

Frenkel, Michael

**Article — Digitized Version**

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Intereconomics

*Suggested Citation:* Frenkel, Michael (1989) : The international debt problem: An analysis of the Brady plan, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 24, Iss. 3, pp. 110-116, <https://doi.org/10.1007/BF02928561>

This Version is available at:

<https://hdl.handle.net/10419/140184>

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Michael Frenkel\*

## The International Debt Problem: An Analysis of the Brady Plan

*Recently the American Treasury Secretary, Nicholas Brady, launched a new initiative in which he proposed reducing the developing countries' bank debt. What are the elements of the plan, and which countries would benefit? What problems does it entail? Can it bring about a decisive improvement in the international debt situation of the developing countries? The following two articles attempt to answer these questions.*

The initiative launched by the American Secretary of the Treasury, Nicholas Brady, was the focal point of the spring meeting of the International Monetary Fund and the World Bank at the beginning of April. The Brady Plan would give banks greater incentive to make voluntary reductions in the outstanding debts of heavily indebted developing countries and to grant them fresh money. Some of the original elements in the plan were modified during discussions in the Interim Committee of the IMF, but the central concept was generally welcomed. However, no final decision has yet been taken; it has simply been recommended that the plan be worked out more precisely and further discussions held on its details.<sup>1</sup>

The new American initiative builds on the proposals of Brady's predecessor, James Baker, and should be viewed against the background of recent developments in the international debt situation of the Third World. The change at the top of the American Administration was probably also a decisive factor in the timing of the proposals.

The Baker Plan put forward by Brady's predecessor in 1985 aimed at promoting economic growth in fifteen heavily indebted Third World countries by means of a combination of economic policy reforms and the injection of fresh money. According to the Baker Plan, new bank loans totalling \$20 billion would have enabled these countries to "grow out of" their debt problems.

Today the Baker Plan must be regarded as having failed to reach its objectives. It could not give the banks sufficient incentive to increase their lending to countries described as the "basket cases" of the Plan.<sup>2</sup> Indeed, since 1986 many of the banks have greatly reduced their

claims on these countries. The lack of detailed proposals was the main cause of the plan's failure. It was not clear what incentives the banks were to be given to increase their lending, such as guarantees, nor was it explained on what criteria the planned additional credit was to be distributed among the countries concerned.

### Background to the Brady Plan

The continuing problems of the Third World's international debt and the persistent difficulties in the adjustment policy are at the root of the discussions about new solutions. Although the increase in the developing countries' debts slowed down in 1988 (see Table 1), the debt problems have not become less severe. The ratios of debt to export earnings of countries in Latin America and Sub-Saharan Africa and small low-income countries have hardly changed. The worldwide rise in interest rates in 1988 even caused a sharp increase in the ratio of debt service to exports for these groups of countries. In view of the further rise in international interest rates, the situation of many countries is likely to deteriorate further in 1989.

The aim of the proposed debt reduction is therefore to ease debt service payments. It is argued that permanently high levels of debt servicing hamper growth in the debtor countries, since essential imports cannot be afforded. The price of solvency is therefore slower growth. This encourages the debtor country not to meet its debt service obligations in full. In that case, a reduction in debts not only boosts the debtor country's growth but also improves its creditworthiness, since there is less incentive to suspend debt servicing.

<sup>1</sup> See Communiqué of the Interim Committee of the Board of Governors of the International Monetary Fund, Washington, D.C., 4th April 1989.

<sup>2</sup> With regard to the Baker Plan, see for example IMF Survey, 20th March 1989, p. 90.

\* Johannes Gutenberg University, Mainz, West Germany.

In contrast to the Baker Plan, which aimed to generate new loans to finance existing debt service obligations, the proposals of the Brady Plan provide for a limited reduction in the debts of Third World countries. There are probably four main reasons why the USA is now showing greater flexibility in this matter:

- ☐ The USA needs economically sound countries with high purchasing power in Central and South America as markets for its exports.
- ☐ Debt relief is now much easier for the international banking system, because many banks have written off large amounts of their outstanding loans to developing countries. This reduces the impact a reduction in debts would have on bank balance sheets.
- ☐ Some banks are already accepting a devaluation of their claims on developing countries. Quite a few major banks have sold claims on Latin American countries in the secondary market in recent years, sometimes at large discounts. No new proposals can ignore these developments.
- ☐ Political motives have probably played a role as well. The governments of the USA and other Western industrialised countries have repeatedly stressed that

dangers that could threaten the stability of the infant democracies in Latin America must be prevented; such dangers could emerge if living standards and social conditions in these countries do not improve, thus allowing anti-democratic movements to gain influence. This would ultimately make negotiations very much more difficult for the creditor countries.<sup>3</sup>

### **The Proposals of the Brady Plan**

The Brady Plan builds on the idea that the best strategy for reducing the debt burden of the developing countries consists in growth-oriented policy reforms including macroeconomic and structural adjustment. It emphasises that the principles of the current debt strategy remain valid. The IMF and the World Bank should continue to assist governments in formulating and implementing appropriate economic policy programmes. The proposals therefore endorse the case-by-case approach pursued hitherto and reject the idea of an international debt conference or a debt moratorium.

The new element in the Brady Plan are proposals that aim at supporting debtors' continuing adjustment efforts through voluntary reduction of debt to commercial banks and through continued new bank lending.<sup>4</sup> The plan suggests three ways in which this might be done:

**Table 1**  
**External Debt of Developing Countries, 1984-88**

	1984	1985	1986	1987	1988
<b>Outstanding debt</b> (billions of dollars)	933	1051	1152	1281	1320
World Bank reporting system:	852	962	1053	1170	1200
Long-term debt	687	794	894	996	1020
from official sources	238	305	364	437	450
from private sources	449	489	530	559	570
Short-term debt	132	131	119	133	140
IMF loans	33	38	40	40	40
Other developing countries	81	89	99	111	120
<b>Debt as a percentage of exports</b>					
All developing countries	133	150	169	159	146
of which:					
Latin America	274	296	352	341	310
Sub-Saharan Africa	228	274	303	331	325
small low-income countries	344	404	422	456	437
<b>Debt service ratio</b>					
All developing countries	19.2	20.6	22.2	19.5	19.3
of which:					
Latin America	40.9	40.3	45.0	35.5	42.8
Sub-Saharan Africa	24.3	27.9	26.1	22.8	25.2
small low-income countries	26.2	27.7	27.3	26.5	28.4

Sources: World Bank: World Debt Tables, 1988-89; IMF: World Economic Outlook, October 1988.

1. The IMF and the World Bank should encourage a reduction in Third World countries' bank debts by providing financial assistance; in particular, two possibilities are suggested:

- ☐ By collateralising debt service payments, the two international agencies could encourage the conversion of bank debt into long-term bonds issued by the debtor countries. Banks would then have an incentive to swap their claims for lower-risk bonds by accepting a discount in exchange for certain assurances. The debtor country's debt to commercial banks would thus be reduced by the amount of the discount. Whereas the original proposals of the Brady Plan entailed direct guarantees for debt servicing, the financial assurances now being considered after the discussions in the IMF Interim Committee cover only interest payments and are subject to time limits and ceilings.

☐ Bank borrowing could also be reduced if a portion of policy-based loans from the IMF or the World Bank could

<sup>3</sup> This was emphasised in particular at the special meeting of the finance ministers and central-bank governors of the Group of Seven countries at the beginning of February 1989.

<sup>4</sup> See, for example, "The International Debt Strategy", remarks by Nicholas F. Brady at the Interim Committee of the International Monetary Fund, Washington D.C., 3rd April 1989.

be set aside to support transactions involving significant debt reduction. These transactions could also include debt buy-backs at secondary-market prices.

2. The banks should be given incentives to participate in granting "fresh money". Simultaneously, it should be made more difficult for banks to adopt a "free-rider position", whereby they do not contribute to new loans to debtor countries but claim a share in the interest payments financed by the new loans. This would be achieved by eliminating certain agreements that have been customary in bank lending up to now, which forbid the preferential treatment of particular creditor banks ("sharing provisions") and lay down that all creditor banks rank equally as far as interest payments are concerned ("negative pledge clauses"). Without such agreements there would be a stronger incentive for individual banks to participate in new lending in order to avoid being at a disadvantage in future.

3. Finally, changes in national regulations on accounting, banking supervision and taxation should ensure that banks have an incentive to reduce the outstanding debts.

According to the Brady Initiative, financial support for voluntary debt reduction should only be provided in cases in which the IMF and the World Bank considered the debtor country's economic policy to be appropriate. The Brady Plan would therefore give debtors additional incentives to carry out ambitious economic reforms. Unlike the Baker Plan, this initiative is aimed not at fifteen heavily indebted countries but at all Third World countries with debt servicing problems.

The Brady proposals, which have still only been presented in outline, will be analysed in the following sections on the basis of three questions:

☐ What relief can Third World countries expect if the Brady Plan is implemented and which countries would benefit from the initiative?

☐ How would the proposals be financed and what effects would they have on the distribution of risk?

☐ What problems do the individual measures entail?

## Relief for Whom and on What Scale?

The overall objective of the Brady Plan is to reduce the outstanding debt of heavily indebted countries to commercial banks by an average of 20% within three years. According to the US Treasury, this could reduce the international indebtedness of 39 countries by a total of \$ 70 billion. Despite this sizeable amount the plan implies a debt reduction for the group of developing countries as a whole of only 5%. However, the differences in the debt structure of developing countries mean that some Third World countries would experience much greater relief than others. More than two-thirds of bank claims on developing countries with debt problems consist of loans to Latin American countries. Here bank claims total around \$ 240 billion, so that these countries would be the main beneficiaries of the Brady Plan. Independent of the debt structure of the developing countries, one major drawback of voluntary debt reduction schemes is that the smallest benefits go to countries that are most successful in their efforts to adjust.

Even the reduction in the debt burden of the Latin American countries, for which the Brady Plan is obviously tailored, should not be overestimated, if at the same time there is an increase in international interest rates. Mexico, whose bank debts total around \$ 73 billion, illustrates the point clearly; about \$ 62 billion of the debt is denominated in dollars, mostly at interest rates linked to LIBOR. In 1988, LIBOR rose from around 7% to almost 10.5%, so that Mexico's interest payments on this part of its external debt increased from about \$ 4.7 billion to almost \$ 7 billion.<sup>5</sup> If its debt to commercial creditors were reduced by even 25% under the Brady Plan, interest payments would still amount to some \$ 5.3 billion. In this instance, the reduction in debt would have less impact on the debt burden than the rise

<sup>5</sup> Cf. The Economist, 18th - 24th March 1989, p. 110.

PUBLICATIONS OF THE HWWA-INSTITUT FÜR WIRTSCHAFTSFORSCHUNG-HAMBURG

## WELTKONJUNKTURDIENST

Annual subscription rate  
DM 80,-  
ISBN 0342-6335

This quarterly report – compiled by the Department of Business Cycles and Statistics of the Hamburg Institute for International Economics – analyses and forecasts the economic development of the most important Western industrial nations and of the international raw materials markets.

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in interest rates. Although interest payments would be even higher in the absence of a reduction in debt, this example demonstrates that the relief being proposed would be relatively modest by comparison with the effect of recent interest rate developments.

It is still unclear what criteria would be used to decide which countries should be eligible for the proposed debt reduction. Once they have been determined, the requirements a country would have to fulfil to qualify for given levels of debt reduction would have to be specified. Although only countries with sound economic reform programmes are to be considered and the extent of relief is to average 20%, it is not ruled out that an even higher percentage might be allowed for countries carrying out particularly ambitious economic reforms. Here one is thinking of Mexico, for example, where the budget deficit has been reduced by 9 percentage points in relation to GNP over the last five years. The criteria laid down for a debt reduction also have implications for the conditionality of IMF loans. It must be clarified whether a country can draw on financial assistance from the Fund for debt reduction operations by fulfilling the

conditions of an existing facility, or whether a separate set of conditions must be established for this purpose. In addition, the share of IMF and World Bank loans that countries can use for debt reduction operations has to be determined.

Since the proposals of the Brady Plan focus on debt to commercial creditors and the debt structure between developing countries with persistent debt-servicing difficulties is very different, the initiative can only be regarded as a part of a comprehensive debt strategy. The fact that the Brady Plan is tailored to suit Latin America is explained by the importance these markets hold for US foreign trade. However, a comprehensive debt strategy must also include loans from official creditors, for only in this way can the Third World be treated even-handedly and the debt burden be reduced on a larger scale. Such a comprehensive strategy does not yet exist. In late 1988, creditor governments participating in the Paris Club adopted a new menu approach which provides concessional terms to the poorest countries for the rescheduling of official debt obligations. This could reduce the present value of official debt of these countries by 10-20%.<sup>6</sup> However, there is a number of countries that do not benefit from the exceptional Paris Club debt relief and would not benefit from the Brady proposals either. In sum, the Brady Plan focuses on a limited number of countries and in itself it can only make a dent in the stock of outstanding debt.

### **Financing and Risk Distribution**

For the banks, the implementation of the Brady Plan would mean that part of their claims on the countries concerned would become irrecoverable. They would have to write this portion off, if they have not already done so. In recent years non-American banks, in particular, have already made substantial provisions on their claims on developing countries on the basis of more favourable tax incentives. American banks, by contrast, have sold a very small part of their Latin American claims at a considerable discount in the secondary market. As Table 2 shows, the secondary market prices of debt have fallen sharply in recent years, in other words discounts have risen significantly.<sup>7</sup>

The resources the IMF and the World Bank would require to finance a debt buy-back scheme depend on the volume of debt to be repurchased and the discount obtained. Table 3 gives an idea of the order of magnitude

<sup>6</sup> For a summary of the new menu approach for low-income countries see IMF Survey, 3rd April 1989.

<sup>7</sup> In some cases, discounts in the secondary market fluctuate widely and can be regarded only as a rough indicator of a country's creditworthiness.

**Table 2**  
**Prices of Selected Third World Debts**  
**in the Secondary Market**  
(as a percentage of face value)

	March 1987	March 1989
Argentina	60	18
Brazil	66	28
Mexico	58	33
Venezuela	72	33

Source: Euromoney

**Table 3**  
**Transactions under Debt Buy-back Arrangements**  
(in billions of dollars)

Existing debt to banks	350
Buy-backs	117
Loans for buy-backs (at 60% discount)	47
New level of debt (only in relation to amounts originally owed to banks)	280

**Table 4**  
**Transactions involving Debt-to-Bonds Exchanges**  
(in billions of dollars)

Existing debt to banks	350
Value of debt converted	233
New bonds issued (at 30% discount)	163
New level of debt to banks	280

of the loans needed for this purpose. The calculation has been simplified by assuming that the aim of a 20% reduction in bank debt is to be achieved entirely by means of debt buy-backs. On the basis of \$ 350 billion bank debt of the countries in question, a reduction to \$ 280 billion could be achieved by repurchasing \$ 117 billion debts at an average discount of 60%. This implies a financing requirement of \$ 47 billion. Even if a variety of instruments were combined so that only a fraction of this amount had to be raised, the scale of the funds required points to the need for an increase in IMF quotas, something the US government has opposed so far.

Collateralising interest payments on bonds for which outstanding debt would be exchanged would not create an immediate liquidity requirement for the IMF and the World Bank, only the need for resources to be earmarked by a trust fund, for example, from which interest could be paid if a debtor subsequently defaulted. The amount of resources to be raised for such a trust fund would depend on the scale of bond operations and the guarantees associated with the loans. A partial interest guarantee would leave the banks bearing a risk, so that the expected discount would be less than in the case of debt buy-back schemes. Table 4 shows the scale that the conversion of bank claims into bonds would have to reach in order to achieve a 20% debt reduction by this means alone. If the interest guarantee were sufficient to achieve a discount of 30%, debts of \$ 233 billion would have to be converted into bonds. Partially secured bonds would therefore have a far smaller impact on the debt burden than debt buy-backs.

The Brady Plan's original proposal that these new bonds be granted direct World Bank guarantees was rejected by other creditor governments. Such guarantees would effectively transfer risks directly from banks to international organisations and hence eventually to official agencies and taxpayers. This would have benefited primarily the USA, whose banks hold the largest share of bank claims on Third World countries. However, since the USA has only around 19% of the votes in the IMF and the World Bank, it came as no surprise that the Interim Committee did not want to sanction such a redistribution of risks.

The concept, whereby the IMF or the World Bank would collateralise interest on bonds, would also transfer risks from the commercial banks to international organisations. The only difference between this concept and direct guarantees lies in the scale of the transfer. Since the bonds would then carry a higher default risk compared with bonds with full guarantees, the banks

would have less incentive to swap their existing claims for exit bonds. As a result, the discount would be smaller and the reduction in the burden of debt servicing would be correspondingly less. To achieve a given level of relief a larger volume of existing debt would therefore have to be exchanged, which in turn would increase the scale of risk transferred.

An extension of the scope for banks to make tax-deductible provisions for their claims on developing countries also implies official bodies bearing a larger proportion of private risks. In contrast to the transfer of risks to international organisations, however, it would only entail a shift within creditor countries and not between them.

The financial requirement of international organisations to implement the Brady Plan depends on the terms for debt buy-back schemes and bonds. In particular, it has to be clarified whether debtor countries should be lent additional IMF resources for debt buy-backs or whether such operations should be financed exclusively by drawing on IMF facilities within the existing limits. If the proposed debt buy-backs are implemented, the continuing debt problems would suggest an increase in IMF resources in return for appropriate economic policy reforms. Otherwise, an appreciable reduction in debt service payments cannot be achieved.

### Problems with Debt Repurchases

Unlike the conversion of bank claims into long-term bonds, debt buy-back schemes create an immediate liquidity requirement for the debtor. Under the Brady Plan, this would be met by IMF or World Bank resources. Such an operation would have implications both for the original creditor banks and for the debtor countries.

There would be indirect wealth effects for creditors if debt buy-backs led to a change in the valuation of debt on the secondary market. Assuming that high debt service payments encourage the debtor to suspend payment and that this risk is taken into account in the discount on the secondary market, substantial debt repurchases may cause the discount to decline, reflecting the reduced incentive for the debtor to repudiate payments in future. The precondition for this, however, is that secondary market discounts are indicators of future debt service problems, and not past ones. Whether this is true cannot be deduced clearly from studies of the secondary market carried out up to now.<sup>8</sup>

<sup>8</sup> Studies of this kind were the subject of a World Bank symposium in January 1989; for an overview, see IMF Survey, 6th March 1989, pp. 74 ff.

In addition, there is the question whether the use of financial resources to fund debt buy-backs is an optimal use of resources or whether they could be used more profitably.<sup>9</sup> One could think of their use for investment good imports in order to trigger more growth. However, experience in many developing countries has shown that the returns from using resources in this way are generally uncertain or comparatively small. This would therefore support the view that it is efficient to use a part of new financial resources for debt buy-backs, particularly if the discount were substantial.

Debt buy-back schemes also raise the moral hazard problem, in that debtors might be tempted to behave strategically in future; they might attempt to reach a particular level of debts in order to obtain a partial debt cancellation, for example by means of repurchases. Arrangements must therefore be found that would preclude such behaviour.<sup>10</sup>

## Problems with Debt-to-Bonds Conversions

Debt-to-bonds swaps also involve the moral hazard problem. The risk could be reduced by setting time limits and ceilings on operations to convert loans into long-term bonds, although in practice this would be difficult to implement.

The terms of the bonds would pose a further problem. On the basis of its capital endowment, the World Bank would be in a position to collateralise interest payments or directly to guarantee parts of the debt servicing. The greater the proportion of risks borne by international organisations, the more attractive it would be for creditors to convert existing claims into exit bonds. By setting the volume of the issue and inviting banks to tender, the market could be left to determine the discount.<sup>11</sup>

Since a reduction in existing debt improves the credit rating of the debtor country, causing the secondary market discount to fall, banks individually have an incentive not to participate in the conversion of their claims into exit bonds. For the individual bank it is more advantageous to let other banks carry out a debt reduction and then simply to cash in on the higher value of its own claims.

Debt-to-bonds conversions have an advantage over debt buy-backs, however, in that international

organisations have no immediate need for liquid funds. Moreover, outstanding bank claims would not be transferred directly to the international organisations.

## Summary and Conclusions

It is being stressed ever more frequently nowadays, mainly by academics, that the international debt problem cannot be eliminated without reducing debt service obligations. The proposals of the Brady Plan are pointing in this direction and their implementation may ease the debt problem for some countries. Hence the Brady Plan is a step in the right direction. However, there are five main counts on which reservations can be expressed about the Brady Plan:

□ A reduction in debts to commercial banks alone would lead to unequal treatment among debtor countries. If countries decide to take the debt reduction road, official loans need to be included in some form for all highly indebted countries for reasons of equality and because this would bring much greater relief. In addition, the effect of the implementation of the Brady Plan on the debt burden of highly indebted countries is relatively modest and cannot by itself solve the debt problem.

□ Commercial banks can be expected to cancel debt voluntarily only if they are given sufficient incentive to agree to debt buy-back schemes or the conversion of debts into bonds. The main incentives would be favourable buy-back terms and some form of IMF or World Bank guarantee for debt servicing. However, this entails transferring risks to public bodies and hence to the taxpayer, something that cannot be avoided; if this had to be avoided, one has to ask what incentive the banks would have to carry out the proposed operations.

□ The question as to the incentives for the banks and the consequent redistribution of risks also arises if the proposed debt buy-backs and bonds are to be accompanied by an increase in new lending by the banks. Here the incentives would have to be so great that it would not simply be a question whether or not it was beneficial to sell or swap their claims. It is questionable whether this can be achieved simply by nullifying sharing provisions and negative pledge clauses. Moreover, it must not be overlooked that new loans will lead to an increase in debt and debt servicing.

□ Since debt repurchases and the conversion of claims into bonds could both lead to a reduction in the discount on the secondary market, every bank would have an incentive not to take part in these operations. Therefore instruments have to be designed that prevent banks from taking a free-rider position.

<sup>9</sup> For similar arguments, see. M. P. Dooley: Self-Financed Buy-Backs and Asset Exchanges, in: IMF Staff Papers, Vol. 35, 1988, pp. 714 ff.

<sup>10</sup> Cf. J. Williamson: Approaches to Debt Relief, Washington 1986.

<sup>11</sup> Cf. J. Williamson, op. cit.

□ The proposals could lead debtors to expect further partial debt cancellations in the future. This could lead to heavier borrowing and reduced debt servicing.

Three conclusions can be drawn from the reservations set out above. First, it would make sense to develop a more comprehensive debt reduction or debt relief strategy, in which the Brady proposals and the new menu approach of the Paris Club represent two of several elements. A more comprehensive strategy would have to provide benefits for all lightly indebted developing countries that embark on fundamental and convincing economic reform programmes. In cases of major reform efforts by debtor countries it should

allow for a higher percentage of debt relief. Secondly, steps would have to be taken to ensure that debtor countries received no encouragement to increase their borrowing. Thirdly, in addition to constructing the incentive mechanism, it should be investigated whether debt-burden reductions could be achieved in other ways that avoided some of the disadvantages outlined above. More comprehensive rescheduling at lower interest rates and with longer repayment periods under the auspices of the Paris and London Clubs which would have to be applied to rescheduling arrangements in general and the granting of interest rate concessions by creditors are two possibilities that could be considered.

Gerhard Maier\*

## The Brady Plan – A Vicious Circle or a Way out of the Debt Crisis?

The proposal from the US Secretary of the Treasury on a reduction in debt gave new impetus to the discussions on ways of solving the Third World debt crisis. Since 10th March of this year, when the US government suggested that the commercial banks should cancel part of their claims on selected, heavily indebted developing countries on condition that the countries carry out fundamental reforms, the Brady Plan has dominated the thinking of debt managers in both North and South. The Plan contains nothing original; it merely combines elements that already exist or have been under discussion for some time.<sup>1</sup> Neue Zürcher Zeitung recently counted "well over two dozen plans for coming to grips with the problem".<sup>2</sup>

It has long been hotly debated whether it makes sense for the commercial banks to write off part of their claims and grant interest concessions on existing and new loans and for international institutions such as the

IMF and the World Bank to guarantee redemptions and interest payments. For years banks have been converting claims on developing countries into negotiable instruments (debt-bond swaps) or into shares or other forms of direct investment (debt-equity swaps). However, operations of this kind are not very popular, since the original creditors must often accept substantial losses on the value of their loans.

All of these instruments were tested last year in the major debt rescheduling operations by Brazil and Mexico, although with little success.<sup>3</sup> Neither of the two Latin American countries achieved the coup they were

<sup>1</sup> For an overview, see for example Deutscher Sparkassen- und Giroverband: Lösungsansätze zur internationalen Schuldenkrise aus der Sicht der Kreditinstitute, in: Wirtschafts- und Währungspolitik, No. 9, 1988.

<sup>2</sup> See "Vom Baker-Plan zur Brady-Initiative", in: Neue Zürcher Zeitung, 10th April 1989.

<sup>3</sup> See for example Klaus C. Engelen: Zitterpartie wegen Brasilien-Zinsen, in: Handelsblatt, 22nd February 1989; Gerhard Maier: Problematische Schuldenmenüs, in: Deutsche Sparkassenzeitung, 7th October 1988.

\* Deutscher Sparkassen- und Giroverband, Bonn, West Germany.