

THE BRADY PLAN AND BEYOND:

NEW DEBT MANAGEMENT OPTIONS FOR LATIN AMERICA

N^o-257

Edmar L. Bacha/¹

PUC/RJ

May 1991

1. Introduction. 2. The Brady Plan in Latin America. 2.1. Summary Characteristics. 2.2. Financial savings. 2.3. Confidence boosting. 2.4. Implementation deficiencies. 3. Fiscal Constraint and the Brazil Plan. 4. The Road Ahead. 5. Summary and Conclusions.

¹ Prepared for the Sistema Economico Latino-Americano (SELA). The views expressed herein are those of the author and do not necessarily reflect those of the SELA secretariat.

SUMMARY: An evaluation is provided of the first two years of implementation of the Brady Plan for commercial bank debt and debt service reduction of the highly indebted developing countries. A discussion is included of the Brazilian proposal for public sector debt restructuring. Perspectives and requirements for further debt reduction operations under the Brady Plan are discussed.

RESUMO: O texto contém uma avaliação dos dois primeiros anos de implantação do Plano Brady para redução da dívida e do serviço da dívida de médio e longo prazo dos países subdesenvolvidos altamente endividados com os bancos comerciais estrangeiros. Inclui-se também uma discussão da proposta brasileira para reestruturação da dívida externa do setor público. Discutem-se finalmente as perspectivas e requisitos para a continuação das operações de redução de dívida do Plano Brady.

1. INTRODUCTION

The year 1990 marked the implementation of the Brady Initiative, the new approach to the debt crisis announced by U.S. Secretary of the Treasury, Nicholas Brady, in March 1989. The proposal was that countries "with sound adjustment programs" should negotiate debt and debt reduction operations with their commercial bank creditors, with the financial support of international financial institutions and official creditors/². In May 1989, the World Bank and the IMF indicated that they expected about US\$ 20 billion of such lending. Japan indicated that it would support the program with up to US\$ 10 billion in cofinancing. In October 1990, the Inter-American Development Bank approved plans for lending in support of debt and debt service reduction. Creditor countries adjusted their tax, regulatory, and accounting rules in support of debt reduction.

By April 1991, the Brady proposal was put into practice with the conclusion of operations in six countries - Costa Rica, Mexico, Morocco, the Phillipines, Uruguay, and Venezuela. All these operations utilized a negotiated "menu" of options. The commercial banks provided new money or reduced the face value of debt and debt service by exchanging their existing loans for

² For more details and an initial evaluation, see Bacha (1989).

specific instruments from a menu that had been negotiated between the country and its Bank Advisory Committee.

The next section discusses the implementation of the Brady Plan in Latin America, stressing the basic characteristics of the agreements, the amounts of debt reduction obtained, the confidence enhancing aspects of the agreements, and their implementation shortfalls.

Section three discusses main aspects of the controversial Brazilian proposal for debt restructuring, with its attempted shift of focus from the balance of payments to the government budget as the main limitation to service the foreign debt/³. The fourth section considers the road ahead for the Brady Plan, as it starts dealing with a "second tier" of countries deeply into arrears in their commercial bank debts. A section of summary and conclusions closes the paper.

2. THE BRADY PLAN IN LATIN AMERICA

As of May 1991, four Latin American countries have implemented officially supported debt and debt service reduction agreements with commercial bank creditors under the Brady Initiative: Mexico, Costa Rica, Venezuela, and Uruguay. Summary

³ For a more detailed discussion, see Bacha (1990).

characteristics of these agreements follow. Financial savings produced by these agreements are estimated next. The section continues with an evaluation of the confidence enhancing aspects of the Brady operations. A discussion of main implementation deficiencies concludes the section.

2.1. Summary Characteristics

In brief, the following were the main characteristics of the Brady agreements in Latin America so far, where countries are listed in chronological order of the conclusion of their respective agreements/⁴.

Mexico: In the Mexican deal, creditors were offered a choice between providing new money (chosen by creditors holding 13 percent of the eligible debt) or two new instruments - a discount and a par bond. Creditors opting for the discount bond (40 percent) traded their existing obligations for the discount bond at 65 percent of par; the discount bond carried an interest rate of LIBOR+13/16 percentage points. Creditors opting for the par bond (47 percent) exchanged at par, but the new instrument carried a fixed interest rate of 6.25 percent p.a. Both bonds had 30-year "bullet" maturities - they had no annual amortization payments,

⁴ For more details, see World Bank (1990) and ECLA (1990b). The case of Uruguay is discussed in Cababie (1991).

and principal was repaid only at the end of 30 years. Official support was used to collateralize the principal payment with a zero-coupon U.S. Treasury bond, and to collateralize 18 months (rolling) of interest payments. Finally, the bonds also carried a recapture clause based on oil prices.

Costa Rica: The Costa Rican operation was a pure debt reduction operation, taking into account that the country had been in arrears on its commercial bank debts since the mid-1980s. The main instrument was a buyback offer at a fixed price - 16 cents on the dollar -, with the remaining debt, including part of Costa Rica's interest arrears, converted into long-term bonds with collateralized interest. The bonds also carried a recapture clause based on GDP's growth. To ensure sufficient debt reduction, Costa Rica announced that it would proceed with the operation only if banks holding 95 percent of eligible claims participated, a figure that was exceeded by the operations' conclusion.

Venezuela: The Venezuelan operation was undertaken both to obtain a reduction in external debt and to ensure additional financing. Creditors were offered the option of providing new money, selling back debt or exchanging debt for new instruments. The new money option included conversion rights for debt-equity swaps. The buyback price was set at 45% of face value, and the buyback was done through an exchange of old debt for short-term, fully collateralized notes to avoid any problems with waivers.

Two of the remaining instruments were similar to the Mexico deal: a par bond and a discount bond, both with 30-year,

fully collateralized bullet maturities, collateral for 14 months (rolling) interest, and detachable, value-recovery warrants based on oil prices. In addition, a new instrument was offered, designed to provide debt service relief in the medium term by temporarily reducing interest to below-market fixed rates in the first five years after the operation. These "step-down, step-up" bonds carried a rolling collateral for 12 months of interest in the "step-down" period. With the perceived improvement in Venezuela's credit worthiness, as a consequence of the rise in oil prices, more banks than expected chose the new money option (30 percent); the par (38 percent) and discount bonds (9 percent) also became more attractive, because of the detachable oil warrants. Only 7 percent of banks opted for the buyback, while 15 percent of them preferred the temporary interest reduction bond.

Uruguay: In the Uruguay agreement finalized at the end of January 1991 creditor banks had to opt between three options to exchange US\$ 1.6 billion of loans: a swap for par bonds bearing a fixed interest rate of 6.75 percent per year (33 percent of creditors chose this option), provision of new money equivalent to 20 percent of existing exposure (28 percent), or selling their loans for 56 cents on the dollar (39 percent).

2.2. Financial Savings

The Brady Initiative operations can be evaluated in a number of ways. The simplest and most deceptive one is the impact

on the face value of the affected debt. This is defined as the face value of previously existing commercial bank claims added to the value of the new money facilities, on the theory that the later permits the retirement of an equivalent amount of domestic debt. The net claims resulting from the Brady operations include the new value of banks' claims plus the nominal value of the financing required either for the guarantees or for the buybacks.

TABLE 1: BRADY PLAN OPERATIONS IN LATIN AMERICA: SUMMARY DATA

Country	Affected-Debt		Reduction in face value of net debt	Reduction in net annual interest due	
	Face value	Annual interest due		(US\$ mi)	%
			(US\$ million)		
Mexico	48,700	4,764	-600	915	19
Costa Rica	1,580	157	817	102	65
Venezuela	20,700	2,020	-390	390	19
Uruguay	1,699	165	168	37	23

Source: Appendix tables A1-A4.

Table 1 (see Appendix Tables 1A and 1B for more details) illustrates that, in the cases of Mexico and Venezuela, the Brady operations increased instead of decreasing the net face value of the affected debt, the reason being that the value of the guarantees was in fact higher than the reduction of principal.

The irrelevance of this calculation, however, results from the fact that it does not take into account that the use of collateral for the repayment of principal effectively eliminates the new principal of commercial bank debt on a net basis. It also does not take into account the debt service relief

provided by debt exchanges for par bonds carrying a lower interest rate.

Another more significant measure of the impact of the operations is the immediate debt service relief they provide. This calculation depends on assumptions about the future path of debt service in the absence of a Brady-type operation. The simplest and perhaps most realistic assumption is that existing debt would be indefinitely rescheduled on existing terms. Thus, the relief comes solely from a reduction on interest outflows (net of the additional payments required for the financing of the guarantees and the buybacks). An assumption is also required about the course of market interest rates, both at the international and national levels (the later because of the assumption that the new money facilities allow the retirement of an equivalent amount of domestic debt).

The computations in Table 1 assume a LIBOR of 9.125 percent a.a. and a real domestic interest rate of 20 percent a.a. for all countries concerned (for numerical details see Appendix Tables A3 and A4). The results indicate that, as a result of the Brady operations, Mexico and Venezuela obtained annual interest savings on their affected debt of 19 percent. The corresponding figures were 23 percent for Uruguay and 65 percent for Costa Rica. If the calculations were done with the much lower LIBOR rates observed in 1990-91, the interest savings would be corresponding reduced.

These calculations confirm the generalized impression that, with the exception of Costa Rica, the Brady operations did

not produce a significant amount of debt relief for the countries concerned. Even in the case of Costa Rica the figures would be misleading if understood as actual cash flow relief, for this country had already stopped paying interest on its commercial bank debt since 1986.

2.3. Confidence Boosting

It would be difficult to explain why a significant number of financially strained debtor countries have been so eager to enter Brady-style operations if all they promise are the meager financial savings calculated in the previous paragraphs. Something more than these financial savings must be at play, if a minimum of rationality prevails in the decision making process of debtor countries. Confidence boosting seems to be the name of this missing factor.

To help establish the importance debtors in general attach to confidence enhancement, one should start by noticing that the financial savings of Brady-type agreements are meager, but not non-existent: a 20 percent debt service reduction is certainly better than nothing. But then, how to explain why countries as Chile and Colombia, which are in better financial standing than most other debtors, voluntarily opted out of the Brady scheme, and recently renegotiated their debts with commercial banks under conventional terms? The answer can only be that these countries are renouncing the financial savings they would obtain under a Brady operation to enhance their reputation in both domestic and financial markets.

The importance of this point is also made clear, when attention is paid to the Mexican authorities' justification for subscribing a Brady agreement: they were interested not only in the financial savings on their external debt, but mostly in the beneficial consequences of this agreement for the management of their domestic debt. Mexican authorities made explicit the argument that the domestic credibility enhancement obtained with the Brady agreement allowed them to reduce by 10 percentage points per annum the interest rate paid on domestic debt. And this indirect financial benefit would have outweighed by many times the value of the debt reduction negotiated with foreign banks.

This point is important but also controversial. Islam (1990), for example, maintains that the claim that the Mexico agreement's announcement induced a sharp fall in short-term domestic interest rates and return of flight capital is "misleading and disingenuous". According to him, Mexico's improved performance reflects not so much the debt accord, but sounder policies, higher oil prices, and an absence of natural disasters. And he concludes that it is disappointing that the Brady Plan missed the opportunity to give the Mexicans a bit of room for absorbing the consequences of policy slippage or unanticipated shocks.

A contrasting view is offered by vanWijnbergen (1991), for whom the Brady deal did indeed give Mexico the breathing space it needed to tempt back flight capital and boost domestic investment.

Whatever the final verdict about the Mexican deal is, one conclusion is common to most observers. Restoration of confidence

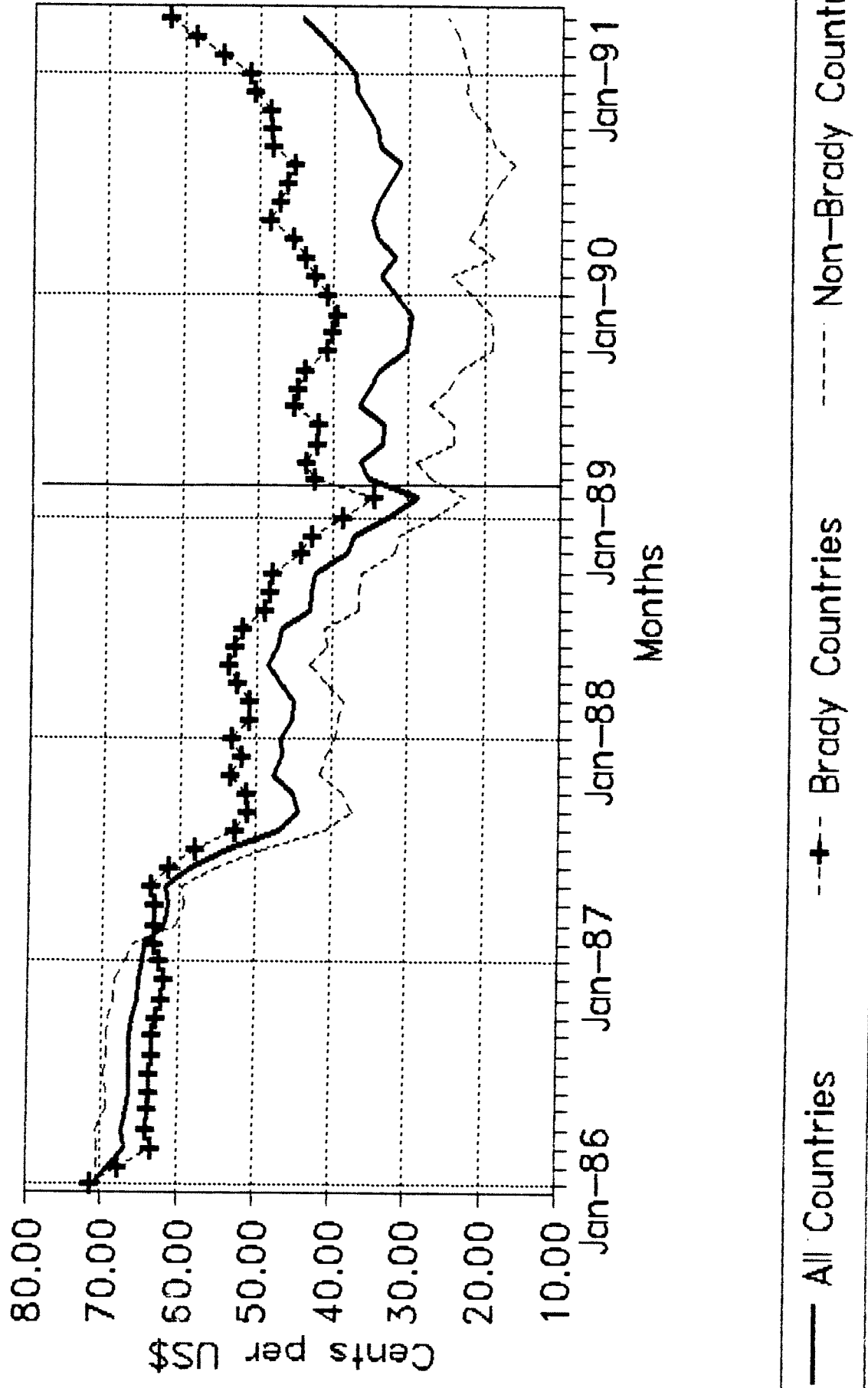
is one of the main potential benefits of an agreement with the creditors. If founded on a solid domestic fiscal stance, a normalization of the relations with the banks should encourage private investors (including domestic investors managing their flight capital) and official creditors to finance the debtor countries' investment needs.

An index of investors' confidence is the secondary market price of foreign debt: the higher it is, the more confident investors must be on a country's solvency⁵. Judged by this yardstick, the Brady plan has been quite successful, as indicated in Diagram 1.

This diagram shows the behavior of average secondary market prices of long-term commercial bank debt for 11 Latin American countries from January 1986 to March 1991. The countries are further divided into two groups, labelled Brady-countries (Bolivia, Chile, Colombia, Costa Rica, Mexico, and Venezuela), and non-Brady-countries (Argentina, Brazil, Ecuador, Panama, and Peru). The reason to include Bolivia among the Brady countries is that it performed a Brady-style buyback operation even before the announcement of the Brady plan. Chile and Colombia are also included in this group, because they opted for conventional

⁵ Controversy rages on the signalling value of secondary market prices of sovereign developing country debts. For a recent, careful econometric evaluation of this issue, which concludes that secondary market prices do indeed reflect investors' perceptions on a country's solvency, see Stone (1991)

DIAGRAM 1
Market Prices of Latin American Debt



NOTES ON DIAGRAM 1

1. Offer prices at the end of the month.
Data for Bolivia from Jul-89/Oct-90 are monthly averages.

2. Weights are the sum of commercial bank debt of 1986, 1987 and 1988 for each country.

3. "Brady Countries" are:

BOLIVIA	COSTA RICA
CHILE	MEXICO
COLOMBIA	VENEZUELA

4. "Non-Brady Countries" are:

ARGENTINA	PANAMA
BRAZIL	PERU
ECUADOR	

5. Due to data unavailability, the following values were interpolated

5.1. For Costa Rica, Ecuador, Panama and Peru

1986		Jan/Feb/Mar/May/Jul/Set/Nov
1987		Jan/Mar/May/Jul/Set/Nov

1988		Jan/Mar/May/Jul/Set/Nov
------	--	-------------------------

5.2. For all countries

Feb-91

6. Sources:

6.1. LatinFinance Magazine:

COSTA RICA		Apr-86/Oct-90
ECUADOR		Apr-86/Oct-90
PANAMA		Apr-86/Oct-90
PERU		Apr-86/Oct-90

6.2. Ambito Financero:

ALL OTHERS	Jan-86/Oct-90
------------	---------------

6.3. Merrill Lynch Debt Markets:

ALL COUNTRIES	Nov-90/Mar-91
---------------	---------------

6.4. World Bank's World Debt Tables 89-90:

Commercial Bank Debt Totals

restructuring operations, even when they could easily have obtained Brady-type debt reduction deals. This fact must certainly have strengthened these countries' bargaining position with their foreign creditors.

This diagram indicates a clear interruption of the downward trend of secondary market prices, starting from the announcement of the Brady plan in March 1989. As the Brady-deals are closed in 1990, an upward trend sets in for the debt prices of the Brady-countries. This upward trend gains increasing strength in the last months of 1990 and into the first quarter of 1991. Except for Chile, prices are still below their levels in 1986, nonetheless the recovery is dramatic from the troughs of early 1989. Moreover, debt price averages were practically the same for Brady- and non-Brady-countries until early 1987; by early 1989, price differences had opened up; but it is only from the inception of the Brady plan that these differences became more significant. In early 1991, debt prices of Brady-countries were more than twice as high as those of non-Brady-countries.

The Brady plan may have provided limited debt relief, but judging from secondary market prices behavior, the countries which either signed the agreements or could have done so at their own discretion certainly witnessed an increase in market confidence on their economic prospects. At a minimum, there is a fortunate coincidence between a turn-around of economic performance (as evaluated by secondary market participants) and the Brady plan deals.

2.4. Implementation deficiencies

The implementation of the Brady plan has been relatively more successful than initially expected. Nonetheless, some serious problems became apparent in the operations so far/⁶.

First, progress in reaching agreements with commercial banks has been too slow, and operations have taken longer than hoped. Reasons for this are that the debt instruments are complex and, in some cases, new; that the banking community has diverse interests and operates under different national regulatory and supervisory systems, which may treat instruments differently; that the banking community is concerned about setting precedents; finally, that disagreements often exist over the size of the medium-term financing gap.

Second, the US\$ 30 billion available from the IMF, the World Bank and Japan to support the operation will need to be supplemented to cover needs of the other eligible countries. ECLAC (1990a) estimates that a tripling of the public resource commitment to US\$ 90 billion is needed to ensure that the voluntary debt reduction achieved will be able to eliminate the debt overhang.

A problem however emerges when consideration is given to the consequent growth in official exposure as a result of further

⁶ The discussion that follows is based on World Bank (1990), G-24 (1990), ECLA (1990a), and Rosenthal (1990).

operations under the Brady Initiative. More specifically, the size of the commercial bank debt of Brazil and Argentina was almost US\$80 billion at the end of 1990. Support for Brady type operations would increase official exposure significantly to these countries, if carried out under terms and mechanisms used thus far.

The worry about excessive official exposure is strengthened by the observation that debt reduction operations have tended to make it more difficult to deal with holders of the new debt in the future, as the agreements have been based on exit bonds, explicitly exempt from future debt restructurings, making official creditors more exposed to policy slippages and adverse external developments in the debtor countries. For these reasons also, the debt reduction by private creditors needs to be large enough to reduce substantially the probability of further restructurings.

The solution of this problem would require the Brady Plan to be better coordinated. The Plan needs more systematic and forceful institutional mechanisms of persuasion. The World Bank and the Fund should assist the indebted country in formulating an ex ante estimate of its medium term capacity to service bank debt, defined in terms of requirements for recovery of investment, and reasonable rates of growth (e.g. 5%), as well as the recovery of adequate international reserve levels. This estimate in turn should service as the central parameter for debt and debt service reduction.

Finally, the trend in the first Brady-type agreements has been to provide for one-way, upside contingencies through

"recapture clauses", while avoiding downside risk contingencies. The international agencies should become more involved in pressing for such contingencies, or if it proves impossible to negotiate them, international reserve targets must be set sufficiently high to cushion the program. The World Bank (1990: 40) itself agrees that, ideally, the operations should include contingency arrangements for additional refinance or further, temporary, reductions in debt service. These contingency arrangements could be triggered by changes in objective, external indicators such as falling export prices or higher oil import prices.

3. FISCAL CONSTRAINT AND THE BRAZIL PLAN

In the October 1990 World Economic Outlook (IMF, 1990: 76-9), the International Monetary Fund strongly made the point that with the expansion of the public sector's responsibility for managing external debt and meeting debt-service payments, external debt management and fiscal policy issues became close intertwined. In many countries, the lack of success of stabilization programs reflect the government's inability to bring about the transfer of resources from the domestic private sector to the public sector. Thus the lack of viability of the fiscal position is at the core of the external payments problems of a large number of low- and middle-income highly indebted countries. In cases where the mobilization of the public sector's resources to service external debt in full is difficult, the fiscal benefits stemming from the

reduction of debt and debt service could help ensure the success of adjustment programs.

It is in this context that Brazil's public sector debt restructuring plan (Brazil, 1990) should be examined. Brazil's plan was unveiled in October 1990. The plan is based upon the fact that the government is liable for approximately 90% of the country's external debt. Thus, any proposal that seeks a lasting solution to the external debt question must take into account the public sector capacity to obtain primary surpluses, that is, an excess of tax receipts over expenditures other than interest payments.

Furthermore, the external debt must be seen within the general framework of the public sector debt as a whole, i.e., the internal and external debts are two sides of the same coin. Any attempt to effect payment of the external debt at the cost of growth in the internal debt or in the money supply leads to greater inflationary pressures. For this reason, the distribution of the resources generated by the primary surplus into internal and external debt servicing must be done carefully, so that the honoring of the country's external commitments will be compatible with internal price stability and renewed development.

Previous debt restructuring agreements of Brazil with the banks were inadequate in that they did not give due consideration to the fact that the debt is almost entirely a liability of the public sector; whereas tradable goods production and consumption is mostly done in the private sector. Hence, the capacity of the country (read: private sector) to generate trade surpluses

overestimates the capacity of the country (read: public sector) to honor its external debt obligations. The major constraint on payments of the external debt is not the capacity of the economy as a whole to generate surpluses in the trade balance, but rather the limited space available for the public sector to generate genuine primary budget surpluses.

Official calculations for the Brazilian case indicate that, should the public sector generate a primary surplus equivalent to .65% of GDP, it could effectively pay 34% of the interest service on its internal and external debts, refinancing the remaining 66%, together with the totality of principal. Under these conditions, the public debt/GDP ratio would remain constant. Given a climate of confidence, this process could normally occur through market operations.

In the 1980s, the Brazilian government generated a primary surplus equivalent to approximately 1% of GDP. Moreover, the projections with respect to the feasible series of primary surpluses, as of 1991, lead to the conclusion that an effective reduction of the total public sector debt could be obtained during this decade. Thus, from this long run perspective, the country is solvent, but the crisis of the 1980s made it clear that both internal and external creditors refuse to supply voluntarily the refinancing required to cover the difference between the primary surplus and interest payments commitments, consistent with a slowly declining public debt to GDP ratio.

To break out from the resulting impasse, an alternative mechanism to service the external debt needs to be defined,

consistent with the public sector's payment capacity for future years. Public sector payment capacity is defined as the volume of resources available for servicing the internal and external debts and for accumulating international reserves. It is arrived at by adding together the primary surpluses, seignorage revenues, and interest revenues derived from investment of international reserves. Aside from this, expected inflows of external loans and net transfers from international financial institutions, government agencies and private suppliers are also computed.

The treatment given in the Brazilian proposal to the total public debt - internal and external - is divided into three phases. The 1st Phase (1991-92) is one of stabilization, during which the priority is to reduce the internal debt/GDP ratio significantly, hence only very limited resources become available to service the public sector external debt. The 2nd phase (1993-95) is one of take-off: once the economy is stabilized, the country will be in a position to resume the growth process. The recovery of domestic confidence in the solvency of the public sector would make it possible to keep constant the real value of internal debt. Thus, it would be possible to service increasing shares of the external debt, subject to the needs to finance public investment in infrastructure, as necessary to guarantee the take-off. The 3rd phase (as of 1996) is one of self-sustained growth. With the extra resources generated by growth, it would be possible to increase external payments rapidly, thus the external debt/GDP ratio would be declining over the course of time.

By category of external creditor, the proposal distinguishes between unaffected debt, which will be fully

serviced from the beginning, and affected debt, payments on which will be postponed until growth is resumed.

Consistently with the basic approach, that the payments difficulties derives not from a lack of private savings or of foreign exchange, but from a lack of tax revenues, the affected debt is restricted to the public sector debts to government agencies, and the medium and long term public sector banking debt, including interest arrears.

The refinancing proposal presented to the banks differs from a typical Brady-plan settlement in the following aspects:

- * it dispenses with debt and debt service reduction, provided that the banks are willing to refinance a substantial portion of interest accruing in the first 10 years, and also wait for 45-years for repayment of principal;

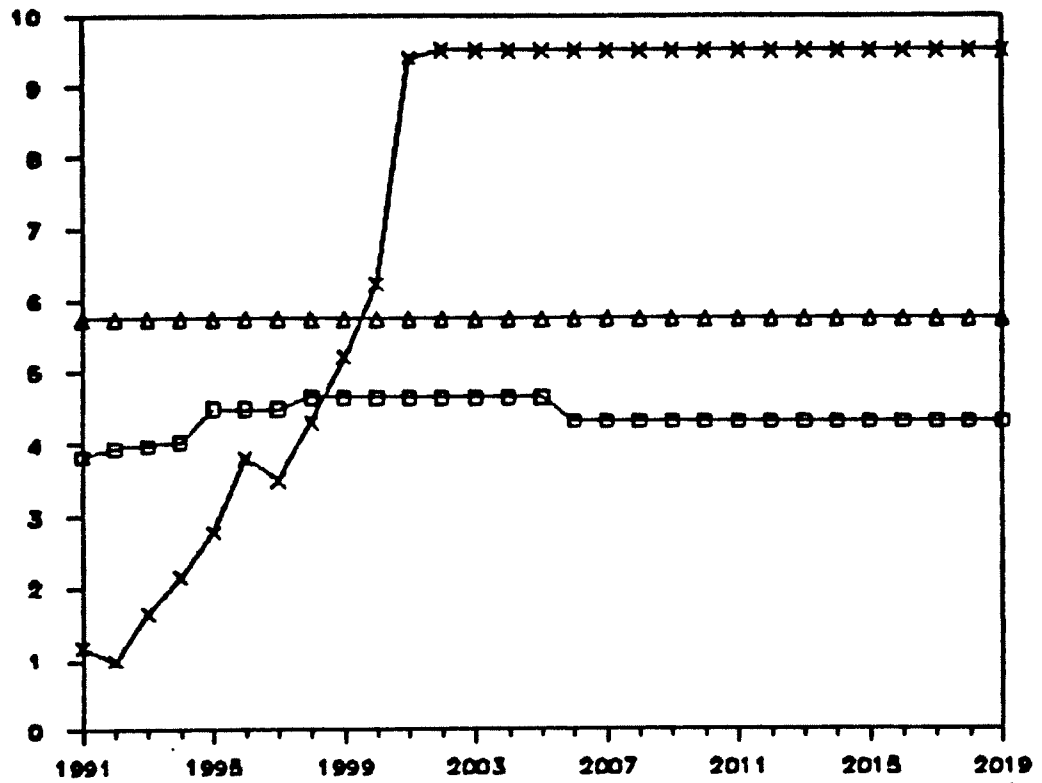
- * it does not offer any international guarantee for debt service payments on the restructured obligations.

Diagram 2 in the next page, presented in Simas (1990), compares the debt service flows contained in the original Brazilian refinancing proposal with those resulting from applying to Brazil the terms of Mexico's Brady agreement. It also shows the payments outflows for a status-quo situation, defined as full payment of contractual interest, plus continued refinancing of principal.

The diagram illustrates that Brazil offers to pay substantially less than Mexico during the first ten years of the restructuring, and then substantially more afterwards, to compensate for the difference.

DIAGRAM 2

Brazil: Payment Flows of Different Financing Alternatives
(in US\$ billions)



□ Mexican terms

△ Status Quo

x Brazil's offer

A synthetic comparison between the present values of the two financing alternatives, which also includes the status-quo, is in Table 2 below, also from Simas (1990). With discount rates up to close to 15% a.a., the Brazilian proposal is more interesting to the banks on a present value basis than a Mexican-type deal. The banks' reluctance even to discuss the Brazilian proposal can thus only be explained by the fact that they are heavily discounting future non-guaranteed promises to pay from Brazil.

TABLE 2: BRAZIL. PRESENT VALUES OF FINANCING ALTERNATIVES
(in US\$ billions)

Alternatives	Discount rates (% a.a.)			
	10	15	20	25
Brazil's offer	52.1	28.3	17.7	12.1
Mexican terms	44.1	28.9	21.3	16.8
Status quo	57.4	38.3	28.7	22.9

Source: Simas (1990).

A way out of the dilemma would involve Brazil obtaining substantial debt reduction under a regular Brady agreement (say, a 70 percent reduction in interest payments for five years or so), with the difference that, mirroring in the example of Costa Rica, the agreement would include a strong recapture clause for the banks, in case the GDP growth projected by the Brazilian authorities does in fact materialize. This could perhaps be done through a "step down, step up" bond à la Venezuela, with a substantial interest reduction in the "step down" period, and with the size and timing of the "step up" conditional on observed GDP growth. Provided that the banks were not given guarantees on

interest and that principal guarantees were calculated on the present value of principal with "step down" interest rates, this scheme would be compatible with a limited use of public money.

4. THE ROAD AHEAD

Up to now, the Brady Plan has dealt with a "first tier" of countries, which, although heavily in debt, with the exception of Costa Rica were not in arrears to commercial banks. However, the "second tier" of eligible debtors are already running growing arrears on their long term public-sector debts. This is brought out in Table 3 below, indicating that interest arrears outstanding to commercial banks from heavily indebted developing countries rose from \$6.5 billion in December 1988 to \$26.8 billion in March 1991.

For these countries, the Brady Plan can no longer provide cash-flow relief through reduction of debt service; these debtors are already helping themselves with such relief by not servicing their bank debts/⁷. What the Brady Plan can do is help to settle the defaulted debts. The settlement will actually aggravate the cash-flow problem as part of the defaulted debts have to be serviced again; the benefits will hopefully involve restoration of confidence as the relationship with the banks is normalized, thus

⁷ The discussion that follows builds on Islam (1990).

encouraging private investors and official creditors to finance the debtors' investment needs.

TABLE 2: INTEREST ARREARS TO COMMERCIAL BANKS
(millions of U.S. dollars, end of period)

Countries	1988	1989	1990	March 1991
Argentina	1949	5216	6823	7294
Bolivia	236	193	156	162
Brazil	0	3454	8376	9500
Bulgaria	0	0	277	410
Cameron	0	23	50	70
Costa Rica	248	372	0	0
Cote d'Ivoire	439	808	1213	1213
Dominican Republic	0	67	158	169
Ecuador	804	1243	1544	1640
Egypt	87	115	145	153
Iraq	0	0	348	580
Nigeria	589	360	342	350
Panama	218	472	728	780
Paraguay	16	32	66	60
Peru	1946	2508	3096	3276
Poland	0	140	920	1180
Total	6530	15004	24243	26827

Source: Institute of International Finance, Inc.

Our previous discussion suggests that it would be advisable to start the exercise with the World Bank and the IMF staffs, in consultation with the debtor country, preparing on the basis of fiscal needs an estimate of adequate debt reduction. Debt reduction should be deemed adequate if meets three conditions: recovery of growth and investment; the full serviceability of the restructured debts; and complete elimination of the need for new

money from the banks to refinance interest payments. This estimate would provide an effective basis for negotiations between debtors and banks.

To encourage the banks' acceptance of the official estimate, the IMF and the Bank should stand unambiguously behind it, allowing the country to accumulate arrears on debt service that exceeds the expected capacity to pay. Likewise, the processing of loans in the pipeline of the World Bank or the IDB should not be delayed on account of arrears to private creditors⁸.

To protect their financial integrity, it would be in the self-interest of the Bretton Woods institutions to ensure that the banks provide deep discounts to the debtor countries. Under the perspective of further affecting their own portfolios to help the banks to collect interest from the debtors, the Bretton Woods institutions should have all the incentive to upgrade the quality of their exposure by making sure that they do not support new debt accords where the extent of debt reduction is not adequate enough.

This attitude will face a strong opposition from the banks. When the Brady Plan was launched, the banks complained that they alone were been expected to reduce their debts, while official creditors were not offering the same terms. Now that

⁸ The latter observation is particularly timing in view of the delaying attitudes of the boards of the World Bank and the IDB towards their project loans to Brazil. The same point is made in the September 1990 G-24 Communique (see G-24, 1990).

Poland has opened the way for substantial official debt relief for middle income countries, banks have begun claiming that they "are not in the foreign aid business" and cannot be expected to match the terms of official creditors. For them, "creditor governments would violate the rights of creditor banks and make meaningful cooperation impossible by imposing, for all practical purposes, the terms of bank debt relief" (Schulmann, 1991).

However, banks need to understand that, for the "second tier" of eligible Brady countries, there is only one way out if a compromise is not struck between the alternatives of more public funds or more debt reduction - and this is to leave bank debts hanging, as suggested by Bulow and Rogoff (1990). Or, as Buiters, Kletzer, and Srinivasan (1990: 1664) put it forcefully:

"In practice, it may be difficult to improve on an approach in which creditor governments and multilateral agencies simply declare victory and retreat from the debt crisis, thus ceasing to act as debt collectors for the international banking community. The commercial banks and the debtor countries can then negotiate among themselves the no doubt sizable write-offs and deep discounts required by the current situation without endangering the prospects for the world's poorest people."

The idea to leave bank debt hanging is shared not only among academics. The World Bank (1990: 29), in its proposals to strengthen the debt strategy for low income countries, says this much explicitly:

"Commercial banks also must expect to share the debt relief burden. If comprehensive settlements through discounted repurchases are blocked, debtor countries may want to use concessional aid available for this purpose to buy out those creditors willing to settle. The resolution of the bond debt crisis of the 1930s followed that pattern: debtor countries repurchased bonds at a deep discount on the secondary market, followed, often after many years, by settlements at less than par with the remaining bond holders".

5. SUMMARY AND CONCLUSIONS

Two years ago, the Brady Plan was received with generalized mistrust, by creditors and debtors alike. After six successful operations, the Plan can be said to have played a much more useful role than anticipated by the critics.

True enough, financial savings provided by the Plan have been, with one exception, very limited. Nonetheless, the Plan managed to revert the tide of declining secondary market prices, and succeed in substantially improving the relations of a selected group of debtors with the financial community.

When the Brady Plan was formulated, it was widely feared that many creditor banks would not participate in debt and debt service reduction operations, in order to benefit through a strengthening of their claims once other banks reduced the country's obligations to them. Also, there was concern that some bank creditors would refuse to grant waivers that were necessary under the existing restructuring agreements to allow the operations to take place. Through a combination of "friendly persuasion" from creditor governments, ingenious financial engineering, and firm attitudes on the part of debtor governments, these fears have been proved unwarranted so far.

Through the creation of an important precedent, the Brady Plan can also be said to have influenced official creditors, first to formulate the Toronto Terms for the reduction of the official

debt of low income countries (these were later extended to some low middle income countries in Latin America), and then to put on the table the discussion on the so-called Trinidad Terms, which purports to reduce official debts of the low income countries by 3/4 of their original values, with outright debt cancellation for the least developed countries⁹.

Interestingly enough, the 75 percent debt reduction of the Trinidad proposal is exactly the same figure suggested in the debt proposal presented by SELA (1990: 34) last year:

"The estimate is made that in order to resume GDP growth, the region needs a reduction of 3/4 in the net financial transfer which it currently makes abroad...One possibility would consist in a combined reduction of principal and interest, such that total debt service does not exceed 25% of current values".

The Brady Plan can be said to have been relatively successful when measured against initial expectations, but not in terms of the actual needs of the majority of debtor countries. First, financial savings through debt and debt service reduction have been limited, and provisions for downside risks inexistent. Second, progress in reaching agreements with commercial banks has been too slow, and operations have taken longer than hoped. Third,

⁹ On the evolution of official debt management, see World Bank (1990).

the US\$ 30 billion currently available will need to be strongly supplemented to cover the needs of the other eligible countries, including Argentina and Brazil. But this means that official exposure will increase significantly to these countries, if the operations were carried out under terms and mechanisms used thus far.

This suggests that the Plan will need more systematic and forceful institutional mechanisms of persuasion. The Fund and the Bank should assist the indebted countries in formulating an estimate of its medium term capacity to service bank debt, which - as in the Brazil proposal - preserves fiscal solvency under reasonable rates of GDP growth. To encourage the banks' acceptance of the official estimates, the Fund and the Bank should stand unambiguously behind it, allowing the country to accumulate arrears on debt service that exceeds the expected capacity to pay.

Until now, with one exception, the Brady Plan has dealt with a "first tier" of countries, which, although heavily in debt, were not in arrears to commercial banks. The "second tier" of eligible debtors are already running growing arrears on their long term public-sector debts. What the Brady Plan can do to these countries is not to provide cash flow relief, but to help to settle the defaulted debts. These settlements will need to involve much deeper discounts than in past agreements, matching those benefiting Costa Rica.

This required change in attitude of the international financial institutions for the continued implementation of the Brady Plan will be strongly opposed by the banks, which have

already announced that they "are not in the foreign aid business". But banks will need to accept economic and political realities. For if they block comprehensive debt settlements, the only alternative left for debtor countries would be simply to let bank debt hanging, as suggested by some academics and the World Bank alike.

REFERENCES:

- Bacha, E. (1989). The Brady Speech and the Debt Facility: An Evaluation of Policy Alternatives for Latin America. Texto para Discussao n. 224. Rio de Janeiro: Department of Economics, Catholic University of Rio de Janeiro, May.
- Bacha, E. (1990). "O fisco e as divisas: um novo enfoque para a divida externa". Nova Economia (Belo Horizonte, Brazil), 1(1), November: 37-49.
- Brazil. (1990). Brazil's Public Sector Debt Restructuring Plan. Brasilia: Ministry of Economy, Finances and Planning.
- Buiter, W., K. Kletzer and T. N. Srinivasan. (1989). "Some thoughts on the Brady Plan: putting a fourth leg on the donkey?". World Development, 17(10): 1661-64.
- Bulow, J. and K. Rogoff. (1990). "Cleaning up third world debt without getting taken to the cleaners". Journal of Economic Perspectives, 4(1), Winter: 31-42.
- Busqueda. (1990). "Se recomprará el 39 por ciento de la deuda externa uruguaya". Montevideo: Busqueda, December 20: 21.
- Cababie, B. (1991). "Renegociación de la deuda externa y todas las cifras que se conocen". Montevideo: La Mañana, February 4.
- ECLAC. (1990a) Latin America and the Caribbean: Options to Reduce the Debt Burden. Santiago, Chile: United Nations Economic Commission for Latin America and the Caribbean, March.
- ECLAC. (1990b). Balance Preliminar de la Economia de America Latina y El Caribe. Santiago, Chile: United Nations Economic Commission for Latin America and The Caribbean. December.
- G-24. (1990). G-24 Communique and Report on the Role of the Fund and the World Bank in the Context of the Debt Strategy. Report of the Ministers by the G-24 Deputies. Washington, DC: Group of Twenty-Four, processed, August.
- Islam, S. (1990). "Whither the Brady Plan?". The International Economy, Oct/Nov: 80-83.
- Rosenthal, G. (1990). "Beyond Brady: Latin America's three-point plan for deepening debt relief". LatinFinance, 20, September: 17-20.
- SELA. (1990). Informe Final de la Conferencia Regional sobre Deuda Externa. Caracas: Sistema Económico Latinoamericano, processed, September.
- Schulmann, H. (1991). Letter to the Chairmen of the Interim and Development Committees. Washington, DC: The Institute of International Finance, Inc. Processed. April 18.

Simas, C. G. (1990). "Uma análise comparativa das recentes propostas de renegociação da dívida do México e do Brasil". Rio de Janeiro: Departamento de Economia, PUC/RJ, processed, December.

Stone, M. (1991). "On the information content of LDC secondary loan market prices". Washington, DC: International Monetary Fund, IMF Working Paper WP/91/20, February.

vanWijnbergen, S. (1991). "Mexico and the Brady Plan". Economic Policy, April.

World Bank. (1990). World Debt Tables 1990-91. Volume 1. Analysis and Summary Tables. Washington, DC: The World Bank.

APPENDIX TABLES

The following tables set the bases for the figures in Table 1 in the text, on the face value of net debt before and after the Brady plan operations, and on the reduction of annual interest payments resulting from these operations. The countries affected are Mexico, Venezuela, Costa Rica and Uruguay. The figures in the tables are extracted from information in World Bank (1990, Appendix 3: 58-62), ECLAC (1990b, Table 21: 36-41), Busqueda (1990), and Cababie (1991).

TABLE A1: MEXICO AND VENEZUELA. FACE VALUES OF NET DEBT
BEFORE AND AFTER BRADY PLAN OPERATIONS

Country/ Modality	Affected debt (\$mi)	Nominal value of new net debt (\$mi)
MEXICO		
1. Par bonds		
principal	22,600	22,600
guarantees		3,300(=2.1a+1.1b)
2. Discount bonds		
principal	19,700	12,800
guarantees		2,700(=1.2a+1.5b)
3. New money		
rescheduled	6,400	6,400
debt swap/f	1,600	1,600
4. Total	48,700	49,300
VENEZUELA		
1. Buyback	1,400	630
2. Par bond w/ fix interest		
principal	7,400	7,400
guarantees		1,288(=703a+585c)
3. Par bond w/tem- porary interest reduction		
principal	2,900	2,900
guarantees		145d
4. Discount bond		
principal	1,800	1,300
guarantees		227(=124a+103c)
5. New money		
rescheduled	6,000	6,000
debt swap/f	1,200	1,200
6. Total	20,700	21,090

See notes in Table A2.

TABLE A2: COSTA RICA AND URUGUAY. DEBT VALUES BEFORE
AND AFTER BRADY PLAN OPERATIONS

Country/ Modality	Affected debt (US\$mi)	Nominal value of new net debt (US\$mi)
COSTA RICA		
1. Buyback	1,000	160
2. A-Bonds(Principal)		
Principal	240	240
Guarantees		15d
3. A-Bonds (Interest due)		
Principal	50	40
Cash pay		10
Guarantees		8e
4. B-Bonds(Pr'al)	230	230
5. B-Bonds(Interest due)		
Principal	60	48
Cash pay		12
6. Total	1,580	763
URUGUAY		
1. Buyback	628	355
2. Par bonds		
principal	535	535
guarantees		105(=51a+54b)
3. New money		
rescheduled	447	447
debt swap/f	89	89
4. Total	1,699	1,531

a.	Acquisition of 30-year zero coupon US Treasury bonds to guarantee principal of new bonds, in a value estimated as 9.5% of said principal.	
b.	Acquisition of blocked deposits to guarantee 18 months of interest on bonds.	
c.	Acquisition of blocked deposits to guarantee 14 months of interest on bonds.	
d.	Acquisiton of blocked deposits to guarantee 12 months of interest on bonds.	
e.	Acquisition of blocked deposits to guarantee 36 months of interest on bond.	
f.	New money modality includes rescheduled of principal and new loans; the latter are assumed to be used in a debt swap to cancel domestic debt of same dollar value.	

TABLE A3: MEXICO AND VENEZUELA. NET INTEREST PAYMENTS
BEFORE AND AFTER BRADY PLAN OPERATIONS

Country/ Modality	Interest on affected debt		Interest on new net debt	
	%a.a.	\$mi	%a.a.	\$mi

MEXICO				
1. Par bonds				
principal	9.125	2,062	6.250	1,413
guarantees			9.125	292
2. Discount bonds				
principal	9.125	1,798	9.125	1,168
guarantees			9.125	246
3. New money				
rescheduled	9.125	584	9.125	584
debt swap	20.000	320	9.125	146
4. Total		4,764		3,849
ANNUAL INTEREST SAVINGS: \$915mi [19.2% less]				
VENEZUELA				
1. Buyback	9.125	128	9.125	57
2. Par bond w/fixed interest				
principal	9.125	675	6.750	500
guarantees			9.125	118
3. Par bond w/temporary interest reduction				
principal	9.125	265	5.000f	145
guarantees			9.125	13
4. Discount bond				
principal	9.125	164	9.125	119
guarantees			9.125	21
5. New money				
rescheduled	9.125	548	9.125	548
debt swap	20.000	240	9.125	109
6. Total		2,020		1,630
ANNUAL INTEREST SAVINGS: \$390mi [19.3% less]				

TABLE A4: COSTA RICA AND URUGUAY. NET INTEREST PAYMENTS
BEFORE AND AFTER BRADY PLAN OPERATIONS

Country/ Modality	Interest on affected debt		Interest on new net debt	
	%a.a.	\$mi	%a.a.	\$mi

COSTA RICA				
1. Buyback	9.945	99.5	9.125	14.6
2. A-Bond/P. Principal Guarantees	9.945	23.9	6.250 6.250	15.0 .9
3. A-Bond/I.Due Principal Cash pay Guarantees	9.945	5.0	9.125 9.125 6.250	3.7 .9 .5
4. B-Bond/P.	9.945	22.9	6.250	14.4
5. B-Bond/I.Due Principal Cash pay	9.945	6.0	9.125 9.125	4.4 1.1
6. Total		157.2		55.5
ANNUAL INTEREST SAVINGS: \$101.7mi [64.7% less]				
URUGUAY				
1. Buyback	9.125	57.3	9.125	32.6
2. Par bonds principal guarantees	9.125	48.8	6.750 9.125	36.1 9.6
3. New money rescheduled debt swap	9.125 20.000	41.0 17.8	9.125 9.125	41.0 8.2
4. Total		164.9		127.5
ANNUAL INTEREST SAVINGS: \$37.4mi [22.7% less]				

TEXTOS PARA DISCUSSÃO

230. Fritsch, W. e G.H.B. Franco, "Trade Policy, MNCs and the Evolving Pattern of Brazilian Trade, 1970-85".
231. Amadeo, E.J., "Desemprego: Teorias e Evidências sobre a Experiência Recente na OECD".
232. Amadeo, E.J. e J.M. Camargo, "Brazilian Labour Market in an Era of Adjustment".
233. Amadeo, E.J. e J.M. Camargo, " 'New Unionism' and the Relation Between Capital, Labour and the State in Brazil".
234. Marques M.S.B. e S.P.C. Werlang, "Deságio das LFTs e a Probabilidade Implícita de Moratória".
235. Lago, L.A.C., "Uma Revisão do Período do "Milagre" Política Econômica e Crescimento, 1967-1973".
236. Carneiro, D.D. e I. Goldfajn, "Reforma Monetária: Prós e Contras do Mercado Secundário".
237. Carneiro, D.D. e R.L.F. Werneck, "Public Savings, Private Investment and Growth Resumption in Brazil".
238. Carneiro, D.D. e R.L.F. Werneck, "Brazil: Medium-Term Development and Growth Resumption in Brazil".
239. Franco, G.H.B., "Liberalização: Cuidados a Tomar".
240. Abreu, M. de P., "The Rewards of Good Behaviour: Foreign Debt and Economic Growth in South America, 1929 - 1945".
241. Moraes, P.B., "Foreign Banks In The Brazilian Economy in the 1980s".
242. Amadeo, E.J. e P.V. Pereira, "Variáveis Distributivas e Ciclo Econômico: Exame da Indústria Brasileira (1976/1985)".
243. Amadeo, E.J. e J.M. Camargo, "Relações Entre Capital e Trabalho no Brasil: Percepção e Atuação dos Atores Sociais".
244. Camargo, J.M., "Salários e Negociações Coletivas".
245. Amadeo, E.J., "Desemprego: Teoria e Evidência sobre a Experiência Recente na OECD".
246. Franco, G.H.B., "A Regulação do Capital Estrangeiro no Brasil: Análise da Legislação e Propostas de Reforma".
247. Amadeo, E.J., J.M. Camargo, e C. C. de Moura, "The Political Economy of Budget Cuts: a suggested scheme of analysis".

248. Amadeo, E.J., "Keynes, Kalecki e abordagem neoclássica sobre a 'causalidade' entre emprego e distribuição".
249. Franco, G.H.B. e C. Parcias Jr.(BNDES), "Inflação, Clientelas e Preços relativos".
250. Amadeo, E.J. e G.H.B. Franco, "Inflação e Preços Relativos no Plano Collor - Avaliação e Perspectivas".
251. Bonelli, R. e E. Landau, "Do Ajuste à Abertura: a Economia Brasileira em Transição para os Anos 90".
252. Camargo, J.M. e E. Amadeo, "Labour Legislation and Institutional Aspects of the Brazilian Labour Market".
253. Cunha, L.R.A., "Congelamento e Preços Relativos: a Experiência Brasileira".
254. Amadeo, E.J. e E.K. Bastos, "Malthus e Ricardo sobre a Determinação da Taxa de Lucro".
255. Fritsch, W. e G.H.B. Franco, "Trade Policy, Trade Performance and Structural Change in Four Latin American Countries, 1970-1985".
256. Fritsch, W., "Latin America in a Changing Global Environment".