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Paul-Günther Schmidt*

How to Pay for the Debt – Coping with the Third World's Crisis

The Brady Plan is the first official proposal to give priority to a tangible reduction in the debtor countries' debt service burden and is thus a milestone along the path towards overcoming the international debt crisis. However, the instruments foreseen in the Plan virtually invite criticism and scepticism. What are the main inadequacies of the Brady Plan? How can the international debt strategy be developed further and made more effective?

The proposals made at the beginning of 1989 by Nicholas F. Brady, the US Treasury Secretary, to find a new way of tackling the international debt crisis mark a fundamental change in the debt strategy of Western governments, and especially of the US Administration. For the first time since the onset of payment difficulties in a growing number of developing countries in 1982 and after muddling through the debt crisis for years, it seems that politicians in the creditor countries have also finally begun to realise that the debtor countries of the Third World are in a genuine solvency crisis from which many of them can probably not extricate themselves by their own efforts.[1] The burden of adjustment and the sacrifices that some of these countries have accepted in order to resolve their balance-of-payments problems have long threatened to destabilise the young democracies politically and economically and to cement existing military dictatorships in place. Despite considerable efforts and in some cases notable success in international debt management, the debt service burden of the great majority of the countries affected remains unbearably high, limits the scope for urgently needed imports and satisfactory economic growth, accentuates the existing maldistribution of income and wealth and threatens to foment revolt and violence.

With good reason, the Brady Plan therefore gives high priority for the first time to an appreciable reduction in the debtor countries' debt service burden. In this sense it reveals an astonishing and remarkable political learning process and is a milestone on the long and arduous path towards overcoming the international debt crisis. It has finally concentrated minds on the central problems and hence has presumably cleared the way for more workable solutions than that offered by the wrong-headed and hopeless Baker initiative of 1985, which merely treated the symptoms of the international debt crisis while letting the Third World's debt mountain continue to grow.[2]

In terms of its objectives, the Brady Plan is therefore equally welcome from both political and economic points of view. There is undoubtedly an urgent need to reduce the developing countries' debt service burden substantially and in this way to ease the constraints on their ability to take economic measures towards growth and stability. It also seems appropriate to give the governments of industrialised creditor countries a greater share of responsibility in future by increasing the financial involvement of the IMF and World Bank and not, as in the past, to cast the main burden of adjustment and finance solely on the debtor countries and the banks

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[1] The great merit of Alfred Herrhausen, the Managing Director of Deutsche Bank who was murdered by terrorists on 30th November 1989, was that he was one of the first bankers to recognise this and to translate it into tangible recommendations for action. See in particular one of his last appeals for greater efforts to achieve both debt and debt service reduction "Die Zeit ist reif – Schuldenkrise am Wendepunkt", in: Handelsblatt, No. 124 of 30th June/1st July 1989, p. 6.

[2] See for example Morgan Guaranty Trust Company: LDC Debt Reduction: A Critical Appraisal, in: World Financial Markets, December 1988, pp. 1-12.

respectively. However, the means proposed so far to achieve these objectives virtually invite criticism and scepticism, and it is true that there are flaws and inconsistencies in the Brady Plan. This article will therefore attempt to identify the main inadequacies of the latest US debt initiative and to suggest ways in which the international debt strategy could be developed further and made more effective.

Shortcomings and Risks of the Brady Plan

The declared aim of the new US debt plan is to promote substantial "voluntary" debt relief and debt service reductions by commercial banks. Brady suggests different ways to achieve this purpose. Co-ordinated amendments to national regulations on banking supervision, accounting and taxation should be made in order to give commercial banks in the industrialised countries stronger incentives for voluntary debt reduction in the future. The banks themselves are called on to relax constraints on new lending like sharing provisions and negative pledge clauses in existing loan agreements. At the same time, the IMF and the World Bank should provide funding, as part of their policy-based lending programmes, for both debt and debt service reduction purposes. New loans from the multilateral institutions would enable the debtor countries to repurchase part of their liabilities by exploiting the current substantial discounts on developing country loans traded in the secondary market. In addition, IMF and World Bank could offer financial support to collateralize a portion of debt service payments and thus encourage the conversion of old bank debt into long-term bonds at lower rates of interest.

The IMF and the World Bank, which realise that they stand to gain additional responsibilities and resources, have already begun to work out and implement the programme with great enthusiasm. It should not be overlooked, however, that the new strategy has serious shortcomings and entails considerable risks,[3] which may do more than simply impair its effectiveness over the medium term. The Brady Plan also runs the risk of creating entirely false incentives for both creditors and debtors and may thus make a permanent solution to the international debt crisis even more difficult to achieve.

False Incentives

As far as debtor countries are concerned, there is the recognised but underestimated problem of "moral hazard". Under the duress of the serious economic and political situation in which they find themselves, the governments of some developing countries might be tempted to depress the secondary-market price of their old debts by means of "appropriate" economic policies so that they could then convert or repurchase their liabilities more cheaply. Furthermore, there is a danger that debtor countries might reduce their efforts to come to grips with their balance-of-payments problems once a large part of their old debts had been waived, converted or repurchased. The Brady Plan aims to counter these risks by coupling credit assistance for voluntary debt relief strictly to IMF conditionality and expecting recipients to carry out economic adjustment programmes and reforms. However, at present it is not evident how the supranational organisations will be better able than in the past to monitor compliance with undertakings and the implementation of adjustment measures, particularly as the irreversible nature of voluntary debt relief robs them of any effective sanction in the future.

For creditor countries, the Brady Plan can be expected to create strong incentives to curtail private-sector lending. The previous rescheduling negotiations more or less forced the banks to provide "fresh money" in order to ensure that at least current interest continued to be paid and to avoid having to declare their claims to be "non-performing", but they are unlikely to be prepared to make such concessions in future. On the contrary, for the first time the Brady Plan actually offers them an officially-sanctioned way of getting rid of their semi-dud loans and even provides financial assistance to do it. However, it is hardly likely that they can then be persuaded to grant new loans to the very debtors who have just bought back or converted their old debts at a fraction of their nominal value. It is therefore to be feared that those developing countries that take advantage of the Brady Plan will find their access to the international capital markets very restricted and that the flow of private bank capital to the Third World will increasingly dry up.

[3] On this and subsequent points, see especially Gerhard Maier: The Brady Plan – A Vicious Circle or a Way out of the Debt Crisis?, in: INTERECONOMICS, May/June 1989, pp. 116-119, and Michael Frenkel: The International Debt Problem: An Analysis of the Brady Plan, in: INTERECONOMICS, May/June 1989, pp. 110-116 and earlier studies taking a critical view of the effects of debt relief, such as John Williamson: Approaches to Debt Relief, Washington 1986; Morgan Guaranty Trust Company: Debt Relief or Market Solutions?, in: World Financial Markets, September 1986, pp. 1-11; Willem H. Buiter and T. N. Srinivasan: Rewarding the Profligate and Punishing the Prudent and Poor: Some Recent Proposals for Debt Relief, in: World Development, Vol. 15 (1987), pp. 411-417; John Williamson: Voluntary Approaches to Debt Relief, Washington 1988; Peter Nunnenkamp: Kapitalabflüsse aus der dritten Welt und Schuldenerlaß: Zu den Problemen des privaten Kapitaltransfers zwischen Industrie- und Entwicklungsländern, Kiel Discussion Papers, No. 139, Kiel 1988; and Jacob A. Frenkel, Michael P. Dooley and Peter Wickham (eds.): Analytical Issues in Debt, International Monetary Fund, Washington 1989.

Furthermore, the new approach for coping with the international debt crisis is strongly biased to suit only a few countries of special economic and geopolitical interest to the United States, such as Mexico, Venezuela and the Philippines, and may discriminate against the majority of countries plagued by comparable debt servicing problems. It is also disadvantageous to those debtors that have made considerable efforts in the past to overcome the crisis without assistance and for whom for that very reason the scale of voluntary relief that can be achieved from the banks is fairly small. In this sense, the Brady Plan not only creates a wrong incentive for "bad" debtors to vie with one another to achieve the highest market discount on their old debts, it also entails the danger of disillusioning and demotivating those countries that have hitherto been "good" debtors.

Negligible Relief

The medium-term relief that the Brady Plan offers even to the few major debtors who would benefit from the new package of measures is probably negligible. Debt servicing would probably be reduced appreciably only if substantial financial resources were made available. It is doubtful, however, whether the governments of creditor countries will really be prepared to endow the IMF and World Bank with the liquidity needed over a period of many years to facilitate debt buy-backs and conversions on a significant scale. If this does nevertheless occur, the Brady Plan would probably stimulate such an increase in demand for old debts that in all probability the secondary-market value of developing country loans would rise. Debt buy-backs financed with IMF credit would then be highly expensive and the banks would have to make a far smaller financial sacrifice than is currently assumed. The voluntary debt relief that could be achieved via the market would ultimately fall far short of the target and the Brady Plan would not provide the hoped-for breakthrough, despite the substantial resources expended.

It would, of course, be premature to dismiss the new US approach to tackling the international debt crisis as a failure even before it had begun; the programme is still in a kind of experimental phase. The plan also seems sufficiently open and adaptable for modifications and shifts in emphasis to be made. Nevertheless, the problem remains that the Brady initiative is in danger of giving both creditors and debtors wrong incentives, cannot provide the supranational lending organisations with effective monitoring mechanisms and sanctions and arouses serious doubts as to whether the envisaged substantial investment of funds can achieve appreciable reductions in debt servicing burdens for a large number of countries. The new thinking that has begun to emerge in creditor countries should therefore soon be channelled into considering alternative strategies which, like the Brady Plan, aim to reduce the debtor countries' debt service burden as quickly and effectively as possible but which differ from the US Administration's latest initiative by incorporating the necessary measures in a system of incentive, monitoring and sanction mechanisms that orientates all the parties involved more strongly towards the common objective and helps avoid misbehaviour by single actors.

Principles of a New Approach

The central element of the approach presented here is also to bring about a rapid and appreciable reduction in the burden placed on the balance of payments of many debtor countries by the servicing of private and official foreign debt. In this way the debtors would regain the scope for economic policies likely to encourage foreign direct investment, halt the continuing capital flight, possibly even stimulate the return of flight capital, promote export-oriented economic growth and combat more effectively and with less interference from external constraints the domestic problems of accelerating inflation, budget deficits, intensified conflicts over the distribution of income and wealth and increasing damage to the natural environment.

The Brady Plan aims to achieve the same objectives primarily by means of voluntary debt reduction, the conversion of bank loans into long-term bonds at lower interest rates and debt buy-back schemes financed by credit.[4] It would seem more logical, more promising, less costly and hence presumably also more likely to gain political acceptance to apply financial aid directly to debt service payments and to leave the volume of outstanding claims unaltered. Partial debt forgiveness should therefore not be made the general rule but should be restricted to a few special cases, such as voluntary unilateral debt relief by Western governments for the poorest countries of the world or states that are to

[4] The Mexico package, which was put together in July 1989, is regarded as a "model case". Around 500 creditor banks were given three options between which they could choose by the end of the year: grant debt relief of 35% of the nominal value of the old loans and then receive market interest rates on the remaining claims; convert the old loans at face value into new 30-year bonds guaranteed by the IMF and the World Bank and bearing interest at the reduced rate of 6.25%; grant new loans, also at 6.25%. It is expected that around 60% of the banks will opt for conversion at reduced interest rates and that this will reduce Mexico's annual interest payments by a third. Mexico will also receive substantial loans from the IMF to repurchase some of its own debt in the secondary market.

[5] See Jeffrey Sachs: Managing the LDC Debt Crisis, in: Brookings Papers on Economic Activity, Vol. 15 (1986), pp. 397-431.

[6] See Stanley Fischer: Sharing the Burden of the Debt Crisis, in: Economic Impact, Vol. 60 (1987), pp. 28-31.

be given a better chance of making a fresh economic and political start after years of internal disorder, the consequences of war or the replacement of a dictatorship by a democratic form of government.

Appeal to Self-Interest

The voluntary debt service reductions brought about by market forces alone are unlikely to be sufficient at present to reduce the debt servicing payments of most developing countries quickly and decisively enough. Additional incentives to significantly increase the volume of voluntary debt service relief therefore have to be created at national level by creditor governments in the industrial countries and at supranational level by the international organisations. Calls for such action are nothing new; for example, they have been made by Sachs,[5] Fischer[6] and Kuczynski,[7] although these advocates of substantial reductions in debt servicing have not elaborated on the financial arrangements and the actual shape such a scheme would take.

An approach of this kind appears feasible only if it takes account of the participants' desire to increase their own advantage and if it harnesses their self-interest to the joint solution of the problem. "Global" strategies should therefore be shunned just as much as unsystematic and unplanned action. What is required instead are "general rules" for an internationally co-ordinated strategy that would only be applied on a case-by-case basis in the light of the actual conditions and problems in each individual debtor country. The discussion of the international debt problem so far in political, business and academic circles has unfortunately contributed little that would help formulate such general rules. Where at least some useful ideas have been forthcoming, as in the churches, normative and positive aspects have almost inevitably become inextricably entwined.

The approach sketched below also contains similar value judgements, which should therefore be explained briefly. Essentially it assumes that a lasting solution to the international debt crisis can be found only if all those affected and involved recognise that they bear joint responsibility for the present problems – albeit to a greatly differing extent in each country – and are therefore prepared to bear their share of the burden of adjustment or financing. It is based on the premise that any form of discrimination between debtors, creditors and forms of debt should be avoided, but that in the interest of an effective long-term strategy there must be differentiation according to the willingness of debtors to adjust and the ability of creditors to finance. It deliberately refrains from coercion and maintains the principle of voluntary participation for all parties involved, although for that very reason it does stress the importance of establishing effective incentive, monitoring and sanction mechanisms in order to focus the voluntary actions of self-interested individuals, banks, governments and bureaucrats towards the common objective and to help avoid behaviour by individual actors that jeopardizes the success of joint efforts.

Incentives for Voluntary Debt Service Reductions

On the basis of these very general principles and objectives, voluntary debt service reductions should be financed with official funds only for those developing countries that show a genuine willingness to bear a substantial part of the adjustment burden themselves and not simply to pass it on to their creditors. Financial support could be granted to these countries in two main ways. As part of an internationally co-ordinated approach, the governments of creditor countries could grant reductions in interest rates and spread the repayment of all or part of their claims over a very long period. In addition, targeted incentives offered by governments and supranational organisations could

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[7] In this regard see the summary of the views by Pedro Pablo Kuczynski in: Pamela J. Bradley: Seminar on Latin America Focuses on Need for Policy Reform, in: IMF Survey, 13th November 1989, pp. 337-345.

induce commercial banks to offer comparable reductions in debt servicing in the form of interest rate caps, maturity extensions, redenominations and capitalisations. Such a system of incentives to encourage voluntary debt service reductions by banks could be organised as follows.

A new World Debt Bank established for this purpose as a subsidiary of the IMF could act as a kind of sponsor to developing countries that declared their willingness to undertake economic adjustment programmes and structural social reform in collaboration with the IMF and the World Bank. On behalf of debtor countries, it would pay part of the interest owed to those creditor banks that had granted the Bank and the debtor country a voluntary reduction in debt servicing. The WDB would grant the debtor country official loans equal to the interest instalments due to creditor banks year after year; these loans would be denominated in SDRs, have very long maturities and bear low interest rates. The debtor country would maintain its payments to the banks, although at a much reduced level, but instead of paying the accrued interest it would use the funds to repay the principal, something that hitherto was possible only on a very limited scale. In the early years the WDB's outpayments for interest to banks would far exceed receipts from developing countries as servicing of WDB loans. The WDB could finance this temporary shortfall by issuing bonds on the international capital market, which should be guaranteed by the governments of the industrial countries, especially the USA and the main surplus countries of Japan and Germany.

Monitoring and Sanction Mechanisms

Special monitoring and sanction mechanisms should help reduce the risk of abuse of the programme by particular creditors or debtors. In order to ensure that developing contries continue to make an effort to adjust, the WDB should therefore differentiate on the basis of performance and act as sponsor only if and as long as debtor countries opt for the path of economic adjustment and social reform. Accordingly, the WDB should retain sanctions to apply to errant debtors; if a debtor country fails to fulfil its contractual obligations the WDB should issue a warning and then immediately cease to sponsor payments of interest on behalf of that country and to grant it WDB credit. Interest loans from the WDB should therefore be conditional in the same way as IMF facilities.

Control mechanisms must also apply to the commercial banks. To ensure that they too make a tangible contribution to overcoming the crisis, the WDB should put tranches of rescheduled debt out to tender and invite the creditor banks of the debtor in question to indicate the terms on which they would be prepared to participate in the programme (e.g. postponement of repayments, partial cancellation of claims and fresh money for the debtor country, redenomination, interest caps and possibly fixing of the interest rate for the WDB). In preparing its financing package, the WDB could then take account of the offers that were most favourable for itself and the debtor country, though only up to the amount of the agreed tranche. The banks that were

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were successful in these auctions would be those that offered the greatest voluntary debt service relief, in other words those that were prepared to make the greatest financial sacrifice.

Modification of IMF Policies

As hitherto, adjustment programmes would be formulated, negotiated and monitored through the IMF, but the policies applied by the Fund should be modified to take account of the criticisms expressed in various quarters.[8] For example, it seems particularly important that in future the IMF should pay greater heed to the effect its programmes have on the economic and political stability of debtor countries. In the interests of a resumption of sustained economic growth in the developing countries it also seems appropriate that the Fund should go beyond setting purely macro-economic objectives, for example by calling for agricultural reform and the partial privatisation of nationalised industries and demanding that national development policy pay greater attention to ecological objectives. It is also imperative that in future the IMF should publish the contents of the negotiated adjustment programmes, the criteria on which its decisions were based and the performance of the indicators used.

As a matter of principle, there can be no alternative to the conditionality of fund lending, however. Up to now it has been perhaps the most effective means of inducing Third World debtor governments to make their own efforts to adjust. However, in future conditional lending by the IMF and WDB should be directed more clearly towards facilitating "adjustment with a human face".[9] In this way economic programmes and reforms could be made more acceptable to those debtor governments that still balk at IMF-supported programmes because they fear destabilising political and economic consequences.

In parallel to these voluntary debt service reductions by private banks under the aegis of the IMF and WDB, the governments of the industrial countries should organise co-ordinated worldwide action to facilitate reductions in debt servicing on official loans. It seems to be a good idea for creditor governments to adopt the agreements reached between the WDB, the debtors and the banks and to apply them to official loans. This would not only help avoid discrimination but would be easy to apply and would eliminate the time-consuming need for each case to be co-ordinated separately. Only if satisfactory offers from the banks were not forthcoming despite convincing adjustment programmes from particular debtor countries, would the governments of industrial countries have to give the lead by pressing ahead with voluntary reductions in debt servicing, under the auspices of the Paris Club, for example.

Incentives for Banks and Governments

Banks would be willing and able to grant more favourable credit terms, because for the first time since the beginning of the debt crisis they would again be receiving regular payments, even on claims that had been deemed irrecoverable and already wholly or partly written off. In contrast to the failed Baker initiative and the Brady Plan, "free riding" by credit institutions would be unlikely to occur, since banks would receive unexpected or more stable payments on old loans only if they offered sufficiently generous debt servicing relief to be admitted to the WDB programme. It can therefore be expected that in the circumstances outlined above the banks would offer voluntary relief on acceptable terms for a substantial volume of debt service.

Debtor countries would have an equally strong incentive to participate in the WDB programme in collaboration with the IMF and the World Bank and to take economic adjustment measures, since in this way they would obtain appreciable reductions in their debt servicing burden. Substantial relief would fail to materialise only if the banks succeeded in restricting competition before submitting their proposals to the WDB. Such action would be rather unlikely, however, in view of the large number of banks involved worldwide. Greater attention to the social acceptability of IMF-sponsored adjustment programmes would also make it easier for those debtor governments to participate that still reject the conditions imposed by the IMF. By contrast, bad economic policies would bring no relief, so that false incentives such as those inherent in the Brady Plan could more easily be avoided.

Even the governments of creditor countries, which are called upon to make appreciable financial sacrifices, would have an incentive to participate in such a programme. By granting a reduction in debt servicing on

[8] A summary of the debate and of factual developments is to be found in, for example, John Williamson: The Lending Policies of the International Monetary Fund, Washington 1982; Stephan Haggard: The Politics of Adjustment: Lessons from the IMF's Extended Fund Facility, in: International Organization, Vol. 39 (1985), pp. 505-534; Henry S. Bienen and Mark Gersovitz: Economic Stabilization, Conditionality and Political Stability, in: International Organization, Vol. 39 (1985), pp. 729-754; Veronika Büttner: The IMF's Adjustment Concept – A Strategy for a Permanent Solution to the Debt Crisis?, in: INTERECONOMICS, July/August 1985, pp. 168-174; and Scott R. Sidell: The IMF and Third-World Political Instability: Is There a Connection?, New York 1988.

[9] Cf. Giovanni A. Cornia et al. (ed.): Adjustment with a Human Face: *Protecting the Vulnerable and Promoting Growth*, Oxford 1987.

their own loans or those they had guaranteed, they would "only" have to forgo part of receipts that were in any case uncertain, rather than irreversibly forgiving old debts. It is true that in guaranteeing the bonds to be issued by the WDB on the capital market, the governments of industrial countries would be accepting additional risks, but soon after the start of the WDB programme the liability for possible future payments would be offset by higher tax revenue on the commercial banks' windfall profits. The strongest incentive for the governments of the industrial countries to participate in such a programme is probably the fact that the suggested measures take account of the financial potential of the commercial banks and multilateral institutions and try to avoid any unnecessary dissipation of capital they need for other purposes.

The monetary problems of the world economy could probably be tackled more quickly and more effectively by this means than with the present debt strategy. The debt mountain and the interest burden could be significantly reduced year by year. The market value of the residual claims should rise appreciably, there would be a lasting improvement in the banks' reserves and liquid funds and the developing countries participating in the WDB programme would receive new loans, with a larger volume probably also coming from private sources in view of the fundamentally changed environment for the banks. The debtor countries' debt servicing burden would decrease markedly, since although the interest they owed to the WDB would rise year by year it would not be repayable for many years and then only in easy instalments at favourable interest rates. The more debtor countries agreed programmes with the WDB, the more rapidly would the unfavourable structure of Third World debt change. Within a few years the proportion of official, long-term, fixed-interest loans denominated in basket currencies would increase appreciably at the expense of the short-term, dollar-denominated private Euro-credits at variable interest rates that currently predominate.

Political Feasibility

The Brady Plan is unworkable without the provision of substantial additional liquidity by the governments of the industrial countries. The US Government has now dropped its opposition to a further substantial increase in IMF quotas in order not to jeopardise its own new debt initiative, but it is doubtful whether this action and the inflows of resources now expected from the other industrialised countries will be sufficient to allow appreciable reductions in the debt servicing burden that would more than outweigh the current worldwide rise in interest rates. The new approach outlined here, by contrast, entails no additional financial resources from creditor governments, but instead requires them to forgo future receipts and to be willing to bear additional risks. On the one hand they would have to forgo receipts on their own loans for which they had granted debt servicing relief and on the other they would have to shoulder additional risks by officially guaranteeing the international bonds issued by the WDB. The political feasibility of such a financing scheme should therefore be much better than the prospects of mobilising further resources at short notice to implement the Brady Plan on a large scale.

The greatest obstacle to the implementation of the proposal outlined here is therefore probably not the financial requirement as such but the fact that the supranational bureaucracies will unerringly put the Brady Plan into practice, despite its possible adverse effects. Thus, in the years to come considerable sums of taxpayers' money will probably be squandered without producing a significant effect, because the intended debt servicing relief will be more than swallowed up by the present worldwide rise in interest rates. Such a development would probably greatly reduce the preparedness of creditor governments to make further financial sacrifices and debt reductions. In all probability it would also increase the frustration of debtor countries and reinforce their demands for further radical action. The economic constraints creditors and debtors will probably be facing in a matter of only a few years may perhaps clear the way for Brady's initiative to be developed into a more effective international debt strategy that was bearable over the long term.

Massive public credit assistance for voluntary debt service reductions leaving the volume of old debts unchanged would then have a chance to gain political acceptance. It would reduce the debt servicing burden of the developing countries far more effectively than the present approach and could be financed more easily. It would also offer a better chance of motivating all those involved to participate actively in the programme and of distributing the adjustment and financing burden more evenly and hence more fairly. It appears to be a suitable way of avoiding creating the false incentives inherent in the Brady Plan. In this way, officially sponsored voluntary debt service relief could give the governments of debtor countries the latitude they urgently need in order to take economic measures that will restore the political and economic stability of their economies and societies. Only if these requirements are met is it even conceivable that a long-term solution to the international debt problem can be found.