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# BAKER, BRADY AND THE BANKS *

**Abstract**

*The Baker Plan, and its successor the Brady Plan, represent the official US Government policy response to the international debt crisis which erupted in August 1982 when Mexico announced it was unable to service its foreign debts. However, Baker and Brady notwithstanding, the debt crisis has not abated, and the debtor countries are in many respects worse off than when it started. In fact, all the signs suggest that a resolution of the crisis is still a long way off. This clearly has enormous implications for the current international debt strategy, given that each Plan in its turn, was hailed as a major breakthrough at the time of its introduction. This paper outlines briefly the nature and development of the crisis, not in order to apportion blame or responsibility for it, but rather to identify the principal players in this long-running saga, and the constraints and considerations which determine their scope for action. Secondly, it outlines the main features, objectives and operational requirements of both the Baker and the Brady Plan. Within these broad parameters, it focusses on the role relationship and response of the commercial banks to them in order to assess their impact on and contribution to the course and outcome of the crisis.*

The Baker Plan, and its successor the Brady Plan, represent the official US Government policy response to the international debt crisis which erupted in August 1982 when Mexico announced it was unable to service its foreign debts. Within a matter of weeks virtually the whole of Latin America had followed suit, and by the end of that year the international monetary and financial system faced a crisis which threatened its very existence.

That crisis is still with us, having passed through at least three distinct phases, each of which has been signalled by a major change in US policy. The first of these dates from the outbreak of the crisis in 1982 to the introduction of the Baker Plan in 1985. The second corresponds to the years of the Baker Plan (1985 to 1988), and the third was ushered in by the introduction of the Brady Plan in March 1989.

However, Baker and Brady notwithstanding, the debt crisis has not abated, and the debtor countries are in many respects worse off than when it started. In 1988, total external debts of the so-called Highly-indebted countries (HICs)[1] amounted to \$ 529 billion, as compared with \$ 391 billion in 1982. Net flows on an annual basis fell from \$ 34.6 billion to \$ 7.6 billion over the same period, while total net resource transfers turned sharply negative after 1982. In 1988 they exceeded —\$ 31 billion. In fact, all the signs suggest that a resolution of the crisis is still a long way off. This clearly has enormous implications for the current international debt strategy, given

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## Characteristics of the Crisis

There are at least three elements which characterise the present debt crisis. Firstly, it is highly concentrated in terms of principal debtors and creditors. The former group, which is comprised of the 17 members of the HICs, accounted for approximately 45% of all developing countries' debts in 1988. The same pattern of concentration carries over into membership of the group, 12 of which are located in Latin America. Of these, Argentina, Brazil, Mexico and Venezuela between them, accounted for 61% of all HIC debts in 1988.

Secondly, over 70% of all HIC debts are owed to private creditors. In the case of the four principal debtors, the proportion ranged from 72% to 95% in 1988. Most of the debts owed to private creditors were in fact held by a few large commercial banks located in the world's financial centres, but principally by US banks. When the crisis broke in 1982, for example, 9 major US banks held 64% of all commercial credit claims against Argentina. For Brazil and Mexico, the proportion was 60% and 54%, respectively.

Thirdly, there have been significant changes in the flow and quality of lending. During the 1970s, there was a veritable flood of funds to developing countries fuelled by the massive amounts of surplus oil funds needing to be recycled and the "open door" policy of the commercial banks. This changed abruptly during the 1980s. Once interest rates turned positive and the cost of servicing external debts mounted, the commercial banks imposed variable rates of interest on new loans and sought to reduce their exposure in problem countries. As a result, net commercial bank credits to HICs were reduced to a trickle and the direction of the net flow of resources reversed.

The emergence of the commercial banks as the main source of development funding during the 1970s not only brought a new actor on to the scene, but added a new dimension to the process of international financial intermediation for developmental purposes. Up until then, the commercial banks hardly engaged in providing long-term development financing and/or balance of payments support. These activities were regarded as more appropriate for official bilateral and multilateral funding agencies. The recycling process changed all that. The banks now got into development financing in a big way, but more importantly, their lending activities brought them into open and direct competition with multilateral financial institutions, with disastrous consequences for the international monetary system. The IMF and the World Bank for example, were virtually frozen out of the international financial intermediation process for most of the 1970s (i.e. when they were most needed to stabilise the system).

Also, the fundamentals of the international financial market were thrown badly out of synchronisation. In other words, there developed a major divergence between demand and supply conditions. On the one hand, the non-oil developing countries (the debtors) needed additional long-term assistance for developmental purposes as well as for offsetting the effects of the two oil crises. On the other hand, the banks (the creditors) provided vast amounts of short-term credits at variable rates of interest and "no questions asked". The delicate balance of this mismatch depended on the conditions of the 1970s carrying over into the 1980s.

This did not happen. International interest rates rose sharply and the days of cheap money disappeared. The world economy was thrown into recession, and the OECD countries resorted to protectionism and tight monetary policies to get rid of inflation. The combined effect of these developments on the HICs was absolutely disastrous. All their principal economic indicators in fact registered significant falls between 1980 and 1983, the worst years of the recession and the onset of the crisis. These are shown in Table I.

*Table 1: Main economic indicators of the HICs, 1980 — 1983*

| | (% real Changes) | | | |
|---|---|---|---|---|
| | 1980 | 1981 | 1982 | 1983 |
| Gross Domestic Product | 5.6 | 0.6 | —0.4 | —2.9 |
| Investment | 9.4 | 0.4 | —13.1 | —21.0 |
| Per cap: Consumption | 3.4 | 0.3 | —2.2 | —4.1 |
| Exports | 1.1 | —6.6 | 0.0 | 5.0 |
| Imports | 8.2 | 2.3 | —14.1 | —20.4 |

Source: Data abstracted from *World Debt Tables (1988 — 1989 edition) Vol: I Analysis and Summary Tables.* The World Bank, Washington, 1989, Table 5, p. xvii.

The banks' reaction to this rapidly deteriorating situation was swift and predictable. They took action to strengthen their balance sheets and to reduce over-exposure in the problem countries by severely curtailing the amount of new credits and calling in outstanding loans. In terms of sound banking principles and procedures, their actions made good sense. From the debtors' point of view which, by 1982, had reached critical levels though, they served simply to worsen the crisis. The banks were in fact calling in loans at the time when the debtors were least able to pay. They were also cutting off the supply of new funds just when these were most needed.

This dichotomy lay at the heart of the crisis. The banks wanted out at precisely the time they were required to stay in and to provide additional new credits to the debtor countries. The latter, on the other hand, were required to continue to service their foreign debts in the context of a rapidly deteriorating world economic and financial crisis, and at great social and political cost to their domestic economies. Both sides had therefore to be persuaded to pursue policies which ran counter to their own perceived self-interests in order to save the system.

This proved particularly difficult in the case of the creditors. It was the first time the commercial banks had got into development financing, and they clearly overdid it. In 1982 for example, the exposure rate for US banks in HICs was 184% as compared with 127% in 1977. Operating by a different set of criteria and pursuing limited short-term commercial objectives, they were unfamiliar with the techniques and risks of development lending. Also, their excessive and aggressive activities gave the crisis a private sector dimension which set it apart from previous debt crises. In essence, therefore, the various interests which needed to be reconciled revolved around the tripartite relationship of (i) the banks, (ii) the debtors, and (iii) the international financial and monetary system.

Additionally, the crisis spread with remarkable speed. From a purely financial crisis involving Mexico and the commercial banks, it rapidly spread to the rest of Latin America, thereby taking on a regional dimension. From here, aided by the globalisation of international financial markets, it quickly assumed global proportions not only threatening the stability of the world banking and payments system, but involving a whole complex set of international relationships. In other words, far from being a highly localised or regional affair of a few Latin American countries owing a lot of money to a few large US commercial banks, the debt crisis quickly spilled over into the wider arena of inter-American as well as international economic and financial relations. The inter-play of diplomacy, high finance, power politics and international economic relations made it inevitable that the US Government would become an active participant in the crisis, which is what happened when it introduced the Baker and Brady Plans.

## The First Phase

The speed with which the crisis developed took everyone by surprise and largely determined the way the main actors responded. The banks wanted their money back. The debtors could not pay. The debtors, on the other hand, needed additional funds to tide them over the immediate liquidity crisis, while the banks refused to pour good money after bad. Both sides were in fact, activated by different and irreconcilable considerations. The banks had a responsibility to their depositors, while the debtors needed time and additional funding to reduce their deficits on current account and to put their economies on a stronger footing. They faced each other in a tense confrontation and the possibility of widespread defaults, leading to the collapse of the international payments system, loomed large.

There was clearly an urgent need for an "honest broker" to keep both sides in the game and to avert a collapse of the system. This was the role which the multilateral financial institutions played, particularly the IMF, which now found itself, once again, centre-stage. It had to persuade the commercial banks, against their better judgement, to continue to provide new credits to the debtor countries to enable them to meet their immediate liquidity needs and to keep the system going. Basically, it did this by making additional resources of its own contingent on the availability of new commercial lending, and by mounting a massive "bridging finance" operation involving principally the US Treasury and the Bank for International Settlements (BIS). All told, a rescue package, totalling some $ 3 billion, was raised.

To qualify for additional liquidity, the debtors had to agree to reduce drastically their current account deficits in the short-term, and to take a number of specific policy reforms in order to restore long-term growth in their economies and to improve their competitive position in export markets. At the macro-level, aggregate spending was to be severely curtailed by a combination of tight monetary and fiscal policies, reduced credit and interest rate increases. Government expenditure was to be cut back and revenues increased, exchange rates lowered and expenditure switched to tradeables and exports. In this way, existing debt levels would be reduced, export earnings increased and capital flight reversed.

Additional measures required to promote long-term growth included strengthening the price mechanism, promoting greater scope for private sector initiative, reducing subsidies, liberalising and reforming existing trade and commercial policies, deregulation and the removal of import controls, increasing domestic savings and getting rid of uneconomic and wasteful State enterprises. In essence, therefore, the debtor countries were required to undertake a comprehensive programme of reforms in order to regain creditworthiness and to place their economies on a path of long-term growth and development.

As far as the multilateral financial institutions were concerned, the role and responsibility of the IMF, as the principal agent, were to (i) prevent a breakdown in the creditor-debtor relationship, (ii) use its own resources as a catalyst to generate additional external finance principally from the commercial banks, (iii) provide the appropriate guarantees and assurances to enable and encourage the banks to participate in any rescue operation, i.e. "to bail the banks in", to use the jargon of the day, and (iv) to supervise and co-ordinate operations, but more specifically, to ensure that the debtors adhered to the strict conditionality and reform programmes imposed on them. These responsibilities gave the IMF a new and enhanced role in the conduct and supervision of the international monetary and financial system. In fact, they landed it with the job of resolving the crisis.

Two aspects of this strategy are worth underlining. Firstly, the crisis was regarded essentially as a short-term liquidity problem, for which the appropriate policy response lay in the conventional strategy of rescheduling and refinancing. Short-term debts were to be rescheduled and new funds provided for refinancing old debts. Secondly, the comprehensive nature of the reform programmes imposed on the debtor countries was based on the assumption that inappropriate economic policies and domestic mismanagement were primarily responsible for the crisis. A period of austerity and belt-tightening, under IMF conditionality, was therefore required in order to bring about the necessary adjustment in their economies. It was also assumed that resumed growth in the world economy would improve their liquidity and creditworthiness, and help them grow out of their debts. Austerity and adjustment in the debtor countries were thus the main thrust of the debt management strategy during the first phase.

This strategy worked for a while. Notwithstanding the overall deterioration shown in Table 1, individual debtor countries and/or groups of debtors registered a dramatic improvement in their performance. Brazil, for example, managed to turn around its economy from a GDP growth rate of -3.1% in 1981 to 8.4% in 1985. Mexico's GDP growth rate of 8.8% in 1981 fell to -4.2% in 1983, only to recover to 3.6% in 1984, while its gross domestic savings as a % of GDP jumped from 7.9% in 1982 to 30.3% the following year. Trade balances also improved substantially. A group of ten major debtor countries managed to convert a current account deficit of —$ 45 billion in 1981/82 to a surplus of $ 1.5 billion in 1984/85. For the same group of countries, capital flight, averaging $ 26 billion in 1981/82, was reduced to an annual average of $ 11 billion between 1983 and 1985.[3]

The strategy was based on the assumption that real growth in the OECD countries would average 3.5% per annum for the rest of the decade, and that the commercial banks would continue to provide fresh credits to the problem debtors. Neither of these assumptions in fact held. The growth rate for the OECD countries averaged less than 2.5% per annum throughout the first phase of the crisis. There were other external factors which adversely affected the performance of the debtor countries (e.g. the growth of world trade, high interest rates, terms of trade losses, etc.) but these do not concern us here.[4] Of more immediate significance is the fact that the commercial banks failed to deliver their side of the bargain.

As soon as the crisis broke, they cut back their lending to the problem countries. As a result, net commercial lending to the HICs plummeted from $ 29 billion in 1982 to $ 7 billion in 1984. New bank money, provided as a part of rescheduling operations over the period 1983 to 1985, amounted to $ 35 billion, of which $ 20 billion went to Argentina ($ 11.2 billion) and Mexico ($ 8.8 billion). Most of this new money ($ 16 billion) came in 1983, mainly in response to the immediate crisis. By 1985, the flow of new bank money had virtually ceased. The total amount of commercial debts rescheduled between 1982 and 1983 amounted to $ 23.6 billion, or about 50% of the total net liabilities of the major debtor countries. Mexico alone accounted for $ 15 billion.[5]

In addition, exposure rates (i.e. claims to capital ratios) were rapidly reduced. For example, claims of the 9 largest US banks in the 15 largest debtor countries dropped from nearly 200% of primary capital (i.e. loan loss reserves, equity capital and certain subordinated debt) in 1982 to 139% at the end of 1985. The banks also strengthened their balance sheets by increasing primary capital on average by 12% per annum over the same period.[6]

These developments greatly aggravated the crisis. The debt to GDP ratio for the HICs rose from 46.3% in 1983 to 58.6% in 1984, arrears built up and all the usual debt indicators deteriorated. Within the debtor countries themselves, standards of livings fell sharply, consumption was compressed, imports reduced, government revenues fell and fiscal deficits increased. The strategy of austerity and belt-tightening clearly had not worked. Not only was the cost of adjustment too high for the debtors, there was no way they could grow out of their debts. A new approach was needed.

## The Baker Plan

This was put forward by the US Secretary of the Treasury, James Baker, at the joint annual meeting of the IMF and the World Bank in Seoul in October 1985.[7]

Basically, it recognised the difficulty of the debtor countries continuing to service their debts through domestic austerity measures, and called for a new policy approach based on the need to strengthen and consolidate the existing international debt strategy and to restore growth and creditworthiness in the debtor countries. Accordingly, it outlined a *Program for Sustained Growth* which incorporated the following mutually self-reinforcing elements: (i) the need for the debtor countries to adopt comprehensive macroeconomic and structural programmes supported by the international financial institutions, to promote non-inflationary growth on a long-term basis, (ii) an enhanced role for the IMF and multilateral development banks in promoting market-oriented growth policies in the debtor countries, and (iii) increased lending by the commercial banks.

The Plan covered Argentina, Bolivia, Brazil, Chile, Colombia, Côte d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela and Yugoslavia — the so-called Baker 15. It called on them to implement and maintain sound economic policies, provide greater scope for, and reliance on the private sector, mobilise additional domestic savings, liberalise trade regimes, encourage greater foreign direct investment and the return of flight capital.

It also called on the commercial banks to provide a total of $ 20 billion in net new lending over a 3 year period to enable these countries to implement the necessary structural reform programmes and growth-oriented policies. It envisaged that those countries which were presently receiving adequate financing from banks on a voluntary basis would continue to do so, and it expressed the hope that both the banks and the debtor countries would openly and publicly pledge themselves to these new policy commitments.

Finally, the Baker Plan called on Multilateral Development Banks (MDBs), principally the World Bank and the Inter-American Development Bank, to provide additionally, between $ 7 and 9 billion annually for 3 years to the same debtors, mostly in the form of quick-disbursing policy-based credits. The World Bank was to act as the catalyst for providing the additional external private financing on which the Plan was premised, and to ensure that the debtors adopted the necessary growth policies and market-oriented structural reforms. Effectively, therefore the Baker Plan advocated adjustment with growth backed by external financing as the most appropriate strategy for dealing with the debt crisis. The policy was to be flexibly administered on a case-by-case basis.[8]

By 1987 it was clear that things were not going according to plan. After a brief improvement in 1986, growth in the industrial countries slumped to 2.3% in 1987. This, along with a steep drop in commodity prices, the fall in oil prices and the rise in protectionism in the rich countries, resulted in a terms of trade loss of some 21% for the HICs over the two-year period 1986 and 1987. Domestic consumption had to be cut back. Gross investment barely covered capital replacement costs, and the fiscal balance as a percentage of GDP dropped to —5.8% in 1987 for the group as a whole. Some of the Baker 15 (Chile, Colombia and Mexico) did make significant progress in implementing their reform programmes, but on the whole, the economic performance of the group was disappointing, as can be seen in Table 2.

*Table 2: The Baker 15: Summary Performance*
$ billion (except as indicated)

| | Average 1981 — 82 | 1987 | 1988 |
|---|---|---|---|
| Real GDP Growth (%) | —0.8 | 2.0 | 0.8 |
| Consumer Price Inflation (%) | 55 | 118 | 223 |
| Exports of Goods and Services | 152 | 143 | 160 |
| Interest Payments | 41 | 38 | 42 |
| Current Account Balance | —51 | —9 | —10 |
| Flight Capital (1) | —25 | —4 | n.a. |
| External Debt (year end) | 371 | 509 | 505 |
| Interest/Exports (%) | 27 | 27 | 26 |
| Debt/Exports (%) | 229 | 342 | 315 |

Notes:
(1) = minus sign indicates net outflow
n.a. = not available
Source: *World Financial Markets. J. P. Morgan,* Morgan Guaranty Trust Co. 1988, Issue 7, December 30. Table 1.

In addition, the external resources required to finance the Baker Plan did not materialise. Notwithstanding rescheduling of old debts and the projected provision of $ 20 billion in new money through concerted lending, net commercial lending fell from $ 5.3 billion in 1984 to —$ 2.8 billion in 1986. The reversal was due mainly to the rapid reduction in exposure levels, which was almost halved for the 14 US regional banks between 1982 and 1986. There was also a considerable increase in provisioning levels and the sale of debt claims by commercial banks. Despite these developments, interest payments by the Baker 15 exceeded $ 20 billion in 1987.

The multilateral financial institutions, which were supposed to provide strong support and guidance, hardly did better. Between 1985 and 1987 annual gross disbursements by the World Bank and the Inter-American Development Bank averaged $ 6.6 billion, considerably less than the amount envisaged by Baker. When account is taken of repayments and interest, net flows averaged less than $ 1 billion annually. In fact, in 1987 there was a net outflow of —$ 3.2 billion from the Baker 15 to the multilateral financial institutions, including the IMF. In other words, the principal financing agents ended up as a major financial drain on the debtor countries.

By then it was clear that the Baker 15 were not going to grow out of their debts, and that the Plan needed to be modified to give creditors greater flexibility to deal with the crisis. The main change incorporated was the introduction of a menu of market-based options which enabled creditors to exchange existing claims for new assets which carried a lower nominal value as well as a lower credit risk. The menu was later extended to new options such as new money instruments, parallel financing with multilateral agencies, medium-term trade facilities, provisions for on-lending and re-lending, interest and currency switching, securitisation and debt conversion techniques and discounted debt buy-backs. These voluntary debt reduction (VDR) schemes allowed commercial banks to negotiate a reduction of their outstanding claims voluntarily, and were used extensively by private and public sector companies in Mexico, Brazil, Chile and elsewhere to pre-pay foreign currency obligations at a discount. In all, about $ 27 billion debt was reduced by VDR schemes by the end of 1988.[9]

Many banks were in fact prepared to take what they could get and/or get out. They accordingly traded HIC debts at substantial discounts in the secondary market. Between 1984 and 1988, the average price of these countries' loans in the secondary market fell by 35%. In the case of Argentina and Côte d'Ivoire, the fall exceeded 60% and 65%, respectively. In September 1988, their loans were traded at less than 22 US cents of their nominal US dollar value. Collectively, these measures had a dramatic effect on the pattern of external debts of the Baker 15 countries.

*Table 3: The pattern of external debts of the Baker 15 countries in 1982 and 1988*

| | Total ($ bill) | | Distribution (%) | |
|---|---|---|---|---|
| Creditor | 1982 | 1988 | 1982 | 1988 |
| Commercial Banks | 262.3 | 280.1 | 67 | 56 |
| Other Private | 38.8 | 35,8 | 10 | 7 |
| Official Bilateral | 59.7 | 104.8 | 15 | 21 |
| MDBs | 23.2 | 59.8 | 6 | 12 |
| IMF | 5.7 | 18.9 | 1 | 4 |
| Total | 389.7 | 499.5 | 100 (a) | 100 |

Note: (a) Rounded up to 100.

Source: *Data abstracted from Institute of International Finance publications,* Washington D.C.

As Table 3 shows, the share of commercial banks and other private lending fell from 77% in 1982 to 63% in 1988. This was counterbalanced by a proportionate increase in the claims of official bilateral and multilateral creditors, specifically the World Bank, the Inter-American Development Bank and the IMF. The dramatic reduction in exposure rates of the banks and other private sector lending was thus achieved at the expense of a commensurate increase in the claims of preferred creditors. This greatly exacerbated the crisis, since the debts of preferred creditors cannot be rescheduled, and a build-up of arrears reduces the debtors' eligibility for additional funding from these institutions, and elsewhere.

## The Brady Plan

The broad outline of this Plan was sketched out by US Treasury Secretary, Nicholas Brady in a speech to the Bretton Woods Committee on March 10, 1989.[10] It reaffirmed the US Government's support and commitment to the basic principles of the Baker Plan: namely (i) the vital importance of stronger growth in the debtor countries, (ii) the adoption of market-oriented reforms, (iii) the provision of additional financial support, and (iv) a caseby-case approach.

The plan called on the debtor countries to adopt new policies and measures in order to use capital more productively, encourage the new investment flows, strengthen domestic savings and promote the return of flight capital. These policies should form part of the IMF and World bank programmes for easing debt burdens, inspiring confidence and promoting growth in the debtor countries.

Brady assigned a central and continuing role in the new stratagy to the IMF and the World Bank, supported by the MDBs. As part of their policy-based programmes, they were to encourage the debtor countries to intensify and improve their reform efforts, and to focus specific measures on improving the investment climate and encouraging the return of flight capital. They were also to use their own resources as a catalyst for marshalling additional financial support for easing debt burdens and promoting growth.

As regards the creditors, Brady advocated the introduction of a wider range of alternative financial measures for providing effective and timely financial support. These included (i) a comprehensive programme of voluntary debt and debt service reduction by the commercial banks, (ii) rescheduling of existing debts by creditor governments, (iii) new money packages for major debtor countries to put them back on the path of long-term sustainable growth, and (iv) the removal of major constraints and bottlenecks, such as the sharing and negative pledge clauses of existing loan agreements. Where Brady differed markedly from Baker was that it advocated voluntary debt and debt service reduction as an integral part of the new debt strategy. Baker stopped short of calling for debt reduction. Instead, it emphasised growth and policy reforms with financial resources from the creditors.

As part of their enhanced role in the new strategy, the IMF and the MDBs were expected to participate in VDR schemes. Brady proposed that they should provide funds as part of their policy-based programmes for this purpose. These funds could then be used to finance debt reduction transactions between debtors and the banks. The "set-aside" amounts would be used to purchase a monetary instrument to be used as a collateral, which would be forfeited if the debtor failed to meet payment on its bank obligations. Alternatively, it could be used to replenish the debtor's reserves, following cash buy-backs. Another possibility was for the banks to include an exchange with a write-down that would have been applied on principal.

Brady anticipated that part of the general capital increase of $ 75 billion which the World Bank had recently received could be used to finance these operations. It also suggested that the new debt strategy could become the basis for an increase in IMF quotas. There were other difficulties to be overcome, but basically, Brady anticipated that the main sources of financing, and the responsibility for overseeing and co-ordinating the plan would rest with the international financial institutions. Finally, it made the pertinent point that sound policies and growing, open markets in the industrial countries were essential for the success of the new strategy. It was inconsistent to ask the debtor countries to strengthen their economies and increase exports, and at the same time limit their access to the markets of the rich countries.

Operational details of the Brady Plan were later fleshed out bv US Treasury officials in consultation with IMF and World Bank personnel. On the specific point of financing, the Plan is expected to provide between $ 32 and $ 35 billion over a 3 year period (1989 to 1992), to finance debt and debt service reduction for heavily indebted countries with adjustment programmes with the Fund and the Bank. About $ 12 billion of this is expected to come from the existing resources of both these institutions. Another $ 12 billion would be available from the Bank's general capital increase of $ 75 billion and the proposed quota increase for the Fund.

Although no specific amounts were mentioned, the commercial banks were expected to continue to provide project loans and credits for trade financing as well as to participate in concerted new lending packages. For their part, debtor countries are expected to pursue viable debt-equity swap programmes and other debt reducing measures. Finally, the Japanese government which have enthusiastically supported the Plan from the outset, announced that it would provide $ 4.5 billion for additional lending by its Export-Import Bank in parallel financing with Fund lending to the HICs. It also agreed to provide a further $ 5.5 billion for parallel lending with World Bank structural adjustment programmes. It was expected that some 40 debtor countries would benefit from the Brady Plan when fully operational, and that it would reduce interest payments by about 20%.

## One Year Later

Despite extensive discussions and intensive lobbying at home and abroad, the Brady Plan has had at best, a lukewarm reception from its principal participants. Only France and Japan, among the major creditor nations, have supported it. Britain, West Germany and the Netherlands were strenuously opposed to the idea of using the resources of the Fund and the Bank to guarantee debtor country interest payments to the commercial banks — one of the central planks of the new debt strategy. They argued that this was a wholly inappropriate use of public funds, and that it would lead to a transfer of private sector risks to the taxpayers in the industrial countries. It would also jeopardise the creditworthiness of these institutions and their ability to raise fresh funds in international capital markets.

The Fund and the Bank were ambivalent towards Brady for different reasons. The Fund's resources cannot be used to guarantee debt relief operations, so it had no reservations on that score. However, its central role in the new strategy gives it enormous leverage over the debtor countries to ensure that they introduce the appropriate reforms and policies, but it is powerless to exert any pressure on the banks to provide the requisite funds. In other words, it had power but no responsibility. It saw Brady as an opportunity therefore, to press for a quota increase in order to increase its lending activities, which is precisely what it has done.

The World Bank, on the other hand, could use its resources to guarantee interest payments to the banks. However, many members questioned whether "bailing out the banks" was an appropriate use of its resource. It could, for example, draw the Bank into a messy conflict or confrontation between the debtors and the banks, and compromise its own preferred creditor status. The Inter-American Development Bank saw its participation in the Brady Plan as an argument for getting the US Government to agree to a general capital increase, a matter on which the US had been holding out for some time.

The debtor countries were the only ones who were mildly enthusiastic about Brady. Why this should have been though, is not at all clear. Perhaps they were convinced that its call for quick, co-operative and comprehensive action would bear fruit. Maybe it was because the US Government had finally agreed to accept debt and debt service reduction as an integral part of debt management strategy. This certainly represented a major departure from its previous policy stance on this matter. Whatever the reason, Brady raised expectations it could not fulfill. It did not itself provide any funding, nor was it in a position to ensure that any of the proposed funding agencies would deliver. In a manner of speaking, the US Government was proposing sweeping changes and asking others to pay for them.

It was not only a question of who paid. The number of debtor countries identified as potential beneficiaries was clearly unrealistic. There was no way that the amount envisaged by Brady could provide enough relief for the 40 debtor countries which, between them, owed a total of some \$ 650 billion in 1987. About \$ 350 billion of this was owed to the banks and other private creditors. It would in fact, have required \$ 70 billion to reduce this private debt by 20%, the figure targetted by Brady. At 10% rate of interest, (say), this would save them annually approximately \$ 7 billion for 3 years in interest charges, hardly enough to make a major inroad on the problem.

Like its predecessor the Baker Plan, Brady has in fact concentrated on the major debtors. So far, Mexico, Philippines, Costa Rica, Venezuela, Chile and Morocco have concluded agreements in principle with the commercial banks. Ecuador, Uruguay, Bolivia and Nigeria have started negotiations, and according to US officials, Brazil, under its new President Fernando Collor, could work out an agreement with the commercial banks by the end of the year.[11]

Each agreement varies substantially in respect of the emphasis and instruments used. For example, the Mexico deal which was completed in February after prolonged negotiations, focussed on debt and debt service reduction through collateralised par and discount bonds and new money packages. 99% of its commercial creditors actually participated in the deal, thereby virtually eliminating the "free-rider" problem. As regards specifics, interest payments to commercial banks will be reduced by one-third, or \$ 1.5 billion a year, and debt repayment will fall by a total of \$ 42 billion.

The Philippines package placed greater emphasis on new money and direct cash buy-backs, in which the banks agreed to purchase local assets at discounted prices. As a result, the Philippines will save about \$ 120 million on its annual interest payments, or 20% of scheduled payments on medium-term commercial bank debt. Costa Rica had a difference package. It secured an agreement in principle with its commercial creditors on a projected cash buyback of outstanding debt at 80% discount, interest reduction and specific measures to address the problem of outstanding arrears. This will reduce its stock of debt by 60% and annual interest rates by 60% over the next 20 to 25 years.

By the time the details have been worked out and the immediate queue cleared, there will be nothing left for the rest of the Brady 40. This is in fact what happened with the Baker Plan. It concentrated on the 4 main Latin American debtor countries and ignored the smaller ones. Brady is likely to end up the same way. Further, the six countries which have so far adopted agreements are the "easiest cases", so to speak. From now on, negotiations are likely to get more difficult and protracted as the focus shifts to those countries which have built up substantial arrears with the commercial banks. Also, the international environment is a lot less conducive to quick actions this time round, and the relative bargaining strength of the respective participants has changed dramatically. While the situation facing Brady is different to that in which Baker operated, the outcome is likely to be the same.

## US Debt Strategy in Perspective

During the first phase of the crisis, the US Government's policy was directed towards limiting or containing the damage to the international financial and monetary system. The possibility of widespread defaults leading to instability, chaos and collapse of the system was real enough. This had to be averted. The damage to the system would have been incalculable. Comparisons were in fact being drawn between the Wall Street Crash and the Great Depression of the 1930s and the recession (the worst since the end of the Second World War) and the debt crisis of the early 1980s.

Also, the stability and integrity of its own banking system had to be protected. US commercial banks were heavily over-exposed in precisely those countries which were threatening to default. A crisis of non-performing loans would not only have created enormous legal and administrative problems, but crippled its domestic banking system as well. Given the key role of the US dollar in both situations, there was no way the effects of the two crises could have been isolated from each other. The Government had therefore to act quickly and decisively to support the international system and to maintain the stability and financial integrity of its own banking system; hence its contribution to the international rescue package mounted by the IMF.

Damage limitation was however essentially a temporary measure. Once the immediate threat to the international system subsided, and management of the crisis effectively passed to the international financial institutions, US policy was again dictated by regional and domestic considerations. The debt crisis was regarded as being limited to certain Latin American countries, and that it would respond to conventional policies and procedures. The US Government also emphasised the legal obligations of debtors to honour their international debts and the need for good housekeeping at home. As for the banks, it was their responsibility to reduce their exposure and safeguard their depositors' funds.

When the crisis failed to respond to conventional measures, and conditions in Latin America deteriorated, talk turned to the formation of debtors' cartels and other collective measures in order to force a more positive response from the US Government. For its part, the US Government was concerned about a number of other regional developments, such as the strategic importance of the major debtors and foreign policy implications of the crisis, the threat to democracy in the region and illegal immigration from Mexico. However, before it could work out a coherent policy, the election of President Garcia in Peru and his decision to limit debt service payments to 10% of Peru's export earnings effectively forced its hands. The US Government responded with the Baker plan.

The Baker Plan showed all the signs of being hastily put together. There were no previous discussions, blueprint for action, or agreement with the international financial institutions and the banks, both of which were expected to finance the scheme and police operations. Major US political, strategic, diplomatic and foreign policy interests and objectives were involved, but the Government was not prepared to finance operations, which was a strange reversal of the position it took when the crisis first broke. It sought instead to multilateralise the issues while ensuring that priority consideration was given to those debtors which were of major strategic importance to the US, e.g. Mexico.

Further, it made commitments on behalf of the multilateral financial institutions and the commercial banks which it could not itself deliver, or ensure that they did. It underestimated the nature and size of the crisis, and it assumed that there was a consensus among the banks in respect of their business strategies in the debtor countries, which was clearly not the case. In fact, differences in size, resources, risk exposures and operational requirements forced the commercial banks to pursue divergent debt strategies and business policies which culminated in the so-called "menu of options".

Developments in the debtor countries themselves also strongly influenced the banks' response to Baker and the crisis. As the austerity programmes began to bite, many Latin American Governments faced intense domestic opposition to the political and social costs of adjustment and the IMF reforms. Some debtors fell into arrears, and others either unilaterally limited or reduced their service payments; the most obvious cases being Peru's decision to limit its service payments and Brazil's suspension of service payments on its commercial debt in 1987. The banks responded by increasing their loan loss reserves, strengthening their balance sheets and adopting various measures to disengage themselves.[12]

Baker was in fact riddled with inconsistencies. Its success largely depended on the banks putting up substantial sums of new money, but the US Government provided no incentives, fiscal, monetary or otherwise to encourage them to do so. Consequently, they did exactly the opposite. They concentrated on voluntary debt reduction. In other words, Baker called on the banks for positive action, they responded negatively. Also, Baker perceived the debt crisis as a serious threat to the stability and harmonious conduct of inter-American economic relations. Yet the cost of adjustment was placed firmly on the shoulders of the debtor countries. As a result, the Baker 15 lost the equivalent of 2% of their combined GDP between 1982 and 1987. It is difficult to understand why the US Government sought to multilaterise the Baker Plan, given the priority and strategic importance it attached to countries like Mexico, Argentina and Philippines. Not many people would regard large-scale Mexican emigration to the US as a world problem. Actually, what multilateralisation did was to cast doubts on the motives of the US Government. Many countries in fact, regarded the debt crisis essentially as a problem for the US banking system (albeit one with serious implications for the region as a whole) which the US Government was trying to offload on to the international financial community as a major crisis for the world trade and payments system.

These inconsistencies were carried over into the Brady Plan, the introduction of which was precipitated by riots in Venezuela. Brady argued that quick action was needed because democracy was under threat within the region. If this analysis was correct, then the policy prescriptions were woefully inadequate and misdirected. Why should the banks and the multilateral financial institutions regard bolstering democracy as one of their priority tasks? Why did Brady concentrate on Mexico, and what did Philippines and Morocco, two of the early cases, have to do with democracy in Latin America? It is not necessary to answer these questions. To ask them is enough to show the confused thinking that lay behind Brady.[13]

The commercial banks were not, in fact, enthusiastic about Brady. Effectively, they were asked to (i) accept lower interest payments, (ii) reduce the stock of debt and (iii) provide new money. It is not clear though, why they should have agreed to write-down or reduce old loans and at the same time provide fresh money packages, without the introduction of some mechanism for differentiating the two, or establishing some order of ranking between the various types of loans. This remains one of the main operational defects of Brady.

Actually, there is no incentive for them to participate in the Plan. Not only is it a purely voluntary arrangement, they are now in a much stronger position financially than at any time since the crisis started. Having reduced their exposure in problem countries and strengthened their balance sheets, the quality of their remaining loans in the HICs has improved, and will continue to do so the longer they hold off participation. There has also been some improvement in the secondary market for Third World debt. It makes more sense therefore for them to sit it out, at least in the short-run, and use the time to restructure their portfolio.

Whether or not they will (or can do so) is of course, another matter. There is no doubt though, that the banks are greatly exercised about (i) the problem of growing arrears, which currently stands at $ 18 billion, and (ii) waivers and negative pledge clauses which Brady advocated. Further, their main concerns are now centred on matters affecting their domestic banking system, specifically, the rising levels of household and corporate debt and the recent scandals surrounding the Savings and Loan Banks. Having virtually stopped lending to the HICs, they are adjusting to "life after Brady", which, incidentally, ends in 1992. By then though, the rules of the game will have changed, and international banking operations will be subject to the rules and procedures laid down in the Basle Accord which becomes fully operational in 1993.[14]

What then, did the respective participants get out of Baker and Brady? The debtor countries won an important concession from the US, i.e. acceptance of the principle of debt forgiveness. Japan got US endorsement for the No. 2 spot in the IMF. The multilateral financial institutions got an increase in resources, and the US headed off another round of social and political unrest in Latin America and a damaging rupture in inter-American relations. In this regard, therefore, Baker and Brady were in the same tradition as the Alliance for Progress and the Caribbean Basin Initiative.

NOTES

1 These include Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Côte d'Ivoire, Ecuador, Jamaica, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela and Yugoslavia.

2 This paper does not deal with the debt crisis affecting the countries of Sub-Saharan Africa, the other major group of debtor countries in the Third World.

3 The group included Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Nigeria, Peru, Philippines and Venezuela. See *World Financial Markets,* Morgan Guaranty Trust Co. of New York, June/July 1987.

4 For a very detailed and systematic analysis of these issues, see *World Development Report 1985,* The World Bank, Washington DC, 1985, part II; and *Revitalising Development, Growth and International Trade: Assessment and Policy Options,* Report to UNCTAD VII, UNCTAD, Geneva, 1987.

5 For a good account of the rescheduling operations, see Marko Milivojevic, *The Debt Rescheduling Process,* Frances Pinter (Publishers) London, 1985, Chapter 3.

6 International commercial banks in West Germany, Japan, the UK and elsewhere took similar steps to reduce their exposure and strengthen their balance sheets. However, given that they were not as heavily exposed as US banks, improvements were not as dramatic. Also, there are certain methodological and definitional problems involved in measuring primary capital which do not allow a strict comparison of the data.

7 *Summary Proceedings of the Fortieth Annual Meeting of the Board or Governors,* October 8 — 11, 1985, International Monetary Fund, Washington DC, 1985, pp. 50 — 58.

8 The Baker Plan also made proposals for dealing with the debts of the poorest countries, but these have been obscured by the emphasis placed on the Baker 15. See *Summary Proceedings,* op.cit., pp. 57 — 58.

9 There is a voluminous amount of literature on the Baker plan, its menu of options and operations; see, for example, (i) *World Debt Tables 1988/89, Vol. I, Analysis and Summary Tables,* World Bank, Washington DC, 1989; (ii) *World Financial Markets,* Morgan Guaranty Trust Co. of New York, June/July 1987; (iii) *World Financial Markets,* J. P. Morgan, Morgan Guaranty Trust Co., N.Y., 1988, Issue 7, December 30; (iv) Burlow J. and Rogoff, K. "The Buy-Back Boondoggle", *Brookings Papers on Economic Activity No. 2,* Brookings Institution, Washington DC, 1988; and (v) Froot, K. A., "Buybacks, Exit Bonds and the Optimality of debt and relief measures", *NBER Working paper No. 2675,* Washington DC 1988.

10 "Remarks by the Secretary of the Treasury Nicholas F. Brady to the Brookings Institution and the Bretton Woods Committee Conference on Third World Debt, March 10 1989". *Treasury News,* Department of the Treasury, Washington DC.

11 Evidence of David Mulford, Under Secretary of the Treasury to the Senate Banking Sub-Committee of the US Congress on March 21, 199O, as reported by Thomas Eichler in USIA Wireless File, Washington, 21 March 199O page 2, ECO 3O3.

12 See George C Abbott, "Loan Loss Provisioning", *Intereconomics, Review of International Trade and Development,* Verlag, Weltarchiv, GMBH, Hamburg, September/October 1989, Vol. 24, pp. 233 — 245.

13 For a sympathetic view of Brady, see Edward R. Fried and Philip H. Trezise, *Third World Debt: Phase Three Begins,* Brookings Institution, Washington DC, 1989.

14 See Abbott, op. cit., for a discussion of the Basle Accord.

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