Jeffrey Sachs

MAKING THE BRADY PLAN WORK

The Bush Administration has changed the direction of U.S. policies on Third World indebtedness. The new initiative, announced by Treasury Secretary Nicholas F. Brady in March 1989, calls on U.S. commercial banks to accept an orderly process of debt reduction, and calls on the international financial institutions—the International Monetary Fund (IMF) and the World Bank—to support this process through changes in their lending policies.[1] The plan implicitly recognizes that many debtor countries will be unable to repay their commercial bank debts in full, even if repayment is stretched out over time. The focus on cutting the debt burden contrasts sharply with earlier Treasury policies, under both Donald Regan and James Baker, which had held that eventually all of the commercial bank debt should be repaid on market terms.

The Brady Plan is a welcome shift, although to date the proposal's details have remained vague. The general mechanism for achieving debt reduction called for in the new plan is for creditor banks to agree voluntarily to reduce the value of their claims (either through a cut in principal or interest) in return for guarantees on the remaining portion of the debt. In the Treasury's view of the negotiations between the banks and the debtor countries, the banks are to be presented with a "menu of options" of debt reduction mechanisms. The banks will be free to choose one of these, but they may decide to hold on to the existing debt (perhaps with some commitment to make new loans) in the belief that they will be repaid eventually.

To encourage the banks to accept debt reduction rather than hold their debt, the IMF and the World Bank are called upon to help finance the guarantees, either by providing collateral on the reduced value of the debt or by giving debtor governments financial support to repurchase their debt directly for

[1] The Brady Plan was unveiled in a speech by Secretary Brady to the Conference on Third World Debt of the Brookings Institution and the Bretton Woods Committee, March 10, 1989, in Washington, D.C.

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cash. These international institutions have agreed to provide up to $25 billion over three years, and Japan has committed $4.5 billion.

The Treasury has avoided precise targets for debt reduction; the details are to come out of negotiations between the banks and the debtor countries, and in the course of specific market transactions. The Treasury is informally promoting four countries—Costa Rica, Mexico, the Philippines and Venezuela—as the first for early negotiations with the banks under the Brady Plan, although the Treasury has stated that any of 39 countries engaged in commercial bank debt restructurings could eventually qualify to participate. To qualify for debt reduction, the plan stipulates that debtor countries should be undertaking sound economic policies aimed at encouraging domestic savings and foreign investment and promoting the return of flight capital.

Thus, the Treasury is relying on "market" solutions, based on the "voluntary" actions of creditors, to bring about the debt reduction. "Market-based" debt reduction techniques are not new, but the extent of reduction has been limited. The promise of guarantees is intended to encourage debt reduction, but the specific terms and amount of guarantees will be crucial in determining the extent of reductions.

The Brady Plan is a first step in focusing on debt reduction as a way out of the debt crisis. Success depends on the amount of debt reduction and the structure of the negotiations to achieve it. There are reasons to doubt that the voluntary approach of the Brady Plan can deliver an adequate amount of debt reduction. Behind this doubt is the continuing debate over who will determine the allocation of burdens among the banks, the debtors, the international institutions and national governments.

II

The new U.S. focus on debt reduction is rooted in the changing U.S. interests in the developing country debt crisis. Since the early 1980s the debt crisis has actually presented U.S. policymakers with two crises: a crisis of U.S. banks, which had lent too much to the developing countries, and a crisis of the developing countries, which had borrowed too much. Until 1988 concern over the banks took precedence; in 1989 the foreign policy concerns over the deteriorating situation in the debtor countries finally came to the fore.

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TABLE I

EXPOSURE OF U.S. BANKS IN THE DEBTOR COUNTRIES

	End-1982	End-1986	End-1988
NINE MAJOR U.S. BANKS *Percentage of Bank Capital in:*			
Developing Countries	287.7 %	153.9 %	108.0 %
Latin America	176.5	110.2	83.6
ALL OTHER U.S. BANKS *Percentage of Bank Capital in:*			
Developing Countries	116.0 %	55.0 %	32.2 %
Latin America	78.6	39.7	21.8
TOTAL BANK CAPITAL *(in billions of dollars)*			
Nine major banks	$29.0	$46.7	$55.8
All other U.S. banks	41.6	69.4	79.8

Source: Federal Financial Institutions Examination Council, "Country Exposure Lending Survey," April 25, 1983, April 24, 1987, and April 12, 1989.

The shift in concern can be easily explained. The emergence of the debt crisis in 1982 put the nine major U.S. banks at profound risk. Having followed the optimistic dictum of Citicorp's former chairman, Walter Wriston, that countries never go bankrupt, the banks had lent freely. In the 1970s they had earned huge overseas profits on their foreign loans. By the end of 1982 they had lent 176.5 percent of bank capital to Latin America alone, and 287.7 percent of bank capital to all developing countries (See Table I).

When the debt crisis hit in 1982, debt reduction as a response to the crisis was not considered. If even a third of the claims on developing countries went bad, many major U.S. banks would have been insolvent. Thus, Treasury policies were aimed at keeping the pressure on the debtor countries to continue servicing the debt. The developing countries squeezed their economies sharply to meet the interest bills. Latin America alone paid about $25 billion more in interest and principal each year than it received in new loans, which slowed to a trickle.

In 1985 the Baker Plan was introduced with the stated goal of reducing the net outflow from the debtor countries in order

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to spur growth in their economies. Secretary Baker called on the banks to relend $20 billion over three years to the debtor countries, through country-by-country negotiations. Since the countries owed around $80 billion in interest to the banks in those three years, the $20 billion in new loans would have reduced the net outflow by about one-fourth. In the end the banks even failed to deliver on the $20 billion. The Baker Plan is therefore viewed as a failure, but it benefited the banks by providing a political context to press the debtor countries to keep paying the interest.

Between 1982 and 1988, therefore, the banks received most of the interest due on the old debt, while also cutting back decisively on new lending to the debtor countries. At the same time the banks raised new capital. In this way the banks sharply reduced their risks from the developing countries' debts. By the end of 1988 the exposure of the major banks in Latin America had fallen to just 83.6 percent of capital—still high, but low enough to put the banks out of danger of insolvency.[2] This was an important precondition to any change in policy.

At least since 1985 market participants have doubted that the debts would actually be repaid in full, contrary to the official optimism of the Baker Plan. For that reason, the debts have actively traded on a secondary market at a large and growing discount. Table II shows the value of the larger countries' debts in this market as of February 1989, on the eve of the Brady Plan. Note that the total medium- and long-term bank debt amounted to a face value of $279.4 billion, with a secondary market value of only $96.7 billion, or an average market price of just 35 cents per dollar of debt.[3]

The stock market values of those commercial banks holding the developing countries' debts are also deeply discounted, in line with the secondary market prices of the debt. For example, the stock market seems to value Citicorp as if each $1 of its claims on Mexico were actually worth about $0.40, i.e., the

[2] The chairman of the Federal Deposit Insurance Corporation, William Seidman, made this point clearly in testimony to the U.S. House of Representatives Committee on Banking, Finance and Urban Affairs in January 1989: "Even in what surely could be considered a worst-case scenario, each of the nine money-center banks could write off 100 percent of their outstanding loans to these six [largest debtor] countries and, on an after-tax basis, each of these banks would remain solvent."

[3] The focus of the Brady Plan, and the focus of this article, is on the middle- and long-term debt owed by *sovereign borrowers* (i.e., by the public sectors of the debtor countries) to the commercial banks. Debt owed to the banks that is already guaranteed by creditor governments (e.g., U.S. bank loans guaranteed by the Exim Bank) is excluded.

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TABLE II

OUTSTANDING DEBT OF SELECTED COUNTRIES
(in billions of dollars)[1]

Country	*Debt* (billion $)	*Market Value* (billion $)	*Market Price* (% of face value)
Argentina	$33.6	$6.3	19 %
Bolivia	.9	.1	10
Brazil	62.2	21.0	34
Chile	11.2	6.6	61
Costa Rica	1.5	.2	14
Ecuador	5.5	.8	14
Mexico	63.8	24.1	38
Nigeria	11.5	2.4	21
Philippines	10.5	4.8	46
Poland	12.3	4.9	40
Venezuela	22.6	8.2	37
Total for 39 Eligible Countries	279.4	96.7	35

Source: Total debt, from World Bank Debt Tables (with adjustments made to eliminate debt already guaranteed by export credit agencies). Market price of debt, percent offer price in secondary market, Salomon Brothers, February 1989; and Merrill Lynch Capital Markets, April 1989 (for Poland).
[1] Debt and market value rounded to nearest hundred million; market price to nearest percent.

price of the debt in the secondary market. This fact is very significant. It suggests that if Citicorp were to sell $1 of Mexican debt at the price of $0.40, the stock market value of the bank would remain unchanged, even though the bank would report a $0.60 book loss on the transaction. Thus, the banks can now afford to accept large losses on their portfolios without further reducing the banks' market value.

As for the debtor countries, many have fallen into the deepest economic crisis in their histories. Between 1981 and 1988 real per capita income declined in absolute terms in almost every country in South America. Many countries' living standards have fallen to levels of the 1950s and 1960s. Real wages in Mexico declined by about 50 percent between 1980 and 1988. A decade of development has been wiped out throughout the debtor world. The crisis of confidence has led to a collapse of investment, which will create a legacy of hardships in the 1990s.

Unprecedented inflation is raging in Brazil (934 percent inflation in 1988), in Argentina and Peru (annual inflation rates in both reached several thousand percent in spring 1989) and elsewhere. The region is rife with political instability, with

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a sharp shift toward support for populist politicians. The explosive situation in Latin America was registered most dramatically in February 1989, when Venezuelans rioted in Caracas and other major cities, in protest against austerity measures prompted by Venezuela's debt crisis. In the course of a few days an estimated 300 people died. This was particularly shocking since Venezuela had long been regarded as one of the most stable Latin American democracies.

U.S. interests are engaged throughout the debtor world. The bankers view the crisis mainly in terms of the six largest debtors—Argentina, Brazil, Chile, Mexico, the Philippines and Venezuela—which together account for about 75 percent of the U.S. money-center banks' exposure in the developing world. But U.S. interests arising from debts are actively engaged not only in Latin America and the Philippines, but in Eastern Europe and sub-Saharan Africa as well.

III

The Brady Plan carries forward two key precepts of its predecessor, the Baker Plan. First, it calls for the debt problem to be handled on a case-by-case basis, in which each debtor country negotiates separately with its creditor. Second, it envisions that any easing of the terms of the debt must be linked to economic reforms under the supervision of the IMF and the World Bank. The Brady Plan diverges from the Baker Plan, of course, in its stress on the need for debt reduction.

The Baker Treasury had raised two objections to debt reduction. First, it maintained that debt reduction would slow the return of the debtor countries to creditworthiness, because banks would be unwilling to lend to countries that had failed to repay their debts. Second, stretching out the debt repayments was deemed sufficient to restore prosperity. Opposition to debt reduction came not only from the Treasury but from the banks, given the continuing weakness of their balance sheets.

The Brady Treasury has now rejected these arguments. It has recognized that when a debt burden is too high to be repaid, it must be reduced before creditworthiness can be regained. The Brady Treasury has also recognized that a further stretching out of the debt payments without debt reduction is unlikely to restore prosperity, because of the continuing crisis engendered by the large stock of bad debt.

As for the debt itself, the Treasury has pointed to several

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ways to reduce it: buybacks, conversion of debts into bonds with lower principal or interest, and exchanging debt for equity in the debtor countries.

In a buyback, the debtor country uses cash reserves (either its own, or money borrowed from the IMF or World Bank) to repurchase some of its debt from its creditor banks, but at a deeply discounted price. For example, as noted, Mexican debt now sells for about $0.40 per $1 of debt. At this price, Mexico can purchase $2.50 of debt for $1 of cash. By borrowing $1 from the World Bank for this purpose, Mexico would be able to reduce its *net debt* by $1.50 (the bank debt falls by $2.50, the World Bank debt rises by $1).

Another way to achieve debt reduction is through a debt conversion, in which some of the existing debt is converted into a new asset. For example, the banks and Mexico might agree to convert some of its existing debt, which carries a floating market interest rate (approximately 11 percent as of May 1989), into a new debt that carries a fixed below-market interest rate, say five percent, with some or all of the future interest payments guaranteed. Thus, the new asset would have a lower contractual debt service burden. It would be made safer than the original debt by backing it with guarantees or collateral.

The guarantees could be arranged in a number of ways. For example, the World Bank could lend Mexico money to purchase various assets to deposit in escrow as collateral on the new bonds. Alternatively, Mexico could create a mechanism to pledge future oil earnings against the payments of interest.

The third debt reduction mechanism suggested by the Treasury is a debt-equity swap. The debtor government repurchases existing bank debt using local currency, which must then be used by the seller to make a foreign direct investment in the debtor country. The seller may be a creditor bank, or a company that purchases the debt from a bank and then sells the debt to the debtor country's central bank. Typically, the foreign investor acquires the bank debt at its secondary market price, but then sells it to the central bank at a much higher price, albeit one that is paid in local currency.

Debt-equity swaps evidently reduce the amount of outstanding bank debt, but they risk causing tremendous disruptions in the debtor countries. The problem is that the direct repurchase of debt for local currency represents an increase in the money supply, and thereby induces a rise in inflation. Typically, the

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debtor government will offset the monetary effects of the transaction by selling a bond in the local financial market to soak up the money supply increase. In effect, the government rids itself of its external bank debt by increasing its domestic debt. The bank debt is reduced, but the overall debt is not. And since the local debts carry much higher interest rates, the overall interest payments will tend to rise, not fall, after the debt-equity swap. For these reasons, several debtor countries have suspended their debt-equity programs, though other countries continue with them because of pressure from the banks, lobbying by local firms that benefit from the swaps and misguided advocacy by the U.S. Treasury.

IV

While the Brady Plan enunciated some general suggestions for debt reduction operations, the Treasury is relying on market transactions between debtor countries and the creditor banks to achieve the debt reduction. In the Treasury's view, significant debt reduction can occur without a guiding hand. This optimism is questionable in view of the slow progress in voluntary debt reduction to date.[4]

Two factors introduced by the Brady Plan were intended to tilt the balance toward rapid debt reduction. First is the financing that official institutions are to provide for some of the debt reduction transactions. Second, the Brady Plan asked the banks to amend the terms of their loan agreements through waivers to permit the rapid introduction of new debt reduction mechanisms.[5] The banks have balked at unilaterally amending their agreements in order to expedite debt reduction operations.

It appears that the Treasury has miscalculated the chances for significant debt reduction in the current negotiating framework. This is not because the banks dispute the inevitability of losses on the debt—most do not—but because the negotiating framework gives too great an opening for each individual bank

[4] The banks assert that extensive voluntary debt reduction is already under way, and point to "more than $26 billion" of voluntary debt reduction in a recent report of the Institute for International Finance. The vast bulk of this amount is private-sector conversions (roughly $8 billion) and debt-equity swaps and local conversions (about $16 billion), versus only about $2 billion of debt buybacks and exit bonds for public-sector debt, where the real debt crisis lies.

[5] In particular, various technical clauses in the contracts (e.g., the sharing clause) prevent the debtor country from making unequal payments to particular creditor banks. This clause rules out a buyback of debt from a particular bank, for example, because that bank would be receiving a repayment of debt that is not received by the other banks. The Treasury has asked the banks to waive these clauses voluntarily in order to expedite the debt reduction process.

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to hold out, hoping that somebody else (other banks, the IMF, Japan, etc.) will bear the inevitable losses. The Brady Plan does not ask the banks to do anything specific (except to agree to waivers in the loan agreement). Thus, each bank can readily endorse the Brady Plan in the abstract without conceding anything concrete.

Moreover, there is an inherent limitation to any voluntary scheme: participation in the new plan must be no worse for the banks than sticking with the original claim. But an obvious paradox arises. If the debt reduction is deep enough that creditworthiness is truly restored, then *all* of the claims on the debtor, even the "holdout" debt not involved in the debt reduction plan, will rise in value to face value (i.e., to close to 100 cents on the dollar in the secondary market). Therefore, if a voluntary scheme appears likely to work, banks will decide to hold out until creditworthiness is restored, and the goal of debt reduction will not be achieved after all.

This difficulty is often called the "free rider" problem; it is very real and very serious. A senior executive at a money-center bank told me recently: "Mexico will get its debt reduction. We're not going to give it, but we're sure that other banks will." Even aside from the unfairness of this view (why should one bank escape from the burden of debt reduction that is accepted by other creditors), the analysis is probably wrong. Just as the one bank will not participate, other banks will follow the same logic and fail to participate in the "voluntary" scheme. Some money-center banks are privately pressing for a comprehensive approach to the debt negotiations; they express a willingness to engage in deep debt reduction, but only if their corporate competitors do likewise.

Other banks argue that they should be allowed to make new loans while some banks accept debt reduction, but new lending is in practice just a disguised form of free-riding. The bank lending new money does not reduce the value of its original claim, and will also insist on full repayment of the new loan.

Another problem is that the major commercial banks see an advantage in waiting for further bailouts from the official creditor community. For example, they may expect to benefit if Mexico can attract new loans or grants from the official creditors that can be used to make debt service payments. In this case, the banks' optimism would not be misplaced: the IMF, the World Bank and increasingly the Japanese government

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have acted in recent years to supply some of the money needed by the debtor countries to meet interest payments to the banks.

The large U.S. banks are especially resistant to debt reduction operations for two basic reasons. First, even though debt reductions should raise market values of bank stock, they generally require book losses, because the banks are holding the vast proportion of the debt on their books at the original face value.[6] Since capital adequacy standards are based on book values, many banks are loath to report book losses even for the sake of market gains.[7] Second, the large banks have better access to debt-equity swaps than do the smaller banks; these swaps offer the large banks a less costly way of divesting debt, though the swaps increase debtor countries' overall debt.

In sum, sufficient debt reduction will likely be unachievable through a decentralized, "voluntary" process.

V

How then should the Brady Plan be elaborated in order to overcome these problems?

The Treasury must emphasize the need for concerted participation of the banks in debt reduction, with no free riders. All banks should accept an equivalent reduction of their debt, although they may choose among methods of participation, e.g., buybacks or debt conversions. But perhaps the simplest mechanism would be to cut the interest charged on the debt to a fixed level below market rates, combined with official guarantees on part or all of the payments. This mechanism is ideal for achieving a comprehensive settlement: it is administratively straightforward, is equitable in its impact across banks, and avoids the adverse consequences of debt-equity swaps. It may even obviate the need for large, immediate writedowns of capital, because under U.S. banking regulations a debt restructuring that preserves principal but reduces interest rates does not in general require a capital writedown.

Achieving a comprehensive cut in interest rates to submarket levels would require several steps on the part of the official creditor community (especially the IMF and World Bank) to shift the negotiating framework. All of the needed

[6] Consider a bank that holds Mexican debt on the books at full face value, with the market value at $0.40 per dollar of debt. If the bank sells the debt for $0.45, it makes a profit in market values of $0.05, but might have to report a book loss of $0.55.

[7] This could easily be handled, however, through appropriate regulatory policies, such as requiring the banks to hold the debt on their books at true market value.

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steps are within the mandate of the international institutions. All could be carried out in a case-by-case manner, conditioned on prior economic reforms in the participating country.

The first step would be an explicit recognition by the IMF and the World Bank that the debt burden of a particular country should be reduced. IMF and World Bank programs would then be designed with the necessary amounts of debt reduction in mind. The extent of austerity called for by the IMF, for example, would be lessened as the IMF explicitly recognized that some of the debt service burden of the country would be reduced rather than paid.

The targeted amounts of debt reduction would be based on a professional assessment of the country's budgetary and balance-of-payments prospects, and would take into account the price of the debt on the secondary market, the extent of economic decline or collapse in the country in recent years, and so on. The IMF and World Bank would provide guarantees for the banks that participate in the debt reduction process.

The key step would come next: gaining sufficient participation by the banks. The IMF and the World Bank would have to establish as a matter of official policy that the banks should share equally in the debt reduction. They would insist that a "critical mass" of banks holding, say, 80 percent of the debt participate in the debt reduction package before IMF and World Bank funds would be made available to provide guarantees to the participating banks.

Furthermore, the IMF and World Bank should enter into other lending programs to the debtors without tying them to completion of the debtor-bank negotiations. To date, debtors have generally been unable to obtain new IMF programs until they agreed with the banks on a future schedule of debt service payments. This in effect has given the banks veto power over IMF programs. With the banks insisting on full payments, the country would either have to pay or find itself without access to official lending. This is the precise sense in which the IMF has acted as a "bill collector" for the commercial banks: IMF lending has been conditioned on meeting the banks' demands for full repayment. If the country dared to sacrifice its IMF program, it generally lost access to financial support from the Paris Club, official export credits, World Bank loans and so forth.

In an important shift, the Brady Treasury recently recognized the stranglehold that the banks have held over the IMF.

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In his March speech, Secretary Brady called for greater IMF flexibility in making disbursements to countries even before final agreements are reached between the banks and the debtor country. But he was ambiguous about how the IMF should respond to arrearages (nonpayment of debt service due) by the debtor countries should the commercial banks balk at providing debt reduction.

It may be necessary for the IMF and World Bank to take the extra step of tolerating debtors' arrearages to the commercial banks at two crucial points in the negotiating process. Tolerating arrearages means that the official creditor community (the IMF, the World Bank, the multilateral development banks, the Paris Club, the official export credit agencies) would continue normal relations with debtors despite their arrears to the commercial banks. The official creditors would tolerate the arrears of cash-strapped debtors, first, if it proved difficult to assemble the critical mass of banks to participate in the needed debt reduction. Second, official creditors should continue to tolerate debtors' arrearages to any recalcitrant banks which refuse to join in the agreed package once the critical mass has been reached. Such a policy would isolate the holdout banks, and undermine free riding: banks that fail to participate in debt reduction would not get paid.

VI

How much debt reduction is needed, and what will it cost? This depends on (1) the terms on which the debts will be reduced and (2) which debtor countries participate.

The general goal is that debt reduction be sufficient to enable the debtor to pay the remaining debt service routinely and to resume growth. Some Bush Administration officials have suggested an average reduction of 20 percent for eligible debtors, but this amount would not come close to meeting the above goal.

As the Brady Plan suggests, the targets for specific countries should be set by a case-by-case approach after a detailed analysis of the medium-term economic and political prospects of the eligible country. The professional staffs of the IMF and the World Bank are qualified to give guidance on this question, though they should pay much more attention than they have to the simple truth that debt servicing capacity depends on political stability as well as economic factors.

As a starting point, they should use evidence of the secondary

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market value of the debt to judge how much the debt should be reduced. Roughly speaking, the market expects that a country with a debt selling at 40 percent of face value will be able to repay only 40 percent of the outstanding debt. If the debt burden were to be reduced in line with the current secondary market price, the country would have good prospects of full debt servicing thereafter. In fact, the debt need not be reduced this much: the secondary market value of the debt likely *understates* the long-term debt servicing capacity of the country, since it reflects all of the uncertainties and costs of the debt strategy that have been followed until now. For this reason the banks should receive something more than the secondary market price in return for their full participation.

I would propose as a basic guideline that the banks receive (in the present value of repayments) a 20-percent premium over the secondary market price as of some reference date, e.g., February 1989.[8] This number could then be adjusted upward or downward based on the medium-term economic scenario elaborated by the IMF and the World Bank, operating in consultation with economists in the debtor countries and the creditor banks. On this basis, Mexico's debt burden would be reduced to around 45 percent of the current face value.

What debtor countries should participate in debt reduction? There are 39 countries that have been identified as candidates by the Brady Plan; their foreign commercial bank debt totals $279.4 billion, with a secondary market price (as of February 1989) of $96.7 billion. But only a small fraction of these 39 countries would qualify immediately for a debt reduction program, namely, those countries that have undertaken sound, internationally supervised adjustment programs. As of mid-1989 this list would include, among others: Bolivia, Chile, Costa Rica, Ecuador, Mexico, the Philippines and Venezuela. It would not include Argentina or Brazil, which have both failed to make significant progress on economic reform programs.

Therefore, debt reduction should be first undertaken for the handful of qualifying countries. It is important that adequate reductions be made in these countries' debt. The funding already pledged by the IMF, the World Bank and Japan, totaling

[8] To the extent that the secondary market is used as one guideline to set the target for debt reduction, a past reference date for the prices should be chosen to eliminate the incentive for a debtor country to drive down its market price artificially.

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$29.5 billion, should be targeted to finance adequate reductions and guarantees for the currently eligible countries. Only if these test cases receive sufficient reduction of their debt burden will the plan succeed, and thereby gain the political support necessary for creditor governments to pledge additional resources for the reduction of other countries' debt as they qualify for it.

VII

What is the cost of financing debt reduction? Even though debt reduction will proceed on a country-by-country basis, it is useful to look at the overall cost of financing the program.

After a critical mass of the banks accept the package and after the debtor country is certified to be undertaking a comprehensive program of economic reform under the supervision of the IMF and the World Bank, the reduced interest rates would then be guaranteed. These guarantees would be provided by a special guarantee fund set up in the IMF and the World Bank. The principal would not be reduced, but would be rescheduled for 30 years and also guaranteed by this fund.

The key operation of the guarantee fund is to pay the reduced interest to the banks in the event that the debtor country cannot or does not meet even the reduced amount of debt servicing. Thus, the ultimate backers of the guarantee (e.g., the creditor governments) assume only a partial and contingent burden; they bear some of the cost only if the country does not meet its reduced debt repayment schedule.

Fortunately, even if the official community provides comprehensive debt reduction for all of the eligible debtor countries, only very modest new budgetary outlays will be required from the creditor governments. This is because numerous other sources of financing are available.

Let us assume that the present value of the debt service of the 39 eligible countries is reduced to market value ($96.7 billion) plus a 20-percent premium. The total required to guarantee the interest and principal would be $116 billion. One way of funding this is illustrated below.

The first tranche could be provided by the banks out of the 20-percent premium that they earn over the market price. About half of the premium, $9.67 billion, would be deposited into an insurance fund at the IMF and World Bank to provide a portion of the guarantees. The banks would receive their pro-rated share of any funds remaining in the insurance fund

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after ten or 15 years. The other half of the premium would be kept as current income by the banks.

The proposed guarantee fund would then have to cover the remaining $106 billion. A formula for a full funding of the guarantee fund would result from detailed negotiations. Of the $106 billion required, about 60 percent could come from funding sources already in existence and other sources that would not require appropriations by the creditor governments. Furthermore, $106 billion is the maximal cost if all 39 countries participate and then completely default. A breakdown of this magnitude is extraordinarily unlikely. Also, as interest is repaid over time, the amounts needed in the fund would decline.

Among the possible sources for the $106 billion are:

—World Bank and IMF resources ($41 billion, including the $25 billion already suggested under the Brady Plan);

—Contributions from the debtor countries themselves, including: gold reserves, or the pledge of future export earnings as collateral for future interest payments ($25 billion);

—Paid-in and callable capital from the creditor governments ($40 billion).

One key source of guarantees should be pledges by the debtor countries of future export earnings as collateral for future interest payments. Ecuador already has extensive experience with collateralizing interest payments with future oil earnings, in the form of a special "oil facility" with the commercial banks that was operative in 1986–87. Mexico and Venezuela could also pledge future oil earnings, and other countries could pledge earnings of other major exports. A reasonable estimate of the funding available from these sources is approximately $2.5 billion a year, or $25 billion in present value.

Only one-third of the guarantee fund ($40 billion) would require new authorizations by creditor governments, and only a fraction of that would require new appropriations. I propose that the paid-in capital from the Group of Seven industrialized countries be ten percent, or $4 billion, with the rest callable, and that the U.S. share of the paid-in capital be $1 billion. The total U.S. guarantee, therefore, would be $10 billion. The paid-in proportion ($1 billion) could be appropriated over several years, and so would amount to a tiny fraction of any one year's foreign aid budget. Of course, the actual U.S. contribution would rise in the event of massive defaults by the

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debtor countries on their reduced payments. But even an extraordinary 30-percent loss would mean a U.S. liability of $3 billion, a trivial sum assuming that the losses are distributed over many years. For comparison, this is a tiny fraction of the taxpayer obligations under the current crisis of domestic savings and loan institutions.

The Brady proposal has been attacked for recommending any use of taxpayer dollars to support debt reduction operations. As just seen, the amounts likely to be involved are in fact very small. But, in addition, this criticism ignores the fact that the taxpayer was put at much greater risk under the Baker Plan strategy. Under that plan the debtor countries were obliged to meet their full interest payments. Since such payments were beyond the capacity of the countries, and since the banks were unwilling to ease the cash-flow burden through much new lending, it fell on the official (institutional or governmental) creditors to lend the countries the money they needed to pay their interest bill.

Analyzed in this way, the taxpayer stands to benefit significantly if the commercial banks recognize some losses on the debts. Using IMF and World Bank money to support debt reduction will be much safer than simply using the same money to lend to debtors so they can pay the banks' current interest bill. The guarantees will be safer the deeper the debt reduction; the smaller the remaining debt, the more likely it is that the debtor will be able to service it without drawing on the guarantees.

VIII

Debt reduction is a necessary condition for renewed economic growth in the debtor world, but it is surely not a sufficient condition. Without appropriate economic reform measures, most debtor economies would remain in difficulty even after a substantial reduction of debt. Thus, it is essential for the debtor countries to use the opportunity of debt reduction to make fundamental adjustments. Also, the protection of official funds requires that guarantees be conditioned on sound economic policies.

It is sometimes suggested that debt reduction would remove the pressure for economic reforms. This argument is dubious. The economic instability caused by the debt crisis itself is a much greater barrier to economic reform. In Latin America reformers are finding themselves vulnerable to sharp political

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attacks by populists, who charge that economic reforms are simply a way to squeeze the domestic population in order to transfer funds to the foreign banks. In the absence of debt reduction, that charge is both accurate and politically potent.[9]

Seen in this way, the failure in recent years of IMF conditionality to "enforce" good policies is a reflection of the debt management strategy. Noncompliance with IMF programs has grown in recent years, largely because the programs have sought to impose austerity measures aimed at enabling the country to make politically unacceptable levels of debt service payments. If IMF conditionality were to be based on realistic amounts of debt servicing, IMF reform programs would be honored with much greater frequency.

There are many important and complex issues regarding the contents of "economic reform" programs. The basic orientation of IMF and World Bank programs appears to have considerable merit, based on the record of comparative economic performance in the developing world.[10] The IMF properly stresses the need for fiscal discipline, which is the *sine qua non* of overall macroeconomic stability. The World Bank properly stresses the need for an outward-oriented trade regime, the importance of which is most vividly illustrated by the success of the exporters in East Asia, compared with the inward-looking regimes in Latin America. But both institutions have found that their message gets lost in the political firestorm that breaks out when excessive debt payments overwhelm the domestic economy.

One underemphasized area for reform is the striking inequalities in Latin American societies, in which the top 20 percent of the population in some countries earn as much as 30 times the incomes of the bottom 20 percent. The vast inequalities have played a large role in the onset of the crisis, and help to explain the attractiveness of populism, the widespread unpopularity of private enterprise, and resentment at the wealthy elite's avoidance of their share of taxation. Future

[9] To date, the better a country performs, the less it needs emergency loans and the more resource transfers it must make to the rest of the world. "Good behavior" thereby results in larger net debt servicing. The result is that economic reform has come to be viewed within the debtor countries as something that is done for the sake of foreign creditors, rather than for the sake of the debtor country itself. This adverse incentive effect can be overcome only by reducing the debt that is due, so that more of the benefits of economic reform accrue to the country itself.

[10] For a cross-country comparison of economic performance, see Jeffrey D. Sachs, ed., *Developing Country Debt and the World Economy*, Chicago: University of Chicago Press, 1989.

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IMF and World Bank programs should give greater care that the spending, tax and trade measures that they represent help to narrow the profound income gaps in the region.

IX

The Brady Plan will soon arrive at a crossroads. The Treasury will have to choose between the easy path of overseeing a small amount of debt reduction, and the much harder path of active engagement to achieve the deep debt reduction needed to solve the crisis. The market alone will not achieve the necessary extent of debt reduction. The official creditor community must now be prepared to help design meaningful and comprehensive deals between the banks and the debtor countries.

The cost of half-measures will be very high, not only for the taxpayers who will pick up a greater bill in the end, but for the 800 million people now living in economic turmoil in debt-distressed economies. Under the Baker Plan, the Reagan Administration temporized for four years while the banks escaped from the crisis. The Brady Plan has now reawakened the hopes of the debtor nations around the world. More years of temporizing would burst those hopes, with sorrowful and harrowing consequences.

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