilian default on its debt in 1987, Citibank announced that it was building up its loan-loss reserves of $3 billion, representing about one-fourth of its sovereign debt (ibid.: 213). That action weakened not only Brazil's negotiating position with Citibank, but also that of all highly indebted nations Citibank dealt with. It also prompted other money-center banks to follow suit, thus further weakening the negotiating position of developing country governments. The response of the banks to the Brazilian default and the possibility of default by other debtors occurred without significant official intervention.

By the time the Brady Plan was announced, therefore, progress in market-based debt reduction was notable. As George Melloan (1989: A25) observed at the outset of the Brady Plan, "Clearly, the market has come a long way on its own." Given the debtor nations' weakened

TABLE 1

DEBT CONVERSION INSTRUMENTS, 1985–1994
(Millons of Dollars)

Instrument	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1985–94 Amount	1985–94 Percent
Debt equity swaps	570	882	3,578	7,567	6,981	9,624	2,823	8,148	4,586	248	45,007	40.4
Debt buyback or exchange	0	0	0	1,830	1,011	12,347	1,006	9,026	7,106	20,033	52,359	47.0
Local currency payments	0	63	87	3,580	2,269	5,242	800	342	0	2	12,385	11.1
Local currency conversions	156	438	796	1,535	1,512	1,540	1,443	1,217	127	3	8,767	7.9
Private sector restructuring	89	279	3,454	4,341	3,113	337	788	371	293	0	13,065	11.7
Total debt conversions	815	1,662	7,915	18,853	14,886	29,090	6,860	19,104	12,112	20,286	111,297	100.0

SOURCE: World Bank (1996: 87).

bargaining position vis-à-vis the banks, moreover, and their worsening domestic economic situations, debtor nations had little alternative but to introduce real market reforms by the end of the decade. The immediate effect of the Brady Plan, however, was to bring about a pause in that trend.

Finally, from the perspective of the mid-1990s, it is worthwhile evaluating whether the goals of the Brady Plan were accomplished. The most authoritative and generally laudatory assessments of the Brady Plan were produced by William Cline in early 1995. Cline cites the success of the Brady Plan by measuring performance of Brady countries in economic growth, price stability, lowering of interest rates, and return to capital markets.

Alas, it appears that there is no correlation between Brady Plan deals and positive economic indicators. Some Brady countries like Argentina and Mexico (until late 1994) performed quite well, while others, such as Venezuela or Nigeria (Brady Plan initiated in 1992) have performed dismally; still others, such as Brazil, have performed erratically. Of course, many other factors besides the Brady plan affect a country's economic progress or direction. It is precisely for that reason that the Brady Plan cannot confidently be claimed a success.

But while there is no correlation between the Brady Plan and positive economic indicators, there does appear to be a correlation between market reforms and positive indicators. Colombia and Chile, countries that did not agree to undertake Brady deals, have fared notably well. The case of Chile is even more remarkable as Chile was a severely indebted country during the debt crisis of the 1980s but has since become a free-market model for other Latin nations. Since 1990, Peru has also successfully emerged from severe economic crisis through widespread and radical free-market reforms without the aid of a Brady deal (although in the fall of 1995 it agreed in principle to engage in one and did so in late 1996). These last two cases call into question the very need for a Brady Plan in the first place if the goal is to create a growing market economy.

In the end, progress and setbacks in developing nations appear to depend on an assortment of domestic factors. Private creditors, rather than official entities, are in the best position to judge those factors, to act on them, and to accept the responsibility for allocating credit and all of the consequences that that implies. The Brady Plan, although disguised in market rhetoric, has prevented a genuine, private solution to an ongoing debt problem. It is time to allow private creditors to negotiate their problems directly with their debtors—a conclusion

that subsequent events, such as the Mexican peso crisis of 1994, does not alter.[8]

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[8]For a discussion of the Mexican peso crisis and the response to it, see Hoskins and Coons (1996: 139–64).

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