market-based debt reduction schemes compared with the period preceding such swaps, since the price on the remaining debt could actually increase by an amount great enough to eliminate all benefits made from the debt reduction.[5]

The Brady Plan, launched in March 1989, was designed to eliminate the free rider problem inherent in market-based reduction plans by ensuring that most (if not all) commercial banks would reduce outstanding claims.[6] Unlike its predecessor, the Baker Plan, it was the first comprehensive programme that went beyond simple restructuring of outstanding principal and interest payments. It offered commercial banks a menu of options which would reduce their exposure in developing countries, while guaranteeing that the balance would be honoured. Banks agreed to reduce the debt obligations of developing countries (mainly through lower yields or discounted principal amounts) in return for "credit enhancement" of the remaining balance. The menu-based approach differed from open-market debt buybacks since it included most (if not all) commercial creditors, thus avoiding the free-rider problem inherent in the market-based buybacks. The menu of choices also allowed commercial banks to choose the best option according to their specific circumstances, level of risk tolerance, domestic banking regulations, etc. This, in essence, meant that other creditors, principally the IMF and World Bank, would put up guarantees on the remaining debt which could be called by commercial banks if debtors failed to honour these obligations.

Since the inception of the Brady Plan, about one-half of the total commercial bank debt of developing countries has been rescheduled. Seven countries have undergone a debt restructuring under the Plan, reducing the face value of eligible debt from US $111 billion to US $94 billion. The programme has saved these developing countries about US $39 billion in debt and debt-service reductions.

[5]According to Rogoff, the efficiency problem with debt reduction schemes that are not comprehensive is that countries pay the average price of the debt in retiring marginal debt. To illustrate this point, Rogoff uses the example of Bolivia before and after its March 1988 debt buyback. In September 1986, Bolivia debt was trading for 6 cents on the dollar with total outstanding debt of US $670 million, equal to a total market value of US $40.2 million. Using some of its own resources, as well as resources donated by Spain, the Netherlands and Brazil, Bolivia paid US $34 million to purchase US $308 million of its debt at a price of 11 cents on the dollar. By April 1988, the value of the remaining debt (US $362 million) had also risen to 11 cents, for a total market value of US $39.8 million. Thus, in essence, Bolivia only retired US $0.4 million of debt based on current market valuation. The commercial banks, on the other hand, received a windfall of almost US $34 million, since the value of the remaining claims increased. By contrast, over the September 1986 to April 1988 period, the prices of debt for all other highly indebted countries fell by a weighted average of 30%. See Rogoff (1992), pp. 479-80. The positive aspect of the Bolivian buyback was that the principal reduction was taken as a sign of good domestic management, thereby helping to create an environment of creditworthiness that encouraged capital inflow, including returning flight capital.

[6]In this context, the free rider problem occurs when a creditor does not wish to sell its outstanding claims at a discounted amount on the secondary market, well aware of the fact that the unit value of remaining claims is likely to increase the more discounted debt is retired.