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THE BRADY SPEECH AND THE DEBT FACILITY: AN EVALUATION OF POLICY ALTERNATIVES FOR LATIN AMERICA

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SUMMARY

The March 1989 Brady speech, introducing "debt reduction" in the menu of options to solve the debt crisis, is analyzed from the perspective of Latin American debtors. Initial fund commitments are compared with those required for a substantial debt reduction operation. Limitations on the menu of options for debt reduction arising from the fiscal nature of the debt problem are discussed. Suggestions are put forward to increase the bargaining position of debtor countries in their forthcoming bilateral negotiations with the private banks in the context of the Brady initiative.

RESUMO

Analisa-se, de uma perspectiva latino-americana, o discurso de março de 1989 do Secretário Brady, introduzindo a redução da dívida no cardápio de opções para a resolução do problema da dívida externa. Comparam-se os recursos inicialmente comprometidos para essas operações com aqueles que seriam requeridos para uma substancial redução da dívida total dos países em desenvolvimento. Discutem-se as limitações para o cardápio de opções de redução da dívida decorrentes do caráter fiscal dessa dívida. Apresentam-se sugestões para fortalecer a posição de barganha dos países devedores nas próximas negociações com os bancos privados, no contexto da iniciativa Brady.

1. INTRODUCTION

Last March, the U.S. Secretary of the Treasury, Nicholas Brady, announced in a speech new ideas for the solution of the international debt problem, centered on a reduction of debt service obligations for the debtor nations. The importance of this speech is that it signals the acceptance by the Bush administration of the principle of debt reduction, which was considered as a "non-starter" by the previous U.S. administration[1]. The speech conforms to the widely shared assessment that the Baker strategy, of additional lending by commercial banks, did not work, as these banks continued to reduce their exposure in third world countries.

As a consequence, a progressive shift was occurring of lending risk to the multilateral and bilateral public sector institutions in the creditor countries, accompanied by a continuous deterioration of the secondary market prices of third world debt. The weighted average price for commercial bank debt of the 15 major debtors was 68 cents per dollar of face amount in January 1987, while in January 1989, it was only 36 cents: a decline of 47 percent[2]. This clearly indicates that the Baker

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[1] Cf. "Remarks by The Secretary of the Treasury Nicholas F. Brady to the Brookings Institution and The Bretton Woods Committee Conference On Third World Debt", Treasury News (Department of the Treasury, Washington DC), March 10, 1989.

[2] The source for these figures is Salomon Brothers, apud Department of the Treasury, "Interim Report to the Congress Concerning International Discussions on an International Debt Management Authority". Washington, DC: March 1989, p. 12.

strategy was leading away from rather than in the direction of a resumption of market based lending to the debtor nations.

Thus, Secretary Brady could justify his shift towards "debt reduction", using the same arguments that in September 1985 Secretary Baker used to justify his "financing strategy", namely, to avoid a transfer of lending risk from the private to the public sector, and to restore the creditworthiness of the debtor nations in international credit markets.

The main problem with the Brady speech is the lack of an adequate institutional machinery capable of transforming words into deeds. It thus runs the same risk of failure as the Baker Plan, which as some critics have pointed out, was not really a plan, but rather a declaration of intentions for financing targets, without firm commitments or enforcing mechanisms.

Putting the Brady ideas to work would require:

(i) adequate funding on the part of the industrial countries governments, based on a realistic assessment of the required amounts of debt relief for the debtor countries, and of the commercial banks capacity to absorb the consequent reduction in interest earnings;

(ii) recognition of the debt problem as one affecting the overall financing requirements of the public sector in indebted countries, more so than simply a balance of payments problem in these countries. Below, it will be argued that the perception of the debt problem as causing a fiscal drag in debtor nations not only limits the available "menu of options"

for debt reduction, but also requires a reconsideration of the institutional and policy changes needed in indebted countries to accompany the debt reduction operations; and

(iii) recognition of the need for a coordination mechanism capable of resolving the fundamental market failure problem involved in purely voluntary debt reduction negotiations - i.e., the problem that each individual creditor has an incentive not to participate in these debt reductions, in order to enhance the market value of his claims after the other creditors have agreed to reduce the value of their own claims.

These topics are discussed in the next three sections seriatim. Conclusions are summarized in section 5.

2. FUNDING NEEDS

To estimate the funding needs of a substantive debt reduction operation, consider the case of an international facility fully guaranteeing a new obligation issued by the debtor countries to exchange with the creditor banks for their current loans.

Ideally, this swap operation should satisfy three requirements. First, to make the debtor nations solvent in the sense of reducing their debt service obligations to levels which they can realistically be expected to meet. Second, to allow the commercial banks to break even, in the sense that their net

worth, as measured by the market value of their shares, is not lower than at present. Third, to provide a buy/sale spread sufficiently high to cover the residual risk involved in the new bond.

Latin America is currently transferring abroad about $30 billion per year, or nearly 4.5% of the region's combined GNP. A tripartite recovery program to deal with this situation could contemplate a $12.5 billion reduction in interest payments on medium and long term debt to commercial banks; a $7.5 billion increase in capital flows (official bilateral and multilateral credits, direct investment, interest rate capitalization, bank club loans and trade credits, and capital flight return); and a $10 billion increase in domestic savings. This would allow an increase of 4.5% in the rate of fixed investment, thus providing a substantial impulse to the region's economic growth and hence to its capacity to keep current on its external debt obligations.

An approximate estimate of the medium and long term Latin America debt to private creditors is $230 billion, with an annual interest bill of approximately $25 billion. Hence, a 50% average reduction in this interest bill, to $12.5 billion, would meet the solvency test as previously outlined.

As indicated above, the secondary market evaluation is more pessimistic about the solvency needs of debtors, as the average price for the 15 major debtors' bank debt was only 32.3 cents per dollar in early February, implying that a debt service

reduction of over 65% would be required to make the typical debtor solvent.

In a recent paper, Jeffrey Sachs makes his calculations for the funding requirements of a debt reduction operation on the basis of a required 54% percent discount, corresponding to the secondary market prices at the beginning of 1988[3].

These several estimates suggest that an average discount in the range of 50% to 65% would be required to make Latin American debtor countries creditworthy again.

The second question is whether the commercial banks would be able to take the hit of such substantial reduction in earnings without going under. Contradictory evaluations arise in this context. First, there is the observation by Sachs and Huizinga, that there is a close correspondence between the secondary market prices for the major debtors' bank debt and the stock market evaluation of these banks' shares[4]. This would mean that - in net worth terms - the banks have already taken the hit, and have nothing to lose, it the debt swap is done at current secondary market prices.

Second, there is the observation in a more recent paper by Sachs that the banks have been doing much better in their

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[3] Cf. Jeffrey Sachs, "New approaches to the Latin American debt crisis". Paper prepared for the Harvard Symposium on New Approaches to the Latin American Debt Crisis, Harvard University (Cambridge, MA), September 1988.

[4] Cf., J. Sachs and H.Huizinga, "The U.S. commercial banks and the developing country debt crisis", Brookings Papers on Economic Activity 2, 1987: 555-601.

Latin loans than indicated by the secondary market prices[5]. Thus, he points out that, for Argentina, Brazil, Chile, and Mexico, in the 1985-87 period, the commercial banks earned a rate of return of about two-thirds of the market rate (i.e., they had to refinance about one third of the interest that they were paid). The fact that the secondary market price of debt is lower than would be justified by the cash flow earnings of the banks in this three year period indicates that the market expects that the net cash return will fall in the future - even though in their public pronouncements, the bankers adamantly refuse to accept this judgement[6]. It also indicates that, given their current bargaining strenght, the Latin nations have been willing to pay 66% of what they owe to the banks, even though the secondary market participants believe that they can pay only half as much.

Third, there is the observation that current reserve ratios for third world loans by the U.S. money center banks are in the 25-30% range, and the effect of increasing LDC reserve to 50% of outstanding loans would imply a substantial equity loss for these banks. But if Sachs and Huizinga are correct, this would be only a "paper loss", requiring that the "hidden assets" implicit in current market prices for bank shares be brought

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[5] Cf. J. Sachs, "New approaches...", cit., pp. 20-1

[6] In fact, however, they implicitly accept the market judgement, as otherwise they could enter the market as buyers of Latin paper, which would raise prices to the point corresponding to their current earnings on these loans.

into the open as a means of covering the capital losses consequent upon additional provisioning for third world loans[7].

This discussion suggests a wide margin - perhaps from 30 to 65% - for the discounts that the banks might be able to take without themselves becoming insolvent. In summary, an average discount of 50% maybe in the required ballpark for both creditors and debtors. Allowing for a 10% margin to cover remaining default risks, this suggests that the international facility could buy Latin debt from the banks at an average discount of 52.5%, passing on to the debtors an average discount of 47.5%.

Defining eligible debt for the discounted swaps to be the medium- and long-term commercial bank debt of the public sector of 25 problem debtor countries, Sachs arrives at figure for total eligible debt of $238 billion, with a swap value (for a fully guaranteed bond of the international debt facility) of roughly $110 billion. This would be the amount of the <u>contingent liability</u> required from the creditor country governments to turn the Brady speech into an effective debt reduction scheme.

By comparison, the US seems to be urging other members of the G-7 to have $20 to $25 billion in funds from the IMF and

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[7] For example, if these hidden assets did not exist, the current market price of Manufacture Hanover's shares should be zero, as the required aditional provisioning would take more than the book value of its capital. For the relevant figures, see E. Bacha, "Capturing the discount: towards a debt facility at the Bank and the Fund. Rio de Janeiro: Department of Economics of PUC/RJ, Discussion Paper n. 197, July 1988, Table 2.

the World Bank set aside to support debt service reduction for a group of 39 countries, with a total bank debt of $340 billion. According to press reports, these funds would allow cutting $70 billion of the debt owed by these countries, implying a surprisingly high discount of 60 to 75%. However, at the same time the press reports that the $70 billion estimate assumes that the debtor countries would be able to win an average discount of 45% on their current debt from the banks - which would require the international agencies to put up $38.5 billion, rather than the reported $20 to $25 billion, or else that the principal and interest guarantees on the new bonds would be much less than full, raising doubts about their acceptance by the banks on a voluntary basis[8].

Unfortunately, the initial discussions on the Brady ideas at the boards of the Bank and the Fund reportedly are placing the amount of additional lending for debt reduction in the $10 to $12 billion range, spread out over three years, or only one half of the values originally mentioned by the U.S. Treasury - and 1/10 of the values needed for a full-fledged debt reduction operation. Additional lending is here understood as resources that otherwise would not be available to the debtor countries, under current rules of access to Bank and Fund loans. This is an important point, because as mentioned before,

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[8] The US estimates for debt reduction financing may also include additional money pledged by Japan - reportedly in the order of $6 billion - plus the commitment of part of the international reserves of the debtor countries themselves.

resumption of Latin America's growth will require a substantial increase in official loans beyond those set-aside to fund debt reduction operations.

The point is that, at these funding levels, debt reduction will become an extra addition to the banks' "menu of options", without having a decisive impact on the net transfer problem of the highly indebted countries as a group. Some small countries with large commercial debts traded at a substantial discount - as Bolivia or Costa Rica - may benefit from this type of implementation of the Brady ideas, but the debt problem of the large countries will remain unsolved.

The understanding of the debtor countries then must be that the initial figures mentioned for the implementation of the Brady ideas refer only to the debt swaps contemplated for the very first debt reduction operations, and that much larger resource commitments from the public sector of the creditor countries need to be made in the near future.

In order to start benefiting from the future release of these funds, debtor countries might want to follow the approach of the Mexican government, eliciting in the next round of negotiations with the banks their commitment to a plurianual package of new money, adding up - on the average for Latin America - to 50% of prospective interest payments for, say, a five-year period. Moreover, debtor countries should consider witholding an average 50% of the interest accrued on their medium and long-term bank debt as a bridge-loan, while the

negotiations with the banks on these plurianual packages of new money proceed.

These actions - which should taken as part of a negotiating strategy, rather than in a confrontational mood - would be in line with one of the most interesting proposals in the Brady speech, which asks for the provision of more timely and flexible financial support for the debtor countries, which means inter alia that the banks "need to provide diverse, active, and timely support in order to facilitate servicing of the commercial debt remaining after debt reduction (p.7)."

3. FISCAL DRAG AND CONDITIONALITY

Most of the medium and long-term external debt of the debtor countries directly or indirectly is a liability of the governments of these countries. Until recently, this budgetary aspect of the external debt crisis was treated as secondary in importance, when compared with the fact that the currency of denomination of the debt was foreign rather than domestic. The balance of payments aspect of the debt problem has tended to dominate its fiscal aspect at the level both of the academic debate and the debt negotiations.

To illustrate, financing gap estimates are almost always calculated from balance of payments data rather from a consideration of fiscal variables. As another example,

calculations of required exchange rate devaluations tend to consider only estimates of price elasticities of exports and imports, without evaluating the impact of these devaluations on the borrowing requirements of the debtor governments, via an increase in the domestic currency value of the negative financial transfer which these governments since 1983 have been making to their foreign creditors. A third instance is the illusory but frequent separation between "external" and "internal" disequilibria in debtor countries, as if the collapse of public sector investment, the increase in domestic public sector borrowing requirements, and the consequent inflationary pressures were solely caused by "domestic" policy mistakes, independently of the "external" disequilibria generated by the debt crisis[7].

More recently, however, the sharp reduction in public sector infrastructure investment brough about by the debt crisis, associated with the virulent inflation experienced by some of the major debtors, have helped to focus attention on the fiscal aspects of this crisis. Brazil, for example, has shown an enormous capacity to generate trade surpluses, but since these do not have as a counterpart equally large primary surpluses in

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[7] To illustrate the staying power of this mistaken position, even as recently as January 1989, William Cline states that "the principal cause of stagnation [in Latin America] in 1987 and 1988 was from domestic policy distortions and high inflation in particular, not the debt problem. Nor was inflation caused primarily by the debt burden." Cf. William Cline, "The Baker Plan: Progress, Shortcomings, and Future Evolution". Washington, DC: Institute for International Economics, January 1989, p. 23.

the current account of the government budget, the consequences have been a collapse of public sector investment, an explosive increase in public sector internal debt, and insustainably large real interest and inflation rates[10].

U.S. Treasury officials are putting a lot of emphasis on debt-equity swaps and the return of capital flight as sources of additional finance for the debtor coutries. But when consideration is given to the impact of the debt crisis on the fiscal accounts, these sources of funds are clearly seem to be non-starters for the purpose at hand.

Thus, swaps of public sector external debt for foreign investment in the local private sector aggravate the public sector debt problem, rather than helping to solve it. This is because these swaps add to the domestic borrowing requirements of the public sector, which are more expensive to satisfy than their external borrowing requirements. At the level of the public sector accounts, these swaps simply mean that domestic debt with short maturities and carrying higher interest rates (or a high inflation tax in the case of monetary debt) substitutes for external debt of a longer maturity and with lower interest rates.

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[10] These processes are easier to exemplify making use of the macroeconomic identity: $X - M = (T - G) + (S - I)$, where X are exports, M are imports, T are taxes, G is government consumption, S is private savings, and I is investment. If an increase in the trade surplus, X-M, is not matched by an increase in the goverment primary budget surplus in current account, T-G, the difference S-I must be raised by a combination of inflation taxes, interest rate increases, and cuts in government infrastructure investments and their associated upstream private investments.

Debt swaps involving foreign participation in public enterprises would not require an expansion of domestic debt, but then they would reduce the cash proceedings that the public sector could otherwise have obtained from the privatization of its enterprises.

Finally, private capital flight is clearly associated with the unsustainable position of the public sector accounts. Faced with the perspective of an hyperinflation or other forms of taxation of domestically-held wealth, the response of the private sector is to place its wealth in safe heavens outside the reach of the debtor government. Capital flight return (for long-term productive, rather than short-term speculative purposes) pressuposes that the public sector is first made solvent, and thus it cannot be counted on to help solving the fiscal crisis created by the debt problem.

If this discussion helps to dispel some of fantasies about alternative sources of finance contemplated by the U.S. Treasury, it also indicates the importance of fiscal responsibility in debtor countries as a critical factor to ensure that the proceedings of eventual debt reductions are productively used. Thus, the U.S. Treasury demand for sensible fiscal policies in debtor countries - if this is understood as a complement rather than as a substitute for debt reduction - makes abundant sense. The experience of the last few years clearly indicates that adjustment with growth, from a domestic policy point of view, requires a sensible economic program for

stabilization and public sector restructuring, involving tax reform, tight control of government consumption, and concentration of public sector investment in areas where there is a clear complementarity with the private sector.

In this context, external conditionality could potentially play a useful role, as a countervailing force against coalitions of domestic lobbying interests, within and outside the public sector, which only too often have shown their capacity to block needed public sector reforms in debtor countries.

The difficulty is to shape this conditionality system as a collaborative effort with domestic authorities - rather than as an adversary relation with them, as it has been so often the case in the history of the relations of Latin America with the Bank and the Fund.

For this, it is necessary that the Bank and the Fund stop been viewed in the region as collector agencies for the commercial banks. This requires, first, that their loan programs start being disbursed independently of the arrears that the debtor countries may have accumulated with private banks. And, second, that these two institutions be endowed by the industrial countries with the volume of resources necessary to proceed with a major debt reduction operation.

Once these steps are taken, debtor country governments should realize that external conditionality - provided it evolves from a policy dialogue rather than from an external

imposition of a pre-set policy package - may help the implementation of sensible domestic economic programs, in terms both of weaking the hold on the government of powerful domestic lobbying interests, and of quickening the pace of return of the debtor countries to normal access to the international credit markets[11].

4. COORDINATION MECHANISMS

Another weak point of the Brady speech resides in visualizing only two extreme alternatives for debt reduction operations. Either a "mandatory centralization of debt restructuring" or purely voluntary, market based transactions.

In the first category, according to the U.S. Treasury, is the variety of proposals for an international debt facility, including that contained in the U.S. Congress Trade Bill of 1988[12]. In his interim report to the Congress on this Facility, the Treasury finds that:

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[11] For a further discussion of the conditionality theme, see Richard Feinberg and Edmar Bacha, "When supply and demand don't intersect: Latin America and the Bretton Woods Institutions in the 1980s", Development and Change (SAGE, London), 19, 1988: 371-400.
[12] The following remarks are based on Department of the Treasury, "Interim report to the Congress concerning international discussions on an International Debt Management Authority". Washington, DC: March 1989.

> "Significant up-front costs to the participating creditor governments and international financial institutions would be involved...in addition to bearing the risk on the claims assumed by the Authority, the creditor governments would become contingently liable for the payment of interest due until the debt is repaid...the potential cost to U.S. and other industrial country taxpayers could be substantial - there is some $275 billion of commercial bank debt to the 15 heavily indebted middle income debtors alone...these proposals inherently shift the risk on developing country loans from commercial banks to the international financial institutions or creditor governments as the principal menas of solving international debt problems (op. cit., pp. 3-4)."

By contrast, the approach suggested by Secretary Brady:

> "...would catalyze new opportunities for voluntary market-based transactions and would better tap the potential for alternative sources of private capital...unlike in the case of a debt facility, this suggested approach (1) minimize the cost or contingent shift in risk to creditor governments, (2) avoid mandatory prices for debt exchanges (with prices pre-set by the facility), and (3) maintain a market-oriented approach to debt restructurings...Our suggestions can produce substantial results in terms of debt and debt service reduction with less shift in risk to the public sector (op. cit., pp. 6-8)".

This presentation can be criticized on at least two grounds. First, there is an implicit suggestion that the Facility, only for Latin America, would cost taxpayers in the industrial countries "some $275 billion". This is totally misleading. On one hand, the debt would be bought with a substantial discount. On the other, the bulk of the Facility's capital cost would be raised in international capital markets and not from the industrial country treasuries. For example, the recent $75 billion capital increase of the World Bank did not cost $75 billion to the treasuries of donor countries, but only $2.25 billion spread over a six-year period.

On the basis of a paid-in capital of 10 percent of the contingent liability of the Facility, distributed over a five-year period, Sachs estimates that the annual U.S. share would amount to $550 million or about 4 percent of the annual foreign aid appropriation - a figure which he correctly considers as a bargain to clear up the commercial bank debt crisis for 25 countries around the world[13]. Moreover, as the discussion in Section 2 shows, there is no financial trick capable of evading the fact that a substantial commitment of public funds - in the form of guarantees or calable capital - will be required if a serious debt reduction operation is contemplated.

Secondly, there is the illusion that the Brady ideas simply build on "voluntary debt reduction measures which are already occurring without the need for centralized facilities". According to the U.S. Treasury, these voluntary debt reduction techniques would have already reduced the external debt of 15 major debtor countries owed to commercial banks by more than $26 billion during the past four years. What the Treasury fails to mention is that most of these are debt/equity swaps which have considerably contributed to a worsening of the fiscal situation in countries such as Brazil, Mexico and the Philippines, to the point that the governments of these countries have suspended such operations, in spite of the pressure of the banks to the contrary.

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[13] Cf. Sachs, op. cit., pp. 63-4.

The fact is that individual creditors have little incentive to enter debt swaps involving substantial discounts, as long as they can freely ride the debt swaps offered by other creditors. Minor creditors, without a substantial third world exposure, will accept exit bonds at a discount, only because by doing so they manage to exempt themselves from future concerted lending packages - but even so - as demonstrated by the Mexican-Morgan debt/bond swap - they will require from the debtor country a substantially better exchange ratio than that available in the secondary market.

Money center banks, on the other hand (except for a few gestures of political good-will as in the Mexican-Morgan case), will refuse to abide by market valuations as long as they can count on obtaining better deals from individual negotiations with each debtor. In these negotiations, they are able to use their superior bargaining position, derived not only from their capacity to form a cartel, but more importantly from the support that they collectively obtain from the industrial country governments - a fact directly related to the systemic threat that the third world debt used to represent to these countries' financial systems.

At one level, the Brady speech might be viewed as signalling that the U.S. administration is no longer willing to support the money-center banks' refusal to negotiate with the debtor countries on the basis of the market discount on their debts. This is explicit in the demand in the speech for a

relaxation of the sharing and negative pledge clauses included in existing loans agreements, which are a legal barrier to debt reduction. Moreover, in the Brady speech, the Bank and the Fund are urged not to delay their initial disbursements to debtor countries until firm, detailed commitments have been provided by the commercial banks - which seems to be saying that arrears to commercial banks should no longer be an impediment for the disbursements of funds to the debtor countries by the Bretton Woods institutions.

At another level, however, there is a lingering doubt if these are "credible threats" from the point of view of the money-center banks. This is especially so when the U.S. Federal Reserve Bank is known to have opposed the new Treasury ideas. The Fed point is that these ideas had not matured sufficiently to be brought out in the open, thus running the risk of killling the "additional financing" mechanism now in place without being able to replace it with a new "debt reduction" mechanism. The Fed's resistance is paralleled by that of some important European countries, notably the U.K. and West Germany, to the involvement of the Fund and the Bank in extended debt reduction operations. This indicates that the U.S. Treasury failed to properly coordinate its new ideas either internally or at the level of the G-7.

Additional steps are thus required from the U.S. administration and other industrial countries to make credible their new posture towards debt reduction. Specifically, the

creditor governments should make it explicit that - if an IMF program has been agreed upon - they will recognize the legitimacy of arrears on commercial bank interest payments, in situations where a country's debt burden should be reduced through bilateral negotiations. As shown by the Bolivian experience, as soon as the commercial banks recognize that the official community is accepting the buildup of arrears by the debtor country, the banks will be much more disposed to search for long-term solutions to the debt.

Another measure to overcome the holdout problem would be to go beyond the request of the Brady speech, to waive the sharing clauses of existing loan agreements, and introduce legislation in the creditor countries recognizing the right of debtor country governments in compliance with IMF programs to confer senior status over existing claims to new debt instruments offered in exchange for the old bank loans. Once it became clear that unexchanged loans would stand at the end of the queue, the incentive to holdout would disappear - as the secondary market price of the old loans should in this case remain unaffected by the debt swaps.

In this connection, it is important to realize that the final objective of the debt reduction operation is to make the secondary market price of the senior debt rise towards unity - signalling the reentry of the debtor country in the international financial markets. The problem, however, is that the Brady speech contemplates a three-year period during which

the debt reduction operations would be implanted. If the secondary market price rises during this period, the costs of these market-based debt reduction operations will increase accordingly.

It is thus as important to keep the secondary market price from rising ex-ante, i.e., before the debt reduction is completed, as it is that it should rise towards unity ex-post, i.e., after completion of the debt reduction operations. For this purpose, the ground rules for debt reduction need to establish that the resources for these operations should remain in the "property" of debtors - to be used to retire debt only in terms acceptable to them. In particular, the debtors should not be obliged to carry future debt reduction operations at prices above those prevailing before these operations were announced[14].

In summary, there is no escaping from the need of new ground rules for the bilateral negotiations between debtor and creditors. Lacking the explicit coordination mechanism of a debt facility, these negotiations can only succeed under a new set of rules in the creditor countries, providing the debtors with much more leeway in their negotiations with private creditors than they currently have under existing loan contracts.

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[14] For a set of simulations showing the importance of giving seniority to the new claims and maintaining the discretion of the debtors over the debt reduction operations, see M. P. Dooley and S. Symansky, "A dynamic model of buy backs" (Washinton, DC: International Monetary Fund), 16 March 1989.

5. CONCLUSIONS

The Brady speech is a welcome change from the Baker strategy, in accepting "debt reduction" as a legitimate addition to the menu of options to help solving the debt crisis.

Unfortunately, there is a long road ahead before these new words can be turned into deeds. Industrial countries are still very reluctant to the commitment of public funds for debt reduction at the levels required to make debtor countries as a group capable of resuming economic growth and contemplating the possibility of an early return to the international capital markets.

The U.S. Treasury has also barred for the time being the U.S. Congress initiative to create an international debt facility.

Moreover, U.S. Treasury officials are putting a lot of emphasis on debt-equity swaps and the return of capital flight as sources of additional finance for the debtor countries. But when consideration is given to the impact of the debt crisis on the fiscal accounts of the debtor countries governments, these sources of funds are clearly seem to be non-starters for the purpose at hand.

The initial figures mentioned for the implementation of Brady-based debt reductions are 1/10 of the value necessary for a full-fledged debt reduction operation. The understanding of the debtor countries must be that these figures refer only to

the debt swaps contemplated for the very first debt reduction operations, and that much large commitments from the public sector sector of the creditor countries will be made in the near future.

In order to start benefitting now from the future release of these funds, debtor countries might want to follow the approach of the Mexican government, eliciting in the next round of negotiations with the banks their commitment to a plurianual package of new money, adding up - on the average for Latin America - to 50 per cent of prospective interest payments for a five year period.

This attitude would be in line with one of the most interesting proposals in the Brady speech, which asks for the provision of more timely and flexible financial support for the debtor countries, which means that the Bank and the Fund should not wait for a settlement with the banks to release their own funds, and that the banks "need to provide diverse, active, and timely support in order to facilitate servicing of the commercial debt remaining after debt reduction[15]".

The bargaing position of debtor countries vis-a-vis their private creditors would considerably increase, if industrial countries make it explicit that - once and IMF program has been agreeed upon - they will recognize the legitimacy of arrears on commercial bank interest payments, in

[15] The quote is from the Brady speech, op. cit., p. 7.

situations were a country's debt burden should be reduced through bilateral negotiations.

The conclusion is that there is no escaping from the need of new ground rules for the bilateral negotiations between debtor and creditors. Lacking the explicit coordination mechanism of a new debt facility, these negotiations can only succeed under a new set of rules in the creditor countries, providing the debtors with much more leeway in their negotiations with private creditors than they currently have under existing loan contracts.

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