The Heritage Foundation Backgrounder

No. 699 | The Heritage Foundation 214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202) 546-4400

The Center for International Economic Growth

April 10, 1989

REDUCING THIRD WORLD DEBT: PRIVATE VS. PUBLIC STRATEGIES

INTRODUCTION

Treasury Secretary Nicholas Brady announced a plan early last month to deal with the debt situation in less developed countries (LDCs). Riots in Venezuela, strikes and hyperinflation in Brazil, military coup attempts in Argentina, and instability in the Philippines, all blamed in part on their foreign debts, seem to threaten these democracies and lend urgency to the need for debt relief. While still short on details, the Brady Plan would emphasize reducing existing debt rather than granting new loans. Further, the Plan calls for International Monetary Fund (IMF) or World Bank assets to be used to lessen the risk to creditor banks when they arrange debt reduction schemes.

While well intended, the Brady Plan does not take adequate account of the fact that creditor banks and debtor countries already have employed debt reduction techniques successfully without the intervention of the United States government or international lending agencies. The most successful is debt-equity conversion. With this technique, creditor banks sell their Third World debt to investors at a discount, which represents partial forgiveness; the investors then exchange the debt for equity shares in an enterprise in the debtor country or for local currency or bonds from the debtor country's government, to be used for local investment. Chile has made the best use of this technique. In conjunction with free market economic reforms and privatization of state enterprises, debt-equity swaps have allowed Chile to reduce its debt from $19.6 billion in 1986 to $17.7 billion today.

Restoring Confidence. Especially important is the fact that over half of these debt-equity swaps are made by Chileans anxious to invest in their own economy. In the more common practice, citizens from debtor countries have deposited hundreds of billions of dollars in foreign banks because of lack of

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

confidence in their own economies. These deposits are known as flight capital. Until confidence is restored and citizens are willing to invest in their own countries, the debt crisis will continue.

Another technique used to manage debt is exchange of debt for export goods. In effect, debtor governments repay loans or pay interest by turning over export goods – generally nontraditional ones – to creditor banks.

Still another technique, growing in importance, is the straight debt buyback. Debtor countries purchase their debt at a discount directly from creditor banks.

Doubtful New Approach. In total, these techniques and practices have reduced the foreign debt of the fifteen principal middle-income LDCs by an estimated $28 billion. While this a just a small portion of their remaining $500 billion foreign debt, it demonstrates that innovative policies can be expanded to cut the debt significantly. U.S.-backed schemes may not be necessary. It is unwise policy and poor economics for the Brady Plan to suggest that IMF or World Bank funds be used to help Western banks out of a dilemma created by the banks' own lending decisions. To be sure, the Brady Plan would push reforms. Yet given the past failures of the U.S., the IMF, and the World Bank to promote market-oriented economic reforms in debtor countries, it is doubtful that this new approach would fare better.

U.S. policy on LDC debt should not employ IMF or World Bank resources to lessen the risk of losses to creditor banks. The banks and debtors countries should continue to work out debt reduction schemes for themselves. Further, the U.S. government should draw the attention of other debtor countries to the world's most successful case of debt management, debt reduction, and economic growth – Chile. Perhaps Treasury Secretary Brady should outline in detail how debt reduction schemes can succeed in the long run only if they are accompanied by privatization of state-owned enterprises and free market economic reforms. Finally, Brady should emphasize the need for debtor governments to attract back from foreign banks the flight capital of its citizens through free market reforms that give these citizens the confidence to invest in their own countries.

TOWARD THE CURRENT DEBT CRISIS

Governments have been borrowing money, defaulting, and then reaching agreements with their creditors for centuries.[1] In the widespread Latin American defaults of the 1930s, creditors were generally bondholders. International agencies such as the International Monetary Fund and the World Bank did not exist. Therefore, private creditors and country debtors negotiated debt settlements directly. Today, the creditors are primarily the large, chiefly New York-based commercial banks, often known as money

1 See, for example, Clifford M. Lewis, "When Countries Go Broke: Debt Through the Ages," *The National Interest*, Winter 1986-1987.

center banks. International debt settlements also involve multilateral agencies and the governments of creditor countries. The relatively recent participation of these official parties in the settlement process has altered substantially the character of debt settlements. Explained economist Anna J. Schwartz, referring to U.S. policy on LDC debt throughout the 1980s:

> The strategy devised by the U.S. treats not only the debtor countries but also the creditor banks as wards of the U.S. regulators. . . .The regulators abetted the accumulation of the debt by U.S. banks, praising them for effectively recycling surplus current account funds of OPEC [Organization of Petroleum Exporting Countries]. . . .When the debt problems erupted [in 1982], the banks were not urged to reduce dividends and build loan loss reserves... [instead] the regulators orchestrated new lending by the creditor banks...the intervention of the official players has prolonged and worsened the debt problem.[2]

In response to Mexico's suspension of interest payments in August 1982, for example, the U.S. Treasury Department and the Federal Reserve Board, in conjunction with the multilateral Bank for International Settlements, moved quickly to provide a $1.85 billion emergency bridge loan. In addition, the U.S. provided $1 billion in food aid and another $1 billion in prepayment for Mexican oil. Washington also helped to secure for Mexico a $3.6 billion IMF loan and a $5 billion loan from Mexico's foreign creditor banks.

The Baker and Bradley Plans

In October 1985, then Treasury Secretary James A. Baker sought more funds for debtor countries from creditor banks, the IMF, and the World Bank in exchange for free market economic reforms in debtor countries. This so-called Baker Plan assumed that LDCs would grow their way out of debt. The following summer, Senator Bill Bradley, the New Jersey Democrat, proposed a very different approach, whereby debtors, creditor banks, the multilateral financial institutions, and Western governments would sit down annually and negotiate debt relief in return for free market economic reforms in debtor countries.

Both the Baker and Bradley Plans correctly recognized that only market-oriented structural reforms would spur economic recovery and sustained growth. But neither plan had a mechanism to enforce free market economic reforms in exchange for new assistance. Despite Baker's plea, U.S. commercial banks volunteered little new money. The World Bank and IMF then drastically increased their lending to the heavily indebted LDCs –

2 "International Debts: What's Fact and What's Fiction," address to the Western Economic Association, July 2, 1988; published in *Economic Inquiry*, January 1989, pp. 1-19.

reformers and nonreformers alike. The Baker Plan's heavy reliance on piling new loans on top of old ones was in effect "throwing good money after bad." It meant that countries would have still higher interest payments on even more debt in the future.

As for the Bradley Plan, despite the Senator's claim that debt relief would be negotiated on a case-by-case basis, relief across-the-board would probably be the result of annual conferences that included hundreds of banks and some 50 countries. Such relief would not provide incentives for debtors to introduce market-oriented reform programs.

Capital Flight

The pervasive practice of debtor country citizens of depositing huge amounts of capital in overseas banks always has indicated the futility of marshaling foreign assistance funds to deal with the debt crisis. Indeed, capital flight is a cause of the debt and development crisis. The Morgan Guaranty Trust Company estimates that flight capital assets of the fifteen most seriously indebted countries totaled $295 billion in 1987, a full 60 percent of these countries' total debt of around $500 billion.[3] During recent hearings, Treasury Under Secretary-designate David C. Mulford agreed with Texas Republican Senator Phil Gramm's observation that capital flight and the debt problem are a result of the lack of confidence of debtor country citizens in their own governments and economies. Gramm noted that these citizens were, in effect, using "the U.S. as a sort of enterprise zone to park their capital."[4]

DEBT-EQUITY SWAPS

While the Reagan Administration sought to deal with the debt crisis through new lending, from the mid-1980s other methods were being tried by bankers and debtor countries. The most successful so far has involved conversion of debt into equity shares of enterprises in the debtor country.

In a typical debt-equity swap, a U.S. bank, anxious to avoid a debtor default or tedious periodical rescheduling negotiations, sells the debt at a discount, say for 50 cents for each dollar of debt, to a business wishing to make a new investment or expand its existing operations in the debtor country. The investor presents the purchased debt to the debtor country's government for redemption in government stock holdings in some local enterprise or in local currency to be used for investment purposes. The U.S. bank avoids the possible loss of its entire investment. The business makes an investment,

3 "LDC Debt Reduction: A Critical Appraisal," in Morgan Guaranty Trust Company, *World Financial Markets*, December 30, 1988, p. 9.
4 From the March 16, 1989, hearing of the Senate Banking Committee, Subcommittee on International Finance and Monetary Policy.

obtaining equity in an enterprise in the debtor country, and the debtor government retires some of its external debt at a discount.

Chile's Success. Chile sets the standard for debt conversion programs. Since May 1985, Chapter 18 of Chile's foreign exchange regulations has permitted Chilean nationals to purchase the nation's external debt and convert it into pesos – so-called debt-for-local-currency swaps. Chapter 19 also permits foreigners to convert Chilean foreign debt into equity investments with approval of Chile's Central Bank.

To avoid inflation, which can occur if governments simply print the local currency required to pay investors under the debt-equity programs, Chile redeems most of its debt by issuing tradeable government securities to the investor. The companies then sell the bonds in Chile's capital market to obtain cash needed for investments. In this way the Chilean government "sterilizes" the debt-equity swap process against inflation by not increasing its money supply.

Through its debt-equity conversion program, Chile retired approximately $5.5 billion of foreign debt by the end of 1988, reducing its outstanding debt to foreign commercial banks by 25 percent and its debt outstanding to all foreign creditors by 10 percent. Total Chilean debt dropped to $17.7 billion from a 1986 peak of $19.6 billion. The net reduction is only $2 billion, rather than $5.5 billion, because Chile's new borrowing abroad has been $3.6 billion since 1985.

Pro-Growth Policies. Johns Hopkins University economist Steve Hanke notes that swaps by Chileans wishing to invest in their own economy accounted for about 60 percent of the 1986 swaps, with foreign investors' swaps accounting for the other 40 percent.[5] Hanke estimates that about $1.4 billion of flight capital was returned to Chile from 1985 to 1986 through this mechanism. As a result of its aggressive debt swap program and pro-growth economic policies, Chile's debt service ratio, the annual debt payments as a percent of export revenue, fell to 28 percent in 1988 from 73 percent in 1982.[6]

The success of the Chilean program is due in very large part to the government's free market economic reforms that encourage investments and increase productivity. Since 1974, the government has received over $1.5

5 Steve H. Hanke, "The Anatomy of a Successful Debt Swap," in Hanke, ed., *Privatization and Development* (San Francisco: Institute for Contemporary Studies Press, 1987), p. 166.
6 Reuters dispatch from Santiago, January 11, 1989.

billion from selling state-owned industries to the private sector, often involving partial sale to these companies' workers.[7] In 1981, Chile's social security system was replaced with individual retirement accounts to which workers must contribute but which are managed by private pension companies. These private pension funds, valued at some $3 billion, or 15 percent of gross national product,[8] have provided substantial domestic capital for the Santiago stock exchange.[9]

In addition to privatization of state-owned enterprises, the Chilean government has created a favorable investment climate by cutting back public expenditures from 43.5 percent of GNP in 1972 to 24.3 percent last year. The fiscal deficit has been cut from 13 percent of GNP in 1973, the last year of Chilean President Salvador Allende's regime, to about 1 percent in 1988. The value-added tax was recently cut by 20 percent.[10] Last year's inflation rate was a manageable 12 percent – tame by Latin American standards. Chile's economy has grown by an average 5.8 percent over the past three years.

DEBT-EQUITY SWAP DISAPPOINTMENTS

Mexico. Mexico's debt-equity swap program, launched in April 1986, was suspended in November 1987 because of its inflationary impact and Mexican officials' belief that the swaps were subsidizing investments that would have been made in any event. Yet Mexico could have avoided the swaps' inflationary effect by following the Chilean example. And regardless of whether a country "purchases" its debt back with cash or tradeable securities, debt-equity swaps for privatization have absolutely no inflationary effect. Privatization of Mexico's state-owned enterprises through debt-equity swaps remains a virtually unexploited opportunity. Further, a 1988 study by the World Bank's International Finance Corporation finds that, while initial investments made through any debt-equity swap program are often those already under consideration, after the first two years new investments that would not have been made without the swap program flow into the debtor countries.

7 For example, as part of a steel company privatization, one-third of the shares were sold to 4,000 of the 6,500 employees. And when a computer services firm was privatized for $1.5 million, 114 of the 120 employees participated in the sale. See Hanke, *op. cit.*

8 Steve H. Hanke and Rolf J. Luders, "Chile's Economic Revival," a paper presented at a conference on "The Unknown Revolution: Chile's Transition to Democracy," Washington, D.C., September 16, 1988, p. 7.

9 The Chilean exchange offers one of the highest rates of return in the world. From 1975 to 1986, an index based on the Standard and Poor's 500 stocks increased from 100 to 449 and the Morgan Stanley World Index of stocks rose from 100 to 567. The index for the shares traded on Santiago's Bolsa de Valores, however, increased from 100 to 2,060 during the same period. See Hanke, "Anatomy," p. 163.

10 Hanke and Luders, *op. cit.*, pp. 7-8.

Brazil. Through formal and informal debt-equity swaps, Brazil cut its foreign debt from $121.17 billion to $114.9 billion, or 5.2 percent of the total, in 1988 alone.[11] Yet the government in Brasilia suspended the debt swap program in January of this year as part of its plan to attack its annual inflation rate of 1,000 percent, caused mainly by irresponsible fiscal and monetary policy. The government's inability to cut its deficit spending, liberalize its investment climate, privatize money-losing state enterprises, and deregulate the economy largely has offset the gains made through debt-equity swaps.

Argentina. Argentina's debt-equity swap program, launched in October 1987, has retired only about $1 billion of its $56 billion foreign debt. Indicative of Argentina's lack of commitment to sell off its wasteful state enterprises that annually account for most of the federal budget deficit, the Argentine debt-equity program cannot be used to purchase any part of a state corporation. And as is the case in Brazil, there have been no major free market economic reforms.

The Philippines. Again out of concern for the inflationary impact of printing money for debt-equity swaps, Manila's 1986 program was effectively halted in 1987 and 1988 through successive restrictions. While some $1.2 billion in swaps has been approved, bureaucratic delays have meant that only half a billion dollars in foreign debt has been converted. As its debt swap program languished, so too has Manila's privatization effort. Washington has recently pledged around $1 billion in future aid for the Philippines as part of a five-year assistance initiative by Western nations. But rather than new funds, the Philippine economy needs to cut wasteful government spending and encourage direct foreign investment, goals that can be achieved in part through a revamped privatization and debt-equity swap program.

DEBT-FOR-EXPORT SWAPS

In 1987, First Interstate Bank of Los Angeles and Midland Bank of London pioneered a plan with Peru to obtain payments on the money they had loaned to that nation. In this approach, Peruvian exporters turn products over to a commercial bank in that country, which passes the products on to a trading company representing a creditor bank for sale overseas. The creditor bank receives the receipts from the sale of the goods. The goods are paid for by the creditor bank, through its trading company, two-thirds in cash and one-third in debt notes. The commercial bank in Peru takes the payment to the country's central bank and exchanges it, cash and debt, for local currency which is passed along to the original supplier of the goods.

Such deals to date have involved only commercial bank debt involving a single creditor. Thus only the debtor nation and one creditor have to reach agreement. While American banks cannot take title to goods, trading

11*The New York Times*, December 30, 1988, p. D-3. The Brazilian government, for its part, estimates 1988 swaps at $8 billion to $9 billion. (The informal swaps are difficult to estimate.)

companies associated with them can. First Interstate, through its trading company's good contacts in Peru and the bank's 21 regional branches in the U.S., was able to find customers for the available goods. The trick, the bank claims, is to find the markets first and then buy the goods. This rather complicated process also makes up for the inability of many Peruvian businesses to market their goods overseas because of a lack of developed trading channels. First Interstate plans to cut in half its outstanding loans to Peru by 1993 through the swaps. For every $3 in sales of Peruvian goods, the Bank will recoup, on average, $1 in undiscounted debt. And London's Midland Bank, which is owed $160 million by Peru, plans to sell $22 million worth of Peruvian goods. It will keep $8.8 million in receipts and hand over to Peru $13.2 million.[12]

Creative Solutions. Chase Manhattan Bank and American Express Bank recently have worked out some debt-for-export trades with Peru. About a quarter of the exports accepted by American Express will take the form of marketable tourism packages. Chase Manhattan seeks to retire all of its unilateral Peruvian debt, which amounts to half of its total Peruvian debt, through these swaps. The potential for debt-for-export swaps is clearly limited by the logistical difficulty involved in marketing export goods. Yet this approach demonstrates that debtor countries and their creditors can work out creative debt management schemes without U.S. government, IMF, or World Bank assistance.

THE MORGAN DEBT-FOR-BONDS SWAP

Under this mechanism developed in late 1987 by the Mexican government and the Morgan Guaranty Trust Company, Mexico had hoped to use $2 billion in reserves to purchase U.S. Treasury bonds worth $10 billion at maturity in 20 years. These bonds would be offered to creditor banks for a full $20 billion in Mexican debt. As such, Mexico would be receiving a 50 percent discount on its debt.

But lackluster interest from banks resulted in bids with discounts averaging only 30 percent. Mexico spent only $500 million in hard currency reserves to buy the U.S. Treasury bonds that were to be collateral for $2.6 billion in new Mexican bonds. Creditor banks purchased these bonds in exchange for $3.7 billion of Mexico's debt. This reduced the debt only $1.1 billion. Part of the problem with the Morgan approach was that, while the principal of the new debt was secured by U.S. Treasury bonds, the interest payments that the Mexican government would have to make on such bonds, estimated at about 85 percent of the total flow of funds to holders of the new bonds, would have no collateral backing.

12 First Interstate's inventory of Peruvian goods includes copper wire, fishmeal, frozen fish, shellfish, garments, fresh asparagus, garlic, onions, and wood products. Midland's inventory includes iron pellets, fishmeal, steel balls, coffee, cotton thread, alpaca cloth, zinc and lead oxides, and copper sulfate. See "Fishmeal? That'll Do Nicely," *Euromoney*, June 1988, pp. 149-152.

Since early last year, Mexico reportedly has been trying to arrange a new version of this technique which would carry World Bank or creditor government guarantees on the interest payments. The emerging Brady Plan apparently will include World Bank or IMF guarantees in this manner.

STRAIGHT DEBT BUYBACKS

In many cases, a wise use of debtors' scarce dollar reserves is a straight debt buyback. Under such an arrangement, the debtor country offers to buy back its debt from the creditor bank at a price lower than face value; the price typically is near the actual discounted market price of the debt. This mechanism allows the debtor to capture 100 percent of the discount.

Ethical Pitfall. Straight debt buybacks were common after the widespread bond defaults of Latin governments in the 1930s. At that time, economist Henry C. Wallich noted the important ethical problem that "...arises when repurchases are made after the bonds have depreciated owing to suspension of service, for in that case the repurchasing debtor is profiting from his own default."[13] Thus, straight debt buybacks could encourage countries to default in order to repurchase their debt at a discount.

Yet, Wallich also noted a great advantage to Latin American government bond repurchases in light of the high export earnings of such countries during World War II:

> If part of the reserves that are currently being acquired [by debtor countries] are not used for repurchases now, the chances are that after the war they will be utilized for imports and not for the service of foreign debts.

Funds for Debt Repayment. Straight debt buybacks today, thus, would allow many debtor countries to divert some hard currency funds away from wasteful domestic spending or the financing of import consumption to at least partial debt repayment.

As recent examples of straight debt buybacks, Bolivia last year repurchased $240 million in foreign bank loans – not serviced since 1984 – at only 11 cents to the dollar with funds anonymously donated by foreign governments. In November, Chile spent $168 million to buy back and retire $299 million of foreign bank debt, paying an average 56 cents on the dollar.[14]

In most cases, LDCs' debt agreements with their creditor banks contain a "sharing clause," which requires that all cash payments be shared by creditors

---

13 Henry C. Wallich, "The Future of Latin American Dollar Bonds," *American Economic Review*, vol. 33, no. 2, June 1943, p. 332.

14 Interested investors bid a total of $822 million in debt, allowing the government in Santiago to be choosy and accept only the best one-third of the offers. Chile's agreement with its creditor banks allows it to buy back another $332 million ($500 million in all).

on a pro-rata basis depending on the size of each creditor's initial loans. Because of this, debtors usually require a waiver of the sharing clause from their creditor banks prior to executing straight debt buybacks, which, by definition, entail cash payments only to participating banks.

Chile had little problem last year when it sought the waiver. Its twelve-bank creditor committee approved it swiftly in April and by August Chile's 300 creditor banks had approved the agreement. While Chile's model debtor status undoubtedly facilitated the creditors' approval, there are now indications that money center banks may be softening their former insistence upon strictly sharing all cash receipts from debtors.

THE BRADY PLAN AND THE DEBT FACILITY DEBATE

Over the past few years, various parties have sought to harness the voluntary debt reduction techniques to some sort of IMF or World Bank "debt facility," buttressed with Western taxpayer funds. The some half-dozen proposals have included those of New York Democratic Congressman John LaFalce and American Express Chairman James D. Robinson III.[15] These proposals would involve guarantees by either the IMF, World Bank, or industrialized country governments on the debtor countries' interest or principal payments to commercial banks.

Recently, the money center banks, through the Institute of International Finance (IIF), a foundation that they wholly fund, supported this general approach. This Washington, D.C.-based institute warned that further voluntary debt reduction by major U.S. banks would require "credit enhancement" in the form of government or World Bank guarantees.[16]

Emphasizing Debt Relief. The plan announced this March 10 by Treasury Secretary Brady moves away from the Baker Plan's emphasis on new money for debtor countries to an emphasis on debt relief. The Brady Plan calls for IMF and World Bank assistance to back debt reduction transactions between debtor countries and their private creditor banks. For example, Brady suggests that IMF and World Bank funds might provide collateral for bonds that debtor governments would issue to their creditors and thus reduce the debt. This is similar to the Morgan approach. The IMF and World Bank funds also could be used to guarantee debtors' future interest payments in such an exchange. Funds even could be used to provide debtors with the hard currency required for straight debt buybacks.

---

15 The Omnibus Trade Bill passed by Congress last year contained a mandate, which was a weakened version of the LaFalce initiative, that the Secretary of the Treasury study the feasibility and advisability of a debt facility to purchase and restructure LDC government debt. IMF gold stock or the World Bank's uncommitted liquid assets would be used as collateral to obtain financing for the facility. Last month, the Treasury reported to Congress, advising against such a facility.

16 *The Way Forward for Middle-Income Countries* (Washington, D.C.: The Institute of International Finance, January 1989).

Treasury Under Secretary-designate David Mulford told Congress last month that no new U.S. contributions to the IMF and World Bank are anticipated for the implementation of the Brady Plan. He pointed out that the Japanese have pledged $10 billion toward the new policy, though not directly to the IMF or World Bank. Yet IMF Managing Director Michel Camdessus of France claims that his agency will need new funds, termed a "quota increase," to carry out the Brady Plan.

The Brady Plan also calls for a general waiver of the sharing clauses present in most debtor loan agreements. which require the banks to share any cash payments from debtors among themselves. Currently, debtors desiring to undertake a straight debt buyback must convince their hundreds of creditor banks to waive the clause.

THE BRADY PLAN EVALUATED

The Brady Plan is correct to move away from the Baker Plan's emphasis on new loans for debtor countries. Yet while debt reduction is preferable, the Brady Plan, aside from its vagueness, has a number of flaws.

A major problem, for instance, is that the IMF or World Bank-backed debt reduction transactions suggested by Brady and others in effect would eliminate the risk of losses for banks engaging in various debt reduction plans. Brady does not explain why the banks deserve government help that amounts to a bailout. Part of it would come from U.S. taxpayers in the form of America's contribution of 20 percent of the funds to these two international bodies. U.S. and other industrial country taxpayers did not share in the profits made earlier by these banks on their LDC loans; why then should taxpayers be burdened with the banks' losses? Indeed, U.S. money center banks registered record profits in the late 1970s and early 1980s on their Latin loans. And with the emergence of the debt crisis in 1982, these banks charged the debtor governments high up-front fees in exchange for loan rescheduling.

Prudent Banks. Further, the major banks since 1982 have covered themselves well against potential losses on their debtor country portfolios. L. William Seidman, Chairman of the Federal Deposit Insurance Corporation (FDIC), recently told the House Banking Committee:

> Since 1982, the nine money-center banks have been successful in building their primary capital to a level which would allow them to withstand any likely event in the LDC arena...[They] would continue to be solvent even if they wrote down to current secondary market levels all their exposures to the six major LDC countries. *Moreover, 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 countries and,*

on an after tax basis, each of these banks would remain solvent. (Emphasis in prepared testimony.)[17]

Similarly, Federal Reserve Board Vice Chairman Manuel Johnson told the same hearing that the average primary capital-to-assets ratio for the major money center bank today is 8.19 percent, in contrast to 4.82 percent in 1982 – and that the earnings of these banks are at high levels. These numbers indicate that most U.S. banks currently are well positioned to absorb losses on their loans to Third World countries without public assistance.

The Brady Plan suggests that all of the creditor banks waive the sharing clause in their LDC debt agreements so that debt reduction deals between individual banks and debtor countries can be facilitated. While such waivers in many cases might be desirable, this should be a matter between the banks and the debtor countries. Debtors should have to continue to negotiate with their creditor bank committees and make the case for how their conduct of economic policy merits the opportunity to buy back some of their debt.

Poor Judges. Perhaps the most troubling aspect of the Brady Plan is that it fails to get at the root of the debt crisis – the flawed economic policies of the debtor countries themselves. The U.S. Treasury, IMF, and World Bank have a questionable record in judging what sort of reforms are best for countries. The international agencies, when imposing conditions in exchange for help with LDC balance of payment problems, often have advocated policies stunting long-term economic growth. Yet growth must be the goal of U.S. policy toward less developed countries.

Follow-up and enforcement of economic reform plans are other problems the Brady Plan does not address. Under the Baker Plan, little attempt was made by the U.S. Treasury to ensure that the economic reforms pledged in exchange for new money were actually ever instituted. There is little indication that Brady will fare better than his predecessor.

RECOMMENDATIONS

The successful techniques with which some debtor countries and creditor banks have been dealing with their debt problems should prompt the Bush Administration to encourage this trend. It should not be proposing schemes, albeit well intentioned, that eliminate either the risks of transactions between debtors and their creditors or the incentives that they have to reach agreements.

The Bush Administration should:

17 L. William Seidman, testimony before the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, January 5, 1989. Seidman also noted that in 1983 the nine major U.S. banks had aggregate exposures of $61 billion to the 31 "rescheduling" LDCs – representing nearly twice the banks' aggregate primary capital of $32 billion. As of June 1988, however, the nine had outstanding debt to these countries of $55 billion – representing less than 85 percent of the banks' aggregate primary capital of $65 billion.

1) Not support the use of IMF or World Bank funds to back various debt reduction techniques.

Bankers took risks when they lent money to less developed countries originally. They take some risks in various attempts to reduce their debts. Public funds should not be used to lessen these risks. Indeed, it originally was the promise of IMF loan guarantees that encouraged many banks to make some irresponsible loans to less developed countries.

2) Highlight Chile as an example of successful debt management, debt reduction, and economic reform.

Too often debt proposals have paid too little attention to the need for those necessary market-oriented economic reforms in LDCs, for which no amount of debt reduction can ever substitute. Brazil, for example, has negated its debt swap successes with disastrous economic policies. Chile, by contrast, has reduced its debt, privatized state-owned industries, lowered inflation and government spending, and instituted other free market reforms. As part of U.S. participation in the $10 billion Western assistance initiative for the Philippines, Washington should encourage President Corazon Aquino to send a delegation to Chile to study that country's debt-equity swap and privatization programs.

3) Make a major public statement stressing that debtor countries must seek to attract the flight capital of their own citizens back to their countries through free market reforms.

Brady should focus attention on the fact that there would be no shortage of capital in less developed countries if citizens in debtor countries did not feel it necessary to place their savings in foreign banks. Estimates of capital flight range from around 50 percent to 100 percent of the value of LDC debt. Further restrictions on capital outflows by debtor countries will probably be just as ineffective in stemming capital flight as the current stringent barriers. Trying to attract flight capital by such artificial methods as driving up domestic interest rates will defeat the ultimate purpose of creating a healthy, growing economy. Brady should point out to debtor governments that only sound, market-oriented economic policies provide the incentives for citizens to keep or bring their money home.

CONCLUSION

The Brady Plan's emphasis on debt reduction rather than new loans to debtor countries is welcome. But its call for IMF or World Bank funds to lessen the risks to American and other commercial banks negotiating such reductions is a subsidy to such banks that is unfair to American taxpayers. Worse, it is a prescription of more of the same medicine that caused the debt crisis. This is especially true in light of the fact that debtor countries and creditor banks have been using various mechanisms requiring no IMF or World Bank funds to manage the debt situation successfully.

Administration Aim. Economic growth through free market reforms not only would help lift the less developed countries' debt burden but would create incentives for increasing economic growth. In the end these countries would not simply manage their debts. They would again begin to prosper and increase the standards of living of their peoples. This should be the aim of Bush Administration policies for dealing with Third World debt.

Prepared for The Heritage Foundation by
Melanie S. Tammen,
a Policy Analyst with the Competitive
Enterprise Institute, Washington, D.C.

All Heritage Foundation papers are now available electronically to subscribers of the "NEXIS" on-line data retrieval service. The Heritage Foundation's Reports (HFRPTS) can be found in the OMNI, CURRNT, NWLTRS, and GVT group files of the NEXIS library and in the GOVT and OMNI group files of the GOVNWS library.

The Heritage Foundation Backgrounder

No. 699 The Heritage Foundation · 214 Massachusetts Avenue, N.E. · Washington, D.C. 20002-4999 · (202)546-4400 · Telex:440235

The Center for International Economic Growth

April 10, 1989

REDUCING THIRD WORLD DEBT: PRIVATE VS. PUBLIC STRATEGIES

INTRODUCTION

Treasury Secretary Nicholas Brady announced a plan early last month to deal with the debt situation in less developed countries (LDCs). Riots in Venezuela, strikes and hyperinflation in Brazil, military coup attempts in Argentina, and instability in the Philippines, all blamed in part on their foreign debts, seem to threaten these democracies and lend urgency to the need for debt relief. While still short on details, the Brady Plan would emphasize reducing existing debt rather than granting new loans. Further, the Plan calls for International Monetary Fund (IMF) or World Bank assets to be used to lessen the risk to creditor banks when they arrange debt reduction schemes.

While well intended, the Brady Plan does not take adequate account of the fact that creditor banks and debtor countries already have employed debt reduction techniques successfully without the intervention of the United States government or international lending agencies. The most successful is debt-equity conversion. With this technique, creditor banks sell their Third World debt to investors at a discount, which represents partial forgiveness; the investors then exchange the debt for equity shares in an enterprise in the debtor country or for local currency or bonds from the debtor country's government, to be used for local investment. Chile has made the best use of this technique. In conjunction with free market economic reforms and privatization of state enterprises, debt-equity swaps have allowed Chile to reduce its debt from $19.6 billion in 1986 to $17.7 billion today.

Restoring Confidence. Especially important is the fact that over half of these debt-equity swaps are made by Chileans anxious to invest in their own economy. In the more common practice, citizens from debtor countries have deposited hundreds of billions of dollars in foreign banks because of lack of

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

confidence in their own economies. These deposits are known as flight capital. Until confidence is restored and citizens are willing to invest in their own countries, the debt crisis will continue.

Another technique used to manage debt is exchange of debt for export goods. In effect, debtor governments repay loans or pay interest by turning over export goods – generally nontraditional ones – to creditor banks.

Still another technique, growing in importance, is the straight debt buyback. Debtor countries purchase their debt at a discount directly from creditor banks.

Doubtful New Approach. In total, these techniques and practices have reduced the foreign debt of the fifteen principal middle-income LDCs by an estimated $28 billion. While this a just a small portion of their remaining $500 billion foreign debt, it demonstrates that innovative policies can be expanded to cut the debt significantly. U.S.-backed schemes may not be necessary. It is unwise policy and poor economics for the Brady Plan to suggest that IMF or World Bank funds be used to help Western banks out of a dilemma created by the banks' own lending decisions. To be sure, the Brady Plan would push reforms. Yet given the past failures of the U.S., the IMF, and the World Bank to promote market-oriented economic reforms in debtor countries, it is doubtful that this new approach would fare better.

U.S. policy on LDC debt should not employ IMF or World Bank resources to lessen the risk of losses to creditor banks. The banks and debtors countries should continue to work out debt reduction schemes for themselves. Further, the U.S. government should draw the attention of other debtor countries to the world's most successful case of debt management, debt reduction, and economic growth – Chile. Perhaps Treasury Secretary Brady should outline in detail how debt reduction schemes can succeed in the long run only if they are accompanied by privatization of state-owned enterprises and free market economic reforms. Finally, Brady should emphasize the need for debtor governments to attract back from foreign banks the flight capital of its citizens through free market reforms that give these citizens the confidence to invest in their own countries.

TOWARD THE CURRENT DEBT CRISIS

Governments have been borrowing money, defaulting, and then reaching agreements with their creditors for centuries.[1] In the widespread Latin American defaults of the 1930s, creditors were generally bondholders. International agencies such as the International Monetary Fund and the World Bank did not exist. Therefore, private creditors and country debtors negotiated debt settlements directly. Today, the creditors are primarily the large, chiefly New York-based commercial banks, often known as money

1 See, for example, Clifford M. Lewis, "When Countries Go Broke: Debt Through the Ages," *The National Interest*, Winter 1986-1987.

center banks. International debt settlements also involve multilateral agencies and the governments of creditor countries. The relatively recent participation of these official parties in the settlement process has altered substantially the character of debt settlements. Explained economist Anna J. Schwartz, referring to U.S. policy on LDC debt throughout the 1980s:

> The strategy devised by the U.S. treats not only the debtor countries but also the creditor banks as wards of the U.S. regulators. . . .The regulators abetted the accumulation of the debt by U.S. banks, praising them for effectively recycling surplus current account funds of OPEC [Organization of Petroleum Exporting Countries]. . . .When the debt problems erupted [in 1982], the banks were not urged to reduce dividends and build loan loss reserves... [instead] the regulators orchestrated new lending by the creditor banks...the intervention of the official players has prolonged and worsened the debt problem.[2]

In response to Mexico's suspension of interest payments in August 1982, for example, the U.S. Treasury Department and the Federal Reserve Board, in conjunction with the multilateral Bank for International Settlements, moved quickly to provide a $1.85 billion emergency bridge loan. In addition, the U.S. provided $1 billion in food aid and another $1 billion in prepayment for Mexican oil. Washington also helped to secure for Mexico a $3.6 billion IMF loan and a $5 billion loan from Mexico's foreign creditor banks.

The Baker and Bradley Plans

In October 1985, then Treasury Secretary James A. Baker sought more funds for debtor countries from creditor banks, the IMF, and the World Bank in exchange for free market economic reforms in debtor countries. This so-called Baker Plan assumed that LDCs would grow their way out of debt. The following summer, Senator Bill Bradley, the New Jersey Democrat, proposed a very different approach, whereby debtors, creditor banks, the multilateral financial institutions, and Western governments would sit down annually and negotiate debt relief in return for free market economic reforms in debtor countries.

Both the Baker and Bradley Plans correctly recognized that only market-oriented structural reforms would spur economic recovery and sustained growth. But neither plan had a mechanism to enforce free market economic reforms in exchange for new assistance. Despite Baker's plea, U.S. commercial banks volunteered little new money. The World Bank and IMF then drastically increased their lending to the heavily indebted LDCs –

2 "International Debts: What's Fact and What's Fiction," address to the Western Economic Association, July 2, 1988; published in *Economic Inquiry*, January 1989, pp. 1-19.

reformers and nonreformers alike. The Baker Plan's heavy reliance on piling new loans on top of old ones was in effect "throwing good money after bad." It meant that countries would have still higher interest payments on even more debt in the future.

As for the Bradley Plan, despite the Senator's claim that debt relief would be negotiated on a case-by-case basis, relief across-the-board would probably be the result of annual conferences that included hundreds of banks and some 50 countries. Such relief would not provide incentives for debtors to introduce market-oriented reform programs.

Capital Flight

The pervasive practice of debtor country citizens of depositing huge amounts of capital in overseas banks always has indicated the futility of marshaling foreign assistance funds to deal with the debt crisis. Indeed, capital flight is a cause of the debt and development crisis. The Morgan Guaranty Trust Company estimates that flight capital assets of the fifteen most seriously indebted countries totaled $295 billion in 1987, a full 60 percent of these countries' total debt of around $500 billion.[3] During recent hearings, Treasury Under Secretary-designate David C. Mulford agreed with Texas Republican Senator Phil Gramm's observation that capital flight and the debt problem are a result of the lack of confidence of debtor country citizens in their own governments and economies. Gramm noted that these citizens were, in effect, using "the U.S. as a sort of enterprise zone to park their capital."[4]

DEBT-EQUITY SWAPS

While the Reagan Administration sought to deal with the debt crisis through new lending, from the mid-1980s other methods were being tried by bankers and debtor countries. The most successful so far has involved conversion of debt into equity shares of enterprises in the debtor country.

In a typical debt-equity swap, a U.S. bank, anxious to avoid a debtor default or tedious periodical rescheduling negotiations, sells the debt at a discount, say for 50 cents for each dollar of debt, to a business wishing to make a new investment or expand its existing operations in the debtor country. The investor presents the purchased debt to the debtor country's government for redemption in government stock holdings in some local enterprise or in local currency to be used for investment purposes. The U.S. bank avoids the possible loss of its entire investment. The business makes an investment,

3 "LDC Debt Reduction: A Critical Appraisal," in Morgan Guaranty Trust Company, *World Financial Markets*, December 30, 1988, p. 9.
4 From the March 16, 1989, hearing of the Senate Banking Committee, Subcommittee on International Finance and Monetary Policy.

obtaining equity in an enterprise in the debtor country, and the debtor government retires some of its external debt at a discount.

Chile's Success. Chile sets the standard for debt conversion programs. Since May 1985, Chapter 18 of Chile's foreign exchange regulations has permitted Chilean nationals to purchase the nation's external debt and convert it into pesos – so-called debt-for-local-currency swaps. Chapter 19 also permits foreigners to convert Chilean foreign debt into equity investments with approval of Chile's Central Bank.

To avoid inflation, which can occur if governments simply print the local currency required to pay investors under the debt-equity programs, Chile redeems most of its debt by issuing tradeable government securities to the investor. The companies then sell the bonds in Chile's capital market to obtain cash needed for investments. In this way the Chilean government "sterilizes" the debt-equity swap process against inflation by not increasing its money supply.

Through its debt-equity conversion program, Chile retired approximately $5.5 billion of foreign debt by the end of 1988, reducing its outstanding debt to foreign commercial banks by 25 percent and its debt outstanding to all foreign creditors by 10 percent. Total Chilean debt dropped to $17.7 billion from a 1986 peak of $19.6 billion. The net reduction is only $2 billion, rather than $5.5 billion, because Chile's new borrowing abroad has been $3.6 billion since 1985.

Pro-Growth Policies. Johns Hopkins University economist Steve Hanke notes that swaps by Chileans wishing to invest in their own economy accounted for about 60 percent of the 1986 swaps, with foreign investors' swaps accounting for the other 40 percent.[5] Hanke estimates that about $1.4 billion of flight capital was returned to Chile from 1985 to 1986 through this mechanism. As a result of its aggressive debt swap program and pro-growth economic policies, Chile's debt service ratio, the annual debt payments as a percent of export revenue, fell to 28 percent in 1988 from 73 percent in 1982.[6]

The success of the Chilean program is due in very large part to the government's free market economic reforms that encourage investments and increase productivity. Since 1974, the government has received over $1.5

---

5 Steve H. Hanke, "The Anatomy of a Successful Debt Swap," in Hanke, ed., *Privatization and Development* (San Francisco: Institute for Contemporary Studies Press, 1987), p. 166.
6 Reuters dispatch from Santiago, January 11, 1989.

billion from selling state-owned industries to the private sector, often involving partial sale to these companies' workers.[7] In 1981, Chile's social security system was replaced with individual retirement accounts to which workers must contribute but which are managed by private pension companies. These private pension funds, valued at some $3 billion, or 15 percent of gross national product,[8] have provided substantial domestic capital for the Santiago stock exchange.[9]

In addition to privatization of state-owned enterprises, the Chilean government has created a favorable investment climate by cutting back public expenditures from 43.5 percent of GNP in 1972 to 24.3 percent last year. The fiscal deficit has been cut from 13 percent of GNP in 1973, the last year of Chilean President Salvador Allende's regime, to about 1 percent in 1988. The value-added tax was recently cut by 20 percent.[10] Last year's inflation rate was a manageable 12 percent – tame by Latin American standards. Chile's economy has grown by an average 5.8 percent over the past three years.

DEBT-EQUITY SWAP DISAPPOINTMENTS

Mexico. Mexico's debt-equity swap program, launched in April 1986, was suspended in November 1987 because of its inflationary impact and Mexican officials' belief that the swaps were subsidizing investments that would have been made in any event. Yet Mexico could have avoided the swaps' inflationary effect by following the Chilean example. And regardless of whether a country "purchases" its debt back with cash or tradeable securities, debt-equity swaps for privatization have absolutely no inflationary effect. Privatization of Mexico's state-owned enterprises through debt-equity swaps remains a virtually unexploited opportunity. Further, a 1988 study by the World Bank's International Finance Corporation finds that, while initial investments made through any debt-equity swap program are often those already under consideration, after the first two years new investments that would not have been made without the swap program flow into the debtor countries.

---

7 For example, as part of a steel company privatization, one-third of the shares were sold to 4,000 of the 6,500 employees. And when a computer services firm was privatized for $1.5 million, 114 of the 120 employees participated in the sale. See Hanke, *op. cit.*
8 Steve H. Hanke and Rolf J. Luders, "Chile's Economic Revival," a paper presented at a conference on "The Unknown Revolution: Chile's Transition to Democracy," Washington, D.C., September 16, 1988, p. 7.
9 The Chilean exchange offers one of the highest rates of return in the world. From 1975 to 1986, an index based on the Standard and Poor's 500 stocks increased from 100 to 449 and the Morgan Stanley World Index of stocks rose from 100 to 567. The index for the shares traded on Santiago's Bolsa de Valores, however, increased from 100 to 2,060 during the same period. See Hanke, "Anatomy," p. 163.
10 Hanke and Luders, *op. cit.*, pp. 7-8.

Brazil. Through formal and informal debt-equity swaps, Brazil cut its foreign debt from $121.17 billion to $114.9 billion, or 5.2 percent of the total, in 1988 alone.[11] Yet the government in Brasilia suspended the debt swap program in January of this year as part of its plan to attack its annual inflation rate of 1,000 percent, caused mainly by irresponsible fiscal and monetary policy. The government's inability to cut its deficit spending, liberalize its investment climate, privatize money-losing state enterprises, and deregulate the economy largely has offset the gains made through debt-equity swaps.

Argentina. Argentina's debt-equity swap program, launched in October 1987, has retired only about $1 billion of its $56 billion foreign debt. Indicative of Argentina's lack of commitment to sell off its wasteful state enterprises that annually account for most of the federal budget deficit, the Argentine debt-equity program cannot be used to purchase any part of a state corporation. And as is the case in Brazil, there have been no major free market economic reforms.

The Philippines. Again out of concern for the inflationary impact of printing money for debt-equity swaps, Manila's 1986 program was effectively halted in 1987 and 1988 through successive restrictions. While some $1.2 billion in swaps has been approved, bureaucratic delays have meant that only half a billion dollars in foreign debt has been converted. As its debt swap program languished, so too has Manila's privatization effort. Washington has recently pledged around $1 billion in future aid for the Philippines as part of a five-year assistance initiative by Western nations. But rather than new funds, the Philippine economy needs to cut wasteful government spending and encourage direct foreign investment, goals that can be achieved in part through a revamped privatization and debt-equity swap program.

DEBT-FOR-EXPORT SWAPS

In 1987, First Interstate Bank of Los Angeles and Midland Bank of London pioneered a plan with Peru to obtain payments on the money they had loaned to that nation. In this approach, Peruvian exporters turn products over to a commercial bank in that country, which passes the products on to a trading company representing a creditor bank for sale overseas. The creditor bank receives the receipts from the sale of the goods. The goods are paid for by the creditor bank, through its trading company, two-thirds in cash and one-third in debt notes. The commercial bank in Peru takes the payment to the country's central bank and exchanges it, cash and debt, for local currency which is passed along to the original supplier of the goods.

Such deals to date have involved only commercial bank debt involving a single creditor. Thus only the debtor nation and one creditor have to reach agreement. While American banks cannot take title to goods, trading

11*The New York Times*, December 30, 1988, p. D-3. The Brazilian government, for its part, estimates 1988 swaps at $8 billion to $9 billion. (The informal swaps are difficult to estimate.)

companies associated with them can. First Interstate, through its trading company's good contacts in Peru and the bank's 21 regional branches in the U.S., was able to find customers for the available goods. The trick, the bank claims, is to find the markets first and then buy the goods. This rather complicated process also makes up for the inability of many Peruvian businesses to market their goods overseas because of a lack of developed trading channels. First Interstate plans to cut in half its outstanding loans to Peru by 1993 through the swaps. For every $3 in sales of Peruvian goods, the Bank will recoup, on average, $1 in undiscounted debt. And London's Midland Bank, which is owed $160 million by Peru, plans to sell $22 million worth of Peruvian goods. It will keep $8.8 million in receipts and hand over to Peru $13.2 million.[12]

Creative Solutions. Chase Manhattan Bank and American Express Bank recently have worked out some debt-for-export trades with Peru. About a quarter of the exports accepted by American Express will take the form of marketable tourism packages. Chase Manhattan seeks to retire all of its unilateral Peruvian debt, which amounts to half of its total Peruvian debt, through these swaps. The potential for debt-for-export swaps is clearly limited by the logistical difficulty involved in marketing export goods. Yet this approach demonstrates that debtor countries and their creditors can work out creative debt management schemes without U.S. government, IMF, or World Bank assistance.

THE MORGAN DEBT-FOR-BONDS SWAP

Under this mechanism developed in late 1987 by the Mexican government and the Morgan Guaranty Trust Company, Mexico had hoped to use $2 billion in reserves to purchase U.S. Treasury bonds worth $10 billion at maturity in 20 years. These bonds would be offered to creditor banks for a full $20 billion in Mexican debt. As such, Mexico would be receiving a 50 percent discount on its debt.

But lackluster interest from banks resulted in bids with discounts averaging only 30 percent. Mexico spent only $500 million in hard currency reserves to buy the U.S. Treasury bonds that were to be collateral for $2.6 billion in new Mexican bonds. Creditor banks purchased these bonds in exchange for $3.7 billion of Mexico's debt. This reduced the debt only $1.1 billion. Part of the problem with the Morgan approach was that, while the principal of the new debt was secured by U.S. Treasury bonds, the interest payments that the Mexican government would have to make on such bonds, estimated at about 85 percent of the total flow of funds to holders of the new bonds, would have no collateral backing.

---

12 First Interstate's inventory of Peruvian goods includes copper wire, fishmeal, frozen fish, shellfish, garments, fresh asparagus, garlic, onions, and wood products. Midland's inventory includes iron pellets, fishmeal, steel balls, coffee, cotton thread, alpaca cloth, zinc and lead oxides, and copper sulfate. See "Fishmeal? That'll Do Nicely," *Euromoney*, June 1988, pp. 149-152.

Since early last year, Mexico reportedly has been trying to arrange a new version of this technique which would carry World Bank or creditor government guarantees on the interest payments. The emerging Brady Plan apparently will include World Bank or IMF guarantees in this manner.

STRAIGHT DEBT BUYBACKS

In many cases, a wise use of debtors' scarce dollar reserves is a straight debt buyback. Under such an arrangement, the debtor country offers to buy back its debt from the creditor bank at a price lower than face value; the price typically is near the actual discounted market price of the debt. This mechanism allows the debtor to capture 100 percent of the discount.

Ethical Pitfall. Straight debt buybacks were common after the widespread bond defaults of Latin governments in the 1930s. At that time, economist Henry C. Wallich noted the important ethical problem that "...arises when repurchases are made after the bonds have depreciated owing to suspension of service, for in that case the repurchasing debtor is profiting from his own default."[13] Thus, straight debt buybacks could encourage countries to default in order to repurchase their debt at a discount.

Yet, Wallich also noted a great advantage to Latin American government bond repurchases in light of the high export earnings of such countries during World War II:

> If part of the reserves that are currently being acquired [by debtor countries] are not used for repurchases now, the chances are that after the war they will be utilized for imports and not for the service of foreign debts.

Funds for Debt Repayment. Straight debt buybacks today, thus, would allow many debtor countries to divert some hard currency funds away from wasteful domestic spending or the financing of import consumption to at least partial debt repayment.

As recent examples of straight debt buybacks, Bolivia last year repurchased $240 million in foreign bank loans – not serviced since 1984 – at only 11 cents to the dollar with funds anonymously donated by foreign governments. In November, Chile spent $168 million to buy back and retire $299 million of foreign bank debt, paying an average 56 cents on the dollar.[14]

In most cases, LDCs' debt agreements with their creditor banks contain a "sharing clause," which requires that all cash payments be shared by creditors

---

13 Henry C. Wallich, "The Future of Latin American Dollar Bonds," *American Economic Review*, vol. 33, no. 2, June 1943, p. 332.

14 Interested investors bid a total of $822 million in debt, allowing the government in Santiago to be choosy and accept only the best one-third of the offers. Chile's agreement with its creditor banks allows it to buy back another $332 million ($500 million in all).

on a pro-rata basis depending on the size of each creditor's initial loans. Because of this, debtors usually require a waiver of the sharing clause from their creditor banks prior to executing straight debt buybacks, which, by definition, entail cash payments only to participating banks.

Chile had little problem last year when it sought the waiver. Its twelve-bank creditor committee approved it swiftly in April and by August Chile's 300 creditor banks had approved the agreement. While Chile's model debtor status undoubtedly facilitated the creditors' approval, there are now indications that money center banks may be softening their former insistence upon strictly sharing all cash receipts from debtors.

THE BRADY PLAN AND THE DEBT FACILITY DEBATE

Over the past few years, various parties have sought to harness the voluntary debt reduction techniques to some sort of IMF or World Bank "debt facility," buttressed with Western taxpayer funds. The some half-dozen proposals have included those of New York Democratic Congressman John LaFalce and American Express Chairman James D. Robinson III.[15] These proposals would involve guarantees by either the IMF, World Bank, or industrialized country governments on the debtor countries' interest or principal payments to commercial banks.

Recently, the money center banks, through the Institute of International Finance (IIF), a foundation that they wholly fund, supported this general approach. This Washington, D.C.-based institute warned that further voluntary debt reduction by major U.S. banks would require "credit enhancement" in the form of government or World Bank guarantees.[16]

Emphasizing Debt Relief. The plan announced this March 10 by Treasury Secretary Brady moves away from the Baker Plan's emphasis on new money for debtor countries to an emphasis on debt relief. The Brady Plan calls for IMF and World Bank assistance to back debt reduction transactions between debtor countries and their private creditor banks. For example, Brady suggests that IMF and World Bank funds might provide collateral for bonds that debtor governments would issue to their creditors and thus reduce the debt. This is similar to the Morgan approach. The IMF and World Bank funds also could be used to guarantee debtors' future interest payments in such an exchange. Funds even could be used to provide debtors with the hard currency required for straight debt buybacks.

---

15 The Omnibus Trade Bill passed by Congress last year contained a mandate, which was a weakened version of the LaFalce initiative, that the Secretary of the Treasury study the feasibility and advisability of a debt facility to purchase and restructure LDC government debt. IMF gold stock or the World Bank's uncommitted liquid assets would be used as collateral to obtain financing for the facility. Last month, the Treasury reported to Congress, advising against such a facility.

16 *The Way Forward for Middle-Income Countries* (Washington, D.C.: The Institute of International Finance, January 1989).

Treasury Under Secretary-designate David Mulford told Congress last month that no new U.S. contributions to the IMF and World Bank are anticipated for the implementation of the Brady Plan. He pointed out that the Japanese have pledged $10 billion toward the new policy, though not directly to the IMF or World Bank. Yet IMF Managing Director Michel Camdessus of France claims that his agency will need new funds, termed a "quota increase," to carry out the Brady Plan.

The Brady Plan also calls for a general waiver of the sharing clauses present in most debtor loan agreements. which require the banks to share any cash payments from debtors among themselves. Currently, debtors desiring to undertake a straight debt buyback must convince their hundreds of creditor banks to waive the clause.

THE BRADY PLAN EVALUATED

The Brady Plan is correct to move away from the Baker Plan's emphasis on new loans for debtor countries. Yet while debt reduction is preferable, the Brady Plan, aside from its vagueness, has a number of flaws.

A major problem, for instance, is that the IMF or World Bank-backed debt reduction transactions suggested by Brady and others in effect would eliminate the risk of losses for banks engaging in various debt reduction plans. Brady does not explain why the banks deserve government help that amounts to a bailout. Part of it would come from U.S. taxpayers in the form of America's contribution of 20 percent of the funds to these two international bodies. U.S. and other industrial country taxpayers did not share in the profits made earlier by these banks on their LDC loans; why then should taxpayers be burdened with the banks' losses? Indeed, U.S. money center banks registered record profits in the late 1970s and early 1980s on their Latin loans. And with the emergence of the debt crisis in 1982, these banks charged the debtor governments high up-front fees in exchange for loan rescheduling.

Prudent Banks. Further, the major banks since 1982 have covered themselves well against potential losses on their debtor country portfolios. L. William Seidman, Chairman of the Federal Deposit Insurance Corporation (FDIC), recently told the House Banking Committee:

> Since 1982, the nine money-center banks have been successful in building their primary capital to a level which would allow them to withstand any likely event in the LDC arena...[They] would continue to be solvent even if they wrote down to current secondary market levels all their exposures to the six major LDC countries. *Moreover, 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 countries and,*

on an after tax basis, each of these banks would remain solvent. (Emphasis in prepared testimony.)[17]

Similarly, Federal Reserve Board Vice Chairman Manuel Johnson told the same hearing that the average primary capital-to-assets ratio for the major money center bank today is 8.19 percent, in contrast to 4.82 percent in 1982 – and that the earnings of these banks are at high levels. These numbers indicate that most U.S. banks currently are well positioned to absorb losses on their loans to Third World countries without public assistance.

The Brady Plan suggests that all of the creditor banks waive the sharing clause in their LDC debt agreements so that debt reduction deals between individual banks and debtor countries can be facilitated. While such waivers in many cases might be desirable, this should be a matter between the banks and the debtor countries. Debtors should have to continue to negotiate with their creditor bank committees and make the case for how their conduct of economic policy merits the opportunity to buy back some of their debt.

Poor Judges. Perhaps the most troubling aspect of the Brady Plan is that it fails to get at the root of the debt crisis – the flawed economic policies of the debtor countries themselves. The U.S. Treasury, IMF, and World Bank have a questionable record in judging what sort of reforms are best for countries. The international agencies, when imposing conditions in exchange for help with LDC balance of payment problems, often have advocated policies stunting long-term economic growth. Yet growth must be the goal of U.S. policy toward less developed countries.

Follow-up and enforcement of economic reform plans are other problems the Brady Plan does not address. Under the Baker Plan, little attempt was made by the U.S. Treasury to ensure that the economic reforms pledged in exchange for new money were actually ever instituted. There is little indication that Brady will fare better than his predecessor.

RECOMMENDATIONS

The successful techniques with which some debtor countries and creditor banks have been dealing with their debt problems should prompt the Bush Administration to encourage this trend. It should not be proposing schemes, albeit well intentioned, that eliminate either the risks of transactions between debtors and their creditors or the incentives that they have to reach agreements.

The Bush Administration should:

17 L. William Seidman, testimony before the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, January 5, 1989. Seidman also noted that in 1983 the nine major U.S. banks had aggregate exposures of $61 billion to the 31 "rescheduling" LDCs – representing nearly twice the banks' aggregate primary capital of $32 billion. As of June 1988, however, the nine had outstanding debt to these countries of $55 billion – representing less than 85 percent of the banks' aggregate primary capital of $65 billion.

1) Not support the use of IMF or World Bank funds to back various debt reduction techniques.

Bankers took risks when they lent money to less developed countries originally. They take some risks in various attempts to reduce their debts. Public funds should not be used to lessen these risks. Indeed, it originally was the promise of IMF loan guarantees that encouraged many banks to make some irresponsible loans to less developed countries.

2) Highlight Chile as an example of successful debt management, debt reduction, and economic reform.

Too often debt proposals have paid too little attention to the need for those necessary market-oriented economic reforms in LDCs, for which no amount of debt reduction can ever substitute. Brazil, for example, has negated its debt swap successes with disastrous economic policies. Chile, by contrast, has reduced its debt, privatized state-owned industries, lowered inflation and government spending, and instituted other free market reforms. As part of U.S. participation in the $10 billion Western assistance initiative for the Philippines, Washington should encourage President Corazon Aquino to send a delegation to Chile to study that country's debt-equity swap and privatization programs.

3) Make a major public statement stressing that debtor countries must seek to attract the flight capital of their own citizens back to their countries through free market reforms.

Brady should focus attention on the fact that there would be no shortage of capital in less developed countries if citizens in debtor countries did not feel it necessary to place their savings in foreign banks. Estimates of capital flight range from around 50 percent to 100 percent of the value of LDC debt. Further restrictions on capital outflows by debtor countries will probably be just as ineffective in stemming capital flight as the current stringent barriers. Trying to attract flight capital by such artificial methods as driving up domestic interest rates will defeat the ultimate purpose of creating a healthy, growing economy. Brady should point out to debtor governments that only sound, market-oriented economic policies provide the incentives for citizens to keep or bring their money home.

CONCLUSION

The Brady Plan's emphasis on debt reduction rather than new loans to debtor countries is welcome. But its call for IMF or World Bank funds to lessen the risks to American and other commercial banks negotiating such reductions is a subsidy to such banks that is unfair to American taxpayers. Worse, it is a prescription of more of the same medicine that caused the debt crisis. This is especially true in light of the fact that debtor countries and creditor banks have been using various mechanisms requiring no IMF or World Bank funds to manage the debt situation successfully.

Administration Aim. Economic growth through free market reforms not only would help lift the less developed countries' debt burden but would create incentives for increasing economic growth. In the end these countries would not simply manage their debts. They would again begin to prosper and increase the standards of living of their peoples. This should be the aim of Bush Administration policies for dealing with Third World debt.

Prepared for The Heritage Foundation by
Melanie S. Tammen,
a Policy Analyst with the Competitive Enterprise Institute, Washington, D.C.

All Heritage Foundation papers are now available electronically to subscribers of the "NEXIS" on-line data retrieval service. The Heritage Foundation's Reports (HFRPTS) can be found in the OMNI, CURRNT, NWLTRS, and GVT group files of the NEXIS library and in the GOVT and OMNI group files of the GOVNWS library.