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The Brady Plan: An Attempt to Solve the Mexican Debt Crisis

by Steven W. Armbrecht

Mexico, not entirely by its own actions, has experienced a devastating increase in foreign debt. The country's history and policy decisions, in conjunction with actions taken by the developed world, have allowed Mexico's debt to escalate. In response, various policies and plans to restructure the debt have been essayed. The Brady Plan, introduced by the United States in 1989, was designed to be an important part of the proposed restructuring process. The failure of this plan to be implemented successfully could affect the United States' banking community, the International Monetary Fund, the World Bank, and the fate of Mexico—as well as the rest of the developing countries experiencing financial difficulties.

History of the Mexican Debt Crisis

In the 1930s it became evident that the rich and more industrialized nations of the world were dominating Mexico's economy. In an effort to gain public support and wrest back some control of its economy, Mexican President Lazaro Cardenas, during his tenure in office (1934-40), began nationalizing the foreign-owned companies. Nationalization, a process that put many of the private and foreign-owned businesses under direct government control, at first helped Mexico, for domestic production increased and reliance on imports fell. However, losses incurred by foreign investors as a result of nationalization were a source of irritation in international relations.

With the outbreak of World War II, the Allies were forced to settle their differences with Mexico in order to use its oil and productive capacity in the war effort. This induced Mexican industry to operate at full capacity to meet both external and internal demand (Rudolf 1985, p. 167). As a result of the Allied demand for war goods, there was a tremendous inflow of capital into Mexico. This increased the income of the average Mexican worker, and the resultant increase in demand for goods put an additional strain on productive capacity.
After the war, Mexico suddenly found that its products were no longer in great demand in the more industrialized countries. In addition, the U.S. began diverting its attention to rebuilding Japan and the war-torn nations of Europe, utilizing American rather than Mexican production facilities. As a result, Mexico was left with excess productive capacity. Mexico’s solution to this problem was to stimulate domestic demand by the active promotion of import substitution industrialization (ISI) policies (Rudolf 1985, p. 167). Under ISI policies, Mexico would produce domestically many of the products it had previously imported. The intention was both to become more self-sufficient and to utilize productive capacity. These ISI policies were continued from the end of the war through the early 1970s. The result was an enlarged middle class that demanded more consumer and social goods. The rising costs of social programs and falling revenues as trade declined in the middle seventies, however, caused a severe budget deficit. The Mexican government found itself in a financial predicament.

Mexico was forced to borrow heavily from abroad to pay for expanded social programs and to further develop its oil fields. World oil prices rose sharply in the 1970s, thus spurring Mexico to increase oil production. The rising oil price was caused by the Organization of Petroleum Exporting Countries’ (OPEC) cutback in production and by the resulting increased world oil demand. Although Mexico was not a member of the OPEC cartel, it found its oil exports to the industrialized nations increasing rapidly.

In 1981, however, the situation drastically changed. The combination of a recession in the industrialized nations and a depressed world oil market caused Mexico’s current account deficit to rise to [US] $13 billion. Also, higher world interest rates on the external debt caused the public to lose confidence in the peso, and capital flight ensued (Rudolf 1985, p. 179). Capital moved to perceived safe havens like the United States or the Bahamas and forced Mexico to replace declining revenues with borrowed funds. As the world oil price weakened in the 1980s and interest rates on borrowed money rose, Mexico’s debt expanded more and more rapidly, creating concern in the lending nations.

**Early Attempts to Solve the Debt Crisis**

When the United Nations was formed after World War II, the United Nations Conference on Trade and Development (UNCTAD) was created to help the developing countries establish more favorable
trade and price balances for their products in the world market. Through UNCTAD the United Nations tried to establish the New International Economic Order (NIEO) in the early 1970s. NIEO would, in essence, forgive the debts of the developing countries and create a level playing field in the world marketplace. Unfortunately, UNCTAD has not been particularly effective. Forgiving developing country debt would require huge financial losses and was no guarantee that the nations would stay out of debt because external financial resources would still be needed. Therefore this UN plan was never seriously considered by the nations holding the debt.

As their financial difficulties continued to mount in the 1980s, Mexico and many developing countries continued to demand financial assistance from the industrialized countries. However, these demands were not heeded. Mexico and the developing countries then turned to the International Monetary Fund for help. However, the United States and other countries providing funds to the International Monetary Fund were reluctant to increase funding to levels necessary to help all developing nations. Instead, they provided provisional loans and attempted to create an environment of free trade which they felt would help solve the debt problem by increasing the flow of external revenues to indebted nations.

Unfortunately, free trade cannot totally solve the debt problem. Exports from Mexico and the other developing countries are typically primary products, the prices of which are highly unstable; indeed, production increases often cause prices and revenues to fall. In effect, trade in these products does not generate cash flow fast enough or large enough to retire developing country debt.

The United States finally recognized the severity of Mexico’s debt and, in 1982, initiated the Baker Plan, formulated by then U.S. Treasury Secretary James Baker III. The plan was based on the premise that oil prices would soon rise and generate a positive cash flow. Mexico’s debt was rescheduled further into the future to allow Mexico time to reap these expected gains. However, the price of oil did not rise; in fact, it declined. The Baker Plan was a failure because the combination of further declining revenues and increased lending to repay the restructured debt forced Mexico and many other developing countries even deeper into debt.

The Brady Plan

As the debt in the developing countries continued to expand, U.S. Treasury Secretary Nicholas Brady presented a new plan for debt
reduction on March 10, 1989. Brady’s plan targeted Mexico because the Mexican debt at the end of 1988 was approximately (US) $107 billion and default on this debt could severely damage the U.S. economy.

The Brady Plan was devised to deter Mexico and/or any other developing country from defaulting on current external obligations. The main objectives of the plan were to:

* alleviate the scarcity of financial resources;

* reverse capital flight;

* maintain the important role of the international financial institutions and preserve their financial integrity;

* encourage debt and debt service reduction on a voluntary basis;

* recognize the importance of continued new lending and;

* provide free markets.

If achieved in Mexico, these objectives would be implemented in the other developing countries to reduce their debts ("Excerpts From Brady Remarks on Debt" 1989, p. 37).

The plan recognized that financial institutions are apprehensive about lending money to the heavily indebted developing countries. It recognized as well that the International Monetary Fund and the World Bank, both created by the United Nations, face financial difficulty as more countries need money. Since these institutions are not receiving additional contributions from the member countries, financial assistance continues to be inadequate. In addition, capital flight continues to be a large problem as nationals in the financially unstable countries deposit large portions of their wealth outside the country. They have done this to keep their wealth intact and to earn higher returns than they can in the unstable domestic economy. If this capital could be reattracted to the developing countries, its investment in the domestic economy could provide a stimulant to economic growth.

Two solutions were put forth by Secretary Brady to solve these problems. In the long run, free markets were seen as the answer to the debt problem. Free markets with low trade barriers would increase trade between nations. By applying the theory of comparative advantage which states that a nation should export products it can produce
at a relatively lower cost and import products it cannot produce as cheaply as other nations, a positive cash flow could be generated to repay the debt. This idea is not new. It has been part of many proposed solutions to Mexico's debt problem.

Secondly, in the short run, Treasury Secretary Brady believed debt reductions and lowered interest rates on all new loans would offer a respite until these economies could become self-sufficient and benefit from free markets. Brady recommended guidelines for U.S. banks to follow in reducing developing country debt. These guidelines consisted of three options:

1) exchange their credits for new bonds carrying a fixed annual interest rate of 6.25 percent (compared with floating interest rates of more than 10 percent);

2) accept a 35 percent reduction in the face value of their loans; or

3) provide additional loans. (Truell 1989, p. A13).

Under option one, the new bonds would be United States Treasury bonds. These more financially sound securities would give banks the incentive to implement the first option. Brady believed implementation of all or part of the recommended debt reduction play (option two) would cut down the developing countries' debt and the interest paid on it, while allowing developing countries to continue borrowing to buttress their economies (option three) (Kilborn 1989, p. 35).

The first test of the Brady Plan to manage Latin America's $400 billion debt was to be aimed at Mexico. It was anticipated that a United States show of confidence in Mexico's ability to recover economically, along with a modest amount of financial aid, would trigger a surge of new investment. In particular, Mexico anticipated that money held by Mexicans abroad (some $84 billion, according to a 1988 estimate by Morgan Guaranty Trust) would be reinvested directly into the Mexican economy (Moffett 1989, p. A1). As a result, Mexico would have some financial maneuvering room. Once the financial sector gained some respite from the imminent short-term debt problems, new business investment would allow markets and free trade to solve a major portion of the debt crisis.
Problems with the Brady Plan

Unfortunately, many problems have arisen since the plan’s announcement in 1989. The Bush administration and Mexico hoped that the hundreds of creditor banks would choose to follow the options proposed by the Brady Plan. This in itself was a huge supposition as banks wrestled with how to get the best return on their current investments at an acceptable risk level. Many larger banks’ loan portfolios are heavily laden with loans to foreign countries. Many banks are also under heavy pressure from shareholders not to offer new loans to the developing countries (Duke 1989, p. A11). These loans were made when the rate of return was projected to be high, but now lenders are skittish because of rumors of default and interest rate restructuring, both of which will reduce banks’ profits.

Chase Manhattan Corporation came up with its own option and began setting up large reserves to use as a buffer to write down its overseas loans. It decided not to lend any new money to Mexico or the other developing nations. If this policy persists and is followed by other banks, Mexico and the other developing countries will be unable to make interest payments on current debt and may have to default on their loans (Guenther 1989, p. A3).

To offset Chase Manhattan’s action, the Bush administration, in September 1989, offered an incentive to the banks. The Securities and Exchange Commission (SEC) would allow banks to write down losses at a slower rate. By slowing the write down process, the banks’ losses from the investments would not be as large as otherwise. By keeping their profits up, banks would appear more financially secure, satisfy their stockholders, and increase flexibility to lenders, thus allowing them to offer new loans to Mexico and other debt-laden countries as the Brady Plan intended (Duke 1989, p. A11).

Unfortunately, a second dilemma loomed on the horizon as it became apparent that the Brady Plan was in reality unlikely significantly to reduce Mexico’s $100 billion foreign debt. It appeared that the debt would continue to escalate even if Mexico and the other developing nations received new loans. To deal with the problem, the new focus of the Brady Plan was to cut back interest payments on foreign bank debt and provide further loans (Truell 1989, p. A13). However, these short-term fixes will do little to help Mexico provide a climate conducive to economic recovery in the markets and free trade arena. If Mexico’s economy falters, new loans to help bail it out will be hard to find.
The United States has already issued Treasury bonds to finance some of Mexico's short-term debt. Issuing more Treasury bonds to offset the financial sectors' unwillingness to incur losses would be folly. Any additional bonds issued would only shift the debt from banks to the U.S. Treasury, or to the International Monetary Fund and World Bank, which, in turn, are heavily financed by the United States.

Loan portfolios of the International Monetary Fund and the World Bank are currently coming under pressure. Both institutions are faced with increased demand for loans from the developing countries as private banks have become reluctant to extend them credit. Consequently, many of the loans from these institutions have been made to the least creditworthy and most heavily indebted countries (Roberts 1989, p. A14). These loans have been made to keep debt-ridden countries from defaulting. As funds from the International Monetary Fund and the World Bank dry up, the United States may be unwilling to provide additional funds.

A final irony is that as economic problems have mounted in Mexico and other debt-ridden nations, the United States is seen by foreigners as a safe place to invest money. The Brady Plan does not address the underlying structural problems that have turned the United States into one of the world's biggest tax havens (Moffett 1989, p. A1). Currently, foreign investments are, for the most part, taxable only by the United States; they are protected from the tax laws of the country of origin. Mexico anticipated that the implementation of the Brady Plan would provide a positive economic climate which would attract some of the capital back from where it is sheltered.

Other Aspects of the Brady Plan

Even though the Brady Plan has not been implemented as planned, it has triggered a surge of economic development and new optimism in Mexico, which has helped keep skittish investors from sending even more money abroad (Moffett 1989, p. A1). Mexico must continue on a path of accelerated economic development. Though reattracting the capital invested outside of the country is necessary, it is not enough. In addition, the market economy and free trade will need to be bolstered by financial sources and/or government supported programs to help complete the recovery.

President Carlos Salinas de Gortari of Mexico spent his first ten months in office implementing government programs designed to influence those Mexican capitalists with wealth abroad to reinvest in Mexico. He has instituted trade liberalization and new foreign-invest-
ment regulations. He has deregulated transportation and announced the sale of some state controlled enterprises. Moreover, privatizations now under consideration in the steel, fertilizer, and banking sectors would further increase investor confidence. Even Mexico’s protected petroleum industry has been partially opened to private and foreign investment (Baer 1989, p. A13). However, Mexico’s domestic debt remains oppressive.

President Salinas and the Mexican government have not undertaken these policy changes without political and private sector opposition. The opposition is concerned that too much foreign investment will return Mexico to the position of domination by foreign-owned businesses. However, nationalized businesses have not helped solve the debt problem; in fact, they may have caused Mexican investors to invest their money out of reach of the government. Encouraging domestic and foreign investment should provide capital and create a positive environment for progress. Thus, the Brady Plan, coupled with the actions taken by President Salinas, could provide some respite from Mexico’s debt crisis.

Conclusion

Even though the problem of finding financing to help Mexico and the other developing nations seems insurmountable, it could be alleviated by a concerted effort by all the countries of the world, not just the United States. As a major world leader, the United States must convince other capital-rich countries to invest in Mexico and other developing countries. If bilateral attempts do not achieve any positive results, multilateral attempts in the United Nations must be undertaken to demonstrate why it is in everyone’s best interest to solve the developing nations’ debt problems. Should sufficient financial aid not be extended and Mexico defaults on its debt, the resulting domino effect as other developing countries default could cause international monetary instability, if not world-wide depression.

The World Bank and the International Monetary Fund must receive increased funding from other countries. The United States has provided a large percentage of the funds to these institutions since the United Nations’ inception after World War II, but many nations are economically better off now than they were then and could shoulder a larger share of the burden. Since no country exists in isolation, all countries must cooperate in order to survive.
References


