

Maier, Gerhard

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□ 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.¹ Neue Zürcher Zeitung recently counted "well over two dozen plans for coming to grips with the problem".²

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.³ Neither of the two Latin American countries achieved the coup they were

¹ 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.

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

³ 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.

seeking; their hopes of being able to reduce their debt burden significantly by swapping their liabilities for negotiable bonds, direct investments and other assets were dashed. Their conception of the rate of discount appropriate to such operations proved to be over-optimistic. Although their situation has not improved at all since then, they are the model on which the American proposal is based.

Strategic Interests

The novelty of the Plan is that the US government is now officially backing a voluntary cancellation of debt and greater involvement by official agencies financed out of taxation. Until very recently both of these notions were taboo. In particular, the American Congress has hitherto opposed the use of public funds to bail out the banks.

The about-turn in Washington on the debt issue was triggered by shock at the riots in Venezuela, which had long been regarded as a model debtor. The ferocity of the clashes, which verged on civil war, signalled a deterioration in the social and political climate in Latin America as a whole. The sub-continent feels it is being bled white by payments to its creditors. The spreading debt fatigue is causing increasing tensions in the relations with international commercial banks, especially those in the United States, which are very heavily committed in Latin America.

Against this background, the United States is now highly concerned about political and economic developments in its neighbours to the South.⁴ Growing debt is progressively restricting the scope for economic policy in Latin America and hence posing an increasing threat to the infant democracies. The fear of political radicalisation is growing, particularly since elections are approaching in several countries. However, the Brady Plan did not spring solely from the United States' perceived responsibility for the "other Americas", as proclaimed in the Monroe Doctrine; the repercussions of the debt issue on the US economy were also giving increasing cause for concern. The Americans are particularly worried by the situation in Mexico, which is creating a flood of immigration to the United States. Latin America is also traditionally an important buyer of American goods. An easing of the debt crisis should therefore not only reduce political tensions in the United States' backyard but also improve its trade balance.

⁴ See for example "Neuer Anlauf zur Entschärfung der Schuldenkrise?", in: *Neue Zürcher Zeitung*, 10th March 1989; "Brady, Brady, Baker und Bacardi", in: *Finanz und Wirtschaft*, 22nd March 1989.

It is remarkable how skillfully US politicians are presenting their strategic interests as the concerns of the international financial community. This has enabled them to win an important partner in the shape of Japan; no wonder, for Japan has a strong interest in raising its foreign policy profile. Caricatured hitherto as an economic giant but a political dwarf, Japan is prepared to pay a high price to win worldwide goodwill. In this way it hopes to create a safety valve for growing international pressure against the stubborn Japanese trade surpluses and especially against Japanese agricultural policy, which gives domestic rice producers massive protection against imports. At the same time, Japan is trying to increase its IMF quota in line with its enhanced world economic status. The Brady Plan appears to be just the instrument for this purpose. It gives the Land of the Rising Sun the chance to demonstrate its commitment to solving global problems and hence to buy the sympathy of its partners in the world. So far, however, it is not clear what form that commitment will take and how much Japan is willing to spend.

Carrot and Stick

The Brady Plan is based on the tried and tested formula of the carrot and the stick. Debtor countries that carry out fundamental economic reforms will be rewarded, but those that refuse to do so will be denied the benefits. The US government's idea is that banks prepared to remit debts will be rewarded by increasing the security of their remaining loans.

A reduction in debt or in interest payments is indeed an attractive proposition for debtor countries. A reduction in debt servicing relieves the burden on the economy and releases resources for other purposes. The demand for fundamental reform is a fly in the ointment, however; it is regarded as grievous interference in national economic policy and has already met fierce resistance in some quarters. There have been few signs of unambiguous structural changes so far, since most reforms will make painful inroads into the already very low standard of living of the population. For ideological reasons many countries cannot bring themselves to remove price controls, pursue a sound budgetary policy and a tight monetary policy, as repeatedly demanded by the IMF and the World Bank.

The international financial community has also shown little enthusiasm so far. Indeed, there is growing scepticism among commercial banks. They have little faith in the carrot of fundamental reform in the debtor countries and support from the IMF and the World Bank,

which is intended to improve the security of the remaining loans. Nor are the banks very impressed by the stick, in the form of the argument that the debt crisis is worsening and will expose them to increasing governmental pressure.

Fumbling in the Dark

So far, the players in the Brady debate are fumbling in the dark. The US Secretary of the Treasury has still only painted a broad outline of his plan; neither he nor his officials have presented a fully detailed proposal. The plan is to be fleshed out in tough negotiations at the many forthcoming global debt conferences. Eugene Rotberg, the former World Bank treasurer, has been acting as pilot in the uncharted waters of the US debt initiative. At a debt conference in Amsterdam organised by private commercial banks he drew up a whole catalogue of critical questions that are very helpful in lightening the darkness.⁵ So far, however, the most important questions have remained unanswered:

☐ If credit institutions forgo part of their claims or interest payments, who will ultimately bear the loss, apart from the banks and their shareholders? Can lenders write off (part of) their claims against tax and hence involve taxpayers in financing the Brady Plan? Will governments or supranational institutions also participate in the cancellation of debts? What will the finance ministries in Washington and Tokyo allow their debt policy commitment to cost?

☐ What consequences does debt cancellation have for banking supervision in the countries concerned? Will the USA allow its banks the same write-off possibilities as their counterparts in Europe?

☐ What volume of resources should be spent restoring the financial health of the Third World and who should provide them? Must the international institutions inject additional money and does this then lead to a corresponding increase in the capital of the World Bank and a raising of quotas in the IMF?

☐ Who will assume what risks if the loans converted into bonds are guaranteed by official agencies? What role should the IMF and the World Bank play? Will the new bonds in place of old claims be fully guaranteed by the IMF and the World Bank? If they must provide guarantees for new loans, what consequences will this have on their financial situation? How will this affect the role of the IMF and the World Bank and their mutual

relations in the future? Do the official guarantees cover repayments of principal as well as interest payments?

☐ To what extent should economic reforms in the debtor countries lead to a reduction in capital repayments? What income can creditors expect in future?

☐ What principle will be applied in the selection of Brady Plan countries? Will they be countries under particularly strong economic and political pressure, such as Venezuela, or countries with particularly good economic prospects? The former have little prospect of becoming good debtors in the foreseeable future, while the latter do not need to have their debts cancelled.

There will be little progress on the debt issue while these questions remain unanswered. Up to now it appears that the costs are to be borne mainly by the Europeans and Japanese. The parties involved are now awaiting with anticipation the forthcoming international debt negotiations, especially at the world economic summit to be held in Paris in July. However, it remains to be seen whether clarification of these questions will really lead to the hoped-for success.

Opportunity for Escape?

It will be some while before the underlying weakness of the Brady Plan becomes apparent. It is obvious that a remission of debts will not exactly encourage the commercial banks to enter into new lending commitments. A renunciation of official creditors' claims on the poor countries in Sub-Saharan Africa can be justified on humanitarian grounds, but credit institutions that have forgone a substantial part of their Third World claims would find it hard to explain to their shareholders if they immediately granted these countries new loans. This would certainly ease the burden on debtors in the short term, but there is a serious danger that many banks would use the Brady Plan as an opportunity to extricate themselves once and for all from the debt morass. They could be counted out entirely as future providers of capital. Those who acquired the newly created exit bonds would hardly be prepared to become lenders in perpetuity.

In the medium term the situation of the debtor countries would therefore inevitably deteriorate markedly, since their already limited ability to raise capital would be further restricted. The already disturbing shortage of capital would become worse.

There can be hope of easing the debt situation by means of debt swaps only if the debtor countries offer sufficiently attractive and secure investments to replace

⁵ See Klaus C. Engelen: Rotbergs dreizehn kritische Fragen zu Bradys Vorschlag eines Schuldenabbaus, in: Handelsblatt, 29th March 1989.

their old debts. For that to happen, however, the fear that exists in many countries that they would be taken over and subverted by foreign investors must be reduced. Until now the developing countries have been very hesitant in letting foreign companies become involved. Indeed, a recent initiative in Brazil constituted a move in the opposite direction.⁶ For that reason, even debt-equity swaps have been slow to make an impact.

Burst Trial Balloon?

Seen from today's perspective, the Brady Plan is pointing in completely the wrong direction. Its first visible "success" is that it is causing increasing uncertainty among the parties involved.⁷ Both sides in the debt issue are playing a waiting game in view of the unanswered questions.

A growing number of debtor countries are suspending payments to the banks, since they first want to see how the creditors will behave. The Brady Plan is therefore causing additional payment arrears. It is inevitable that the banks will react. They are already reluctant to grant fresh money in view of the many open questions, and a suspension of payments will simply provoke an outright refusal. The result will be that the flow of resources to the Latin American debtors will decline sharply, and these countries will again be unable to honour their interest obligations.

The climate on the international debt front has deteriorated appreciably since 10th March. It is no wonder that the Brady Plan is already being described as a "trial balloon" that burst.⁸ Countries such as Venezuela are not yet ready to pay, Argentina is in default and even the model debtor Mexico wants to drastically reduce its interest payments under a loans-for-bonds swap, inspired by the Brady initiative.⁹

If this situation continues for much longer it will set a vicious circle in motion. The credit standing of the World Bank is already coming under scrutiny, for it is suspected that it may have to guarantee doubtful loans. The international debt conferences must therefore quickly identify feasible ways out of the crisis.

Penalisation of Sound Debtors?

The debtor countries cannot avoid carrying out fundamental reforms. The example of South Korea and the remarkable rates of growth recorded in China and India show clearly what can be done. The performance of the Asian NICs has been achieved without the carrot of debt relief. It even appears that the Brady Plan penalises the good debtor and rewards the bad. There is

therefore a danger that the initiative will call into question one of its key components, namely fundamental reform in the debtor countries.

The argument that because of the necessary suspension of redemptions or even interest payments an insistence on maintaining the claims allows the debt to grow rapidly and in the long term leads to an astronomical level of debt, is undoubtedly mathematically correct. However, it ignores the principle of double entry book-keeping. As long as the suspended interest payments are matched by comparable or greater real growth, they pose no real problem. Permanent economic growth in Latin America must therefore be set in motion following the example of many Asian nations such as China and India.

Reversal of Capital Flows

It is essential above all to reverse the direction of capital flows, which at present is away from developing countries. This calls for new bank loans and direct investment. However, as long as massive capital flight continues, which is costing many countries as much in resources as they are receiving in loans, the debt situation will remain a bottomless barrel. Debt relief is little help in this situation.

The industrial countries' contribution should therefore consist not in cancelling debts but in providing effective help to develop an efficient economy. The developing countries must be integrated into the world economy. Only if they are able to sell their products in world markets can they bring their debts under control. This means that the doors to world markets must be opened, primarily under the GATT.¹⁰ The most valuable contribution the industrial countries could make would therefore be to remove the subsidies that blatantly reduce the competitiveness of producers from developing countries, above all in agricultural products, and at the same time to open their own markets to goods from the Third World. As long as the rich nations cling to their protectionist practices, debt programmes like the Brady initiative will remain a farce.

⁶ See "Sieg der Wirtschaftschauvinisten", in: *Finanz und Wirtschaft*, 5th October 1988.

⁷ See "Immer mehr Schuldnerländer setzen ihre Zahlungen aus", in: *Handelsblatt*, 25th April 1989.

⁸ Cf. Klaus C. Engelen: *Rotbergs dreizehn kritische Fragen ...*, op. cit.

⁹ Cf. Norma Cohen: *Mexico seeks two-thirds out in interest payments for six years*, in: *Financial Times*, 26th April 1989.

¹⁰ Cf. Gerhard Maier: *Uruguay-Runde: Eine Waffe gegen den Protektionismus?*, in: *Sparkasse* No. 11, November 1988, pp. 510 ff.