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Walther Otremba\*

## New Debt Strategies after the Brady Plan

*In view of the continuing debt problems of developing and industrialising countries there is a very real danger that a renewed downturn in the world economy could lead to a serious deterioration in relations between debtors and creditors, with far-reaching consequences for growth and employment in both industrial and developing countries. The task to be undertaken consists primarily in altering the basis for decision-making by both debtors and creditors in such a way that the rational strategy is effective action rather than inertia.*

Seven years have passed since the Mexican debt crisis revealed the serious debt problems in developing and newly industrialising countries. For seven years possible solutions to their difficulties have been discussed without any apparent movement in the parties' positions. On the one hand is what hitherto has been the "official doctrine", formulated by James Baker, the former US Treasury Secretary and now Secretary of State: market-oriented reforms coupled with further loans from industrial countries should stimulate faster growth and thus restore a tolerable ratio between the debt of the overextended countries and their potential economic performance. On the other side of the argument are those who hitherto were the outsiders, now increasing in number and influence, who consider that a genuine easing of the Third World debt situation is not possible without debt relief.

When the new US Treasury Secretary, Nicholas Brady, unveiled his plan at the beginning of this year the views of the outsiders under the Baker plan began to take over as the guiding principle of the international debt strategy. The debate is not yet over, however.

Strong reservations are still being expressed about across-the-board debt relief, particularly as regards the claims of commercial banks on middle-income countries. The main arguments advanced against such debt forgiveness are that:

- ☐ debt relief would entail too high a cost by permanently destroying the debtor countries' creditworthiness;
- ☐ a cancellation of claims would devalue the economic efforts and successes of those countries that have fulfilled their debt obligations correctly;

☐ debt relief might encourage economic policies deliberately designed to lead to an inability to service debt;

☐ in view of their good growth potential over the long term, the heavily indebted countries are quite capable of meeting their debt servicing obligations indefinitely; what is needed therefore is action to fill liquidity shortages, not an irrevocable cancellation of debts;

☐ many countries have substantial foreign assets that could be used to meet their capital and foreign exchange requirements.

These arguments carry weight and must be taken into account when seeking solutions to the crisis. On the other hand, however, it is becoming increasingly clear that the debt problem is essentially a solvency problem, not a liquidity problem. Effective debt reductions, even for the so-called middle-income countries, are therefore ultimately unavoidable and should not be postponed any longer:

☐ Debtor countries are faced with the problem of making payments of interest and principal at the same time as fostering investment and preventing the population's standard of living from falling too sharply. As the statistics show, they rarely succeed, with the result that investment declines, in some cases dramatically. According to the International Monetary Fund, the investment ratio of the problem countries fell from 25.6% in 1980 to 18.9% in 1988. In many countries living standards have declined to the level of the seventies. At the same time, the number of cases in which payments to creditors in Western industrial countries have been suspended has again increased.

☐ In the late seventies and early eighties loans were granted on the basis of growth expectations that were

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not fulfilled. For example, Alfred Herrhausen pointed out in an article in "Die Zeit" of 16th September 1988 that loans to South American countries were made on the assumption that the growth trend of the seventies – real growth of around 6% a year – would continue. In fact, these countries recorded little or no growth after the second oil shock.

Foreign debt therefore grew to a point at which it was out of all proportion to the countries' economic potential and would not have been tolerated either by borrowers or by lenders if future growth rates had been forecast correctly. As with loans to private companies, lenders as well as borrowers must bear the consequences of such forecasting mistakes.

□ Too long a delay in giving debtor countries the necessary relief makes a solution difficult, since additional growth is impeded; the internal conflict over the distribution of the burden of foreign debt leads to increasingly serious inflationary problems and hence curbs growth. Higher taxes and duties to raise the funds needed to service the debt hamper investment and job-creation. The prospect of having to make higher debt servicing payments if growth is achieved prevents effective economic reforms from being implemented.

□ Agreed solutions between debtors and creditors are possible only in comparatively favourable world economic conditions, such as those now prevailing. A sharp rise in dollar interest rates or a worldwide recession would affect all debtor countries equally. There would then be an increased danger of debtors banding together to repudiate their debts and thus jeopardising attempts to reach a negotiated settlement.

In view of these arguments, there can be little doubt that the level of accumulated foreign debt is preventing lasting, effective solutions from being reached. Above all, additional private capital will not be forthcoming as long as the risks appear unacceptable to profit-oriented banks in view of the already high level of debt and the countries' poor economic performance. Hence at present new loans will be confined in practice to the amount absolutely necessary to finance part of interest payments, in other words sums that will flow back to the banks. A key element of the Baker plan is therefore missing; without the provision of additional international capital, the chances of this growth concept succeeding shrink to practically nil.

In recent years, the financial markets have witnessed the development of certain types of financing and refinancing instruments that might create the impression that the debt problem could be brought at

least closer to solution by market forces through the interplay of the interests of debtors and creditors. Debt-equity swaps, debt buy-backs, debt conversion and exit bonds are the by-words for these new types of transaction.

## Debt Relief without State Involvement?

It appears doubtful, however, that the debt problems of the newly industrialising countries can be much eased by making claims tradable and having them repurchased at a discount by the debtors or converted into equity participations. For one thing, many countries do not have the foreign exchange reserves to repurchase debt on a substantial scale. Bolivia could not even scrape together the foreign currency to take back part of its debts at a discount of around 90%. Moreover, debt repurchase runs counter to the aim of leaving the capital in the heavily indebted countries if at all possible and thus avoiding impairing their economic performance still further.

The scale of possible debt-equity swaps is also limited by the relatively small number of profitable opportunities for equity participation. Up to now, conversions of claims into equity have reached, as a rule, a magnitude of only about 5% of foreign debt; Chile is an exception, with a figure of around 20%. Moreover, it is politically problematic if the successful industries of developing and newly industrialising countries pass increasingly into the hands of foreigners. Nationalistic reaction to the selling-off of national industries will not be long in coming.

Apart from the limited relief offered under the "menu of options" approach, the commercial banks generally display lasting resistance to more extensive debt forgiveness, as shown by the opinions expressed not only by the German Bankers' Association but also by the Institute of International Finance in Washington, an organisation representing international banks. Even the seemingly more flexible strategy of Deutsche Bank is aimed partly at winning a financial commitment from official quarters; accordingly, the suggested interest equalisation fund would be financed jointly by banks, governments and international financial institutions.

From the standpoint of the commercial banks, the rejection of a "composition" of the kind possible with private firms is understandable. As a rule, composition benefits both parties, since the debtor can ensure the survival of the firm while the creditor usually recovers a larger part of his claims than if the firm were put into liquidation and its assets sold.

This pattern cannot simply be transposed to the relationship between private creditors and nation states, however. Insolvency does not endanger the existence of national states. Even if they declare a unilateral payments moratorium, claims can be served on them at a later date if they subsequently attempt to return to the international capital markets.

There are also other reasons why the banks are unwilling to waive their claims in the present situation:

- ☐ It makes sense for each individual bank to adopt the free rider position, in other words to wait for other banks, public agencies and international financial institutions to cancel the debt they hold. Every concession by other creditors means a rise in the value of their own claims.
- ☐ Commercial banks are holding back from cancelling debt because the Brady plan has reinforced their hope that governments will relieve them of the risks in one form or another.
- ☐ Banks in Germany and some other European countries have meanwhile written down their claims to such an extent that in all probability their book value is significantly below their true value. In some circumstances, exchanging the greatly depreciated claims for new secured instruments with a nominal value higher than the book value would lead to the release of the undisclosed reserves created in this way and hence give rise to a tax liability.
- ☐ In certain circumstances, written-off claims may now be an attractive investment if at least all or a high percentage of the interest is still being paid. For example, the yield on a claim with a nominal interest rate of 10% that has been written down to 30% and on which 50% of the interest payments are still being received is almost 17%.

## Possible Ways of Encouraging Debt Relief

Even if a cancellation of claims does not have a high priority for banks individually at present, the advantages of finding a lasting solution to the international debt problem are considerable for the banks as a whole:

- ☐ Above all, such a solution would reduce the risk that sudden crises would force the banks to write off further substantial losses. This is particularly true of banks that have not yet made adequate valuation adjustments.
- ☐ A worsening of the international debt situation could have an impact on the world economy as a whole, on export industries and hence ultimately also on the creditworthiness of other bank borrowers.

☐ Maintaining orderly business relations with developing and newly industrialising countries with high growth potential safeguards access to markets that may become more attractive in future.

☐ Greater financial stability in the indebted countries also encourages the return of flight capital, which can help stimulate growth and hence improve the countries' ability to service their debts.

There is intense discussion at present as to the instruments for bringing partial relief from the burden of bank debt. The ideas being circulated essentially entail persuading the banks to cancel a portion of the debt in exchange for guarantees covering the remaining debt of interest payments. The guarantors would be either national governments or international financial institutions. The Brady plan is also based on this concept. However, the high risks that official agencies would have to assume in addition to those on their own claims have led the governments of a number of industrial countries to give the proposals a rather guarded reception.

Alternative solutions can be devised on the basis of the above reasons for the banks' reluctance to cancel debt. They take account of the following criteria:

- ☐ the least possible additional burden should be placed on public agencies or on international institutions, whose solvency is ultimately guaranteed by governments;
- ☐ there should be no direct state interference in business relations freely entered into between commercial banks and debtors in developing and newly industrialising countries.

## Promotion of Creditor Cartels

As described above, the free-rider problem means that creditors can benefit from debt reduction only if they act as a group, but not if they act individually. A partial cancellation of private claims is therefore easier to achieve if creditor banks work together in a type of cartel.

Cartels are usually formed in the following conditions:

- ☐ identity of interests of cartel members;
- ☐ comparable framework for action by cartel members;
- ☐ manageable number of cartel members so that it is practicable to organise the cartel.

This opens up several policy options. First, efforts should be made to standardise the conditions affecting the commercial banks' business policies, especially as

regards tax-deductible valuation adjustments and banking supervisory rules at international level. This proposal is already contained in the Brady plan.

Secondly, the number of banks with exposure towards heavily indebted countries could be reduced by encouraging smaller creditors to sell their debt. Such encouragement could be given by allowing amounts at least equal to the previous balance-sheet value of claims to be written off against the proceeds from the sale of claims. In this way undisclosed reserves revealed by the disposal of debt could be transferred to other investments. This would impose no additional burden on public resources.

It is important above all to prevent individual banks from adopting the free-rider position. This can best be achieved by limiting any debt relief incentives to lenders who participate promptly in a joint strategy for the permanent solution of the debt problems. Such incentives could be created, for example, under governmental agreements with debtor countries whereby in the event of a subsequent substantial improvement in the economic situation of the debtor countries only creditors participating in a joint strategy would be rewarded in one way or another for their willingness to co-operate.

### **Priority for Discounted Debt and New Loans**

Strategic pressure for concessions on existing loans could be exerted by giving new loans and old debts converted at a discount priority over other existing debt, either by intergovernmental treaty or by private agreement. What this entails is not guarantee declarations by industrial countries or financing institutions but the establishment of an order of rank for the distribution of scarce debt servicing resources. A precondition for this is the waiving of the "negative pledge clauses" and "sharing clauses", as envisaged by the Brady plan. Up to now these provisions have generally ensured that no bank is treated better or worse than any other in the securing of debt and the distribution of debt service payments.

If senior-ranking new loans and converted discounted old debt become increasingly prevalent, the chances of receiving payments of interest and principal on claims still maintained at their original level decrease. The greater the number of banks prepared to discount their claims, the greater the pressure on other debtors, since junior-ranking claims will be progressively devalued. By way of example, assume that the debtor country can service only 70% of its debts, amounting to \$1 billion each to creditors A and B. A waives 25% of its claim, but

in return will receive the full interest due on the remaining \$750 billion. B will therefore receive only 65% of its interest entitlement out of the remaining foreign currency reserves.

The question whether official agencies are to contribute to reducing private claims and, if so, what form their contribution should take should be answered swiftly and finally to counteract the wait-and-see attitude that is already evident among commercial banks and debtors in the wake of the presentation of the Brady plan.

### **More Efficient Secondary Markets**

Finally, the limited scope for reducing the debt burden via the secondary markets could also be improved. It cannot be taken for granted that financial markets will remain fully operational; that is the rationale for state involvement in the organisation and supervision of stock exchanges. A better climate may help increase the size and stability of secondary markets and hence make it possible for debtor countries to benefit to a greater extent from the discounting of claims that has already occurred in the market.

For example, the secondary markets could be annexed to the existing stock exchanges, which would improve the availability of information and market transparency. Admission to the secondary markets could be regulated, thereby simplifying the drawing of contracts.

The problem of debt relief via the secondary markets lies mainly in the fact that debtors can influence the price of their debt instruments by means of a targeted information policy and economic measures and thus create particularly favourable conditions for repurchasing their debt. Here too, state regulation can help compensate for market imperfections. For example, it is conceivable that trading in debt instruments could be suspended as long as their price was below a pre-determined level corresponding to the lowest estimate of their value. This would deprive debtor countries of the advantage of manipulating prices downwards, since they would be unable to repurchase debt at all if the price fell below the set limit.

### **Necessary Scale of Debt Reduction**

Every conceivable form of agreed reduction in the Third World's debt burden is contingent upon knowing the necessary extent of such an operation. At present there are two indications of the level of losses occurred on problem loans: the amount of write-offs by commercial banks and the valuation of claims in the secondary markets. Both pose problems, however.

□ In the case of write-offs, the banks apply the principles of prudence or lowest value, wherever necessary and possible under commercial and tax law. This means that they depreciate loans on the basis of the least conceivable value, depending of course on their individual profit situation. As a rule, the true value is probably higher.

□ Similarly, discounts in the secondary market are only vague indications of the actual value of the problem claims. The secondary markets are extremely thin, so that even minor changes in demand and supply can cause sharp price movements. In view of the difficulty in estimating the effects of a host of factors influencing the ability of developing and newly industrialising countries to meet their payment obligations, secondary market prices also tend to be at the lower end of the range of possible values.

Since bank balance sheets and secondary markets provide only vague and distorted indications of the scale of debt reduction needed, it makes sense to develop more reliable yardsticks from objective economic data that are already available and hence no longer open to manipulation.

The excessive borrowing, particularly by middle-income countries, came about as a result of extrapolating past growth rates into the future and taking no account of the possibility of a marked deterioration in world economic conditions. The extent of the deterioration in the economic situation by comparison with earlier projections could be measured, for example, by extrapolating the growth in GNP or exports from the end of the seventies onwards at the rates of growth achieved in the seventies and comparing the calculated hypothetical values with the economic results actually achieved. The percentage discrepancy between the two figures would quantify the deterioration in the economic situation by comparison with earlier assumptions by lenders and borrowers alike.

The use of such a concept of measurement would give the following results. In the case of Brazil actual exports in 1988 were around 26% lower than if they had continued to grow at the rate recorded in the seventies. On the basis of economic performance, Brazil's debt should therefore be reduced to around 74%. The same method of calculation indicates that Argentina's would have to be written down to 48% but Colombia's only to 83%. As expected, the secondary market prices are significantly lower than the percentages calculated in this way, but the order of countries is the same; according to a table drawn up by Salomon Brothers of

New York, Brazilian loans are valued at 33%, Argentinian debts at 18% and claims on Colombia at 56%.

On the assumption that the middle-income countries' debt should be reduced to below the maximum these countries could service in order to create room for new loans and encourage the return of flight capital, the discounts that can be calculated by comparing projected and actual growth data should be interpreted as the maximum debt value. Possible discounts on the nominal value of claims on developing and newly industrialising countries should therefore be such as to ensure that the residual value remains above the conservative secondary market valuation but below the limit set by the country's economic potential.

### Summary and Conclusions

The debt problems of developing and newly industrialising countries will not solve themselves. There is therefore a very real danger that a renewed downturn in the world economy could lead to a serious deterioration in relations between debtors and creditors, with far-reaching consequences for growth and employment in both industrial and developing countries.

The task to be undertaken consists primarily in altering the basis for decision-making by both debtors and creditors in such a way that the rational strategy is effective action rather than inertia. This requires that the initial proposals under the Brady initiative be expanded rapidly into a comprehensive programme. The shift in the focus of the debt debate has aroused high expectations. Until the discussions on a truly workable solution of the debt problems are concluded, the parties involved will have little inclination to compromise.

A far-reaching debt strategy must above all give creditors scope for flexibility, primarily by making concessions on tax allowances for loan write-offs. Giving co-operative private creditors tangible advantages should ensure that they will use any scope they are given. International guarantees for residual debts and interest payments, as envisaged in the Brady plan, could be an element in this, although they are not without their problems as they shift private risks onto public authorities.

Opportunities to create additional incentives should be exploited. These might include the possibility of transferring undisclosed reserves revealed by the sale of claims and giving creditors who are prepared to cancel part of their claims priority in the distribution of scarce debt servicing resources.