

A Brady Bond Solution for America's Economic Crisis and Unpayable Corporate Debt

By [Dr. Paul Craig Roberts](#) and [Prof Michael Hudson](#)

Global Research, March 26, 2020

Region: [USA](#)

Theme: [Global Economy](#)

Even before the Covid-19 crisis had slashed stock prices nearly in half since it erupted in January, financial markets were in an inherently unstable condition. Years of quantitative easing had loaded so much money into stock and bond prices that stock price/earnings multiples and bond prices were far too high by any normal and reasonable historical standards. Risk premiums have disappeared, with only a few basis points separating U.S. Treasury bills and corporate bonds.

The Fed's Quantitative Easing since 2008 plus large companies using their earnings for stock buybacks drove the prices of financial assets into a realm of unreality. The result was that markets already were teetering on the brink of fragility. Any rise of normal interest to more normal conditions, or any external shock, was bound to crash the artificial values at which financial markets were priced. The Fed's policy was to perpetuate this situation for as long as possible by pumping in yet more credit. But at near-zero interest rates, there was little that could be done.

A close parallel to this situation was the state of Third World debt in the mid-1980s. Mexico's announcement that it could not meet its foreign debt service was the shock that brought ugly financial reality into conflict with the assumption that somehow any government debt could be paid – even debts denominated in a foreign currency. (Mexico and other countries had denominated their bonds in dollars in order to obtain lower interest rates than bonds denominated in their own currencies would have to pay. The assumption was that export earnings would provide hard currencies with which to redeem the bonds.)

The international financial system was rescued by the issue of Brady bonds – “good” new bonds for old “bad” ones. The capital value of these bonds was still far below the original debt, but they had the virtue of setting realistic levels by bringing the debt balance more in line with the actual ability of debtor countries to earn the dollars or other hard currencies needed to service bonds denominated in foreign currencies, mainly the US dollar.

The current crisis requires a similar write-down and recognition that fictitious price levels must give way to reality at some point. In fact, we have reached the end of an illusion – the illusion that bond (and stock) prices could be sustained indefinitely simply by financial engineering, without an economic base capable of producing enough surplus revenue to justify existing bond and stock prices.

So attractive were the former unrealistic bond and stock levels that the markets are still in the “denial phase” hoping that the Coronavirus bailout may be used as an opportunity for yet further infusion of money into the financial markets. But that merely postpones the inevitable adjustment to bring financial asset prices back in line with real economic

capabilities.

There certainly is a financial panic, and prices are not necessarily more realistic in a panic than they were in the bubble leading up to it. The question is, what is a sustainable asset-price level? What needs to be supported is a realistic value of stocks and bonds. Bad debts should be taken off the books, not supported in an attempt to recover the unrealistic pre-virus levels.

A successful way of coping with overpriced bonds and other debts:

Our situation is similar to Third World debt in the early 1980s after Mexico triggered the Latin American debt bomb by explaining that it did not have the money to service its foreign bonds. Prices for Third World bonds plummeted as investors calculated the dollar-earning power of countries that had to export goods and services (or sell off their assets) to pay their foreign-currency debts. But their export proceeds simply could not cover the debt service that was owed.

The Sovereign Debt market was trading at such low prices that these foreign government bonds had become illiquid. Unable to obtain further credit, countries confronted by this financial state of affairs were threatened with political instability.

The Federal Reserve's long Quantitative Easing and support of the financial markets has provided the appearance of stability. This artificial life support has been viewed as saving banks and large companies, pension funds and state and local finance from insolvency. But in doing this the Fed has been fighting what looks like a losing battle against reality. The Fed has been supporting illusory values that cannot be sustained.

The reality is that large swaths of the post 2008 corporate bond market boom have seen a proliferation of corporate bonds that cannot be paid. The fracking industry is only the most visible example. Airlines, entertainment, hotels and retail companies are facing losses that threaten their solvency.

The Fed fears a free market when it comes to asset prices. Or at least, it fears the political and economic consequences of withdrawing artificial support. Reality forced the Fed into the mid-March support and already a larger intervention has been announced. According to the New York Times, for the first time in history, the Federal reserve announced that it would buy corporate bonds, including the riskiest investment-grade debt. [1] It seems the Fed also intends to purchase stocks (see [this](#)).

This is the "Denial stage" of the illusion that has resulted in crisis- the illusion that the stock and bond run-up could be turned from government manipulation into an actual market reality.

Where is this supposed to end? The Fed could buy up all the bonds - from corporate junk to state and municipal bonds as a way to prevent their prices from falling. At an extreme, this business-as-usual scenario would lead to the Fed owning the junk bond market, municipals, and a large swath of the stock market.

This could have a silver lining: having concentrated the debt in its own hands, the Fed would then have a free hand to write off the debt, privatize the companies and start all over again with a lower debt overhead. That is what China's central bank has been doing: simply

forgiving debt that is owed to itself. The Fed would swap “good” public debt (good in the sense that the government can print the money to pay) for bad (meaning unpayable) debt.

Bringing financial markets in line with reality would mean writing off a large swath of corporate debt and realizing that much corporate equity “wealth” has been created by decapitalizing corporations in stock buy-backs instead of investing in the country’s productive capacity, including decent wages for workers. The American airline industry over the last decade has spent as much as 96% of its cash on stock buybacks – giving financial wealth to their CEOs and share holders rather than investing in their business. Such financial wealth, if not underpinned by real wealth, is built on quicksand, and it is now disappearing as asset markets plummet. So stock buybacks and other artificial ways to “create wealth” were “investments” that have had drastically negative returns.

To implement a rationalization of bond and stock prices bringing them in line with reality, it has to be in the interest of holders of these securities. Acknowledging that bonds are not worth as much as the price at which the Fed is supporting them will not appeal to bondholders as long as prices are artificially supported. A bond-swap (new good bonds for old bad bonds) can only be achieved in a situation where it is more realistic and less risky to have a sound good bond than a low-priced (or fictitiously high-priced) bad bond.

Therefore, the Fed should let prices sink to their “market” level without interference. The Fed is trying to support the unsupportable. By doing this, it has blocked a reasonable solution bringing financial asset prices in line with the realistic ability to carry debt.

Without the Fed’s support, bonds would need to be written down and stock prices would continue to plunge. That would prepare the ground for something like the Brady Bond solution for Third World debts in the 1980s. Latin American and other Third World bonds were selling around 25 cents on the dollar in the wake of Mexico’s announcement that it could not pay its scheduled debt in 1982. There was widespread recognition that Latin American governments couldn’t pay their bonds. That was because these bonds were denominated in US dollars, and foreign governments can only print their own currency. When they did this to throw domestic money onto foreign exchange markets to trade for hard currencies with which to pay their debts, their exchange rates plunged. [2]

Brady bonds addressed the problem by a swap of “good bonds for old.” The new bonds received IMF and other support, and were based on what foreign countries actually could pay in foreign exchange (mainly U.S. dollars). Bondholders could swap their old bonds, which were selling from 15 to 25 cents on the dollar, for new bonds priced higher than the market price but less than the original issue, but which at least were secure and less risky. They were “reality bonds.”

The government can organize something similar for corporate bonds after the market takes the artificial QE-added values out. However, to create a market environment for such an alternative, the Fed must let bonds and stocks fall to their natural “realistic” level recognizing that the existing debt overhead can’t be paid. Then, new “reality bonds” can be issued and the economy can start again with a non-crippling debt level. As panic will take the market price below the reality price, the new debt instruments will have higher values than the market panic prices. Alternatively, a good estimate of the real value of the bonds could be made with the debt written down to that level. If that can be done, it would avoid a panic fall to a lower level.

Banks and major creditors would have to absorb much of the loss resulting from the runup of stock and bond prices to overvalued levels. But something similar was a feature of the Brady reforms, which called for burden sharing by banks (the London club) and also governments (the Paris club) who had to provide debt relief. If the debt-writedown makes banks insolvent, they can be nationalized. When more normal conditions return, the banks can be privatized. This would also provide an opportunity to increase competition by breaking up “banks too big to fail” and to again separate commercial from investment banking. In other words, nationalization would be a way to increase competition and restore Glass-Steagall stability to the financial system.

The alternative is that we will face reality without a solution.

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Dr. Paul Craig Roberts writes on his blog, PCR Institute for Political Economy, where [this article](#) was originally published. He is a frequent contributor to Global Research.

Notes

Dirk Bezemer provided much help in this article.

[1] Jeanna Smialek, “The Fed Goes All In With Unlimited Bond-Buying Plan,” The New York Times, March 23, 2020. This report adds: “Because the Fed cannot take on substantial credit risk itself, the Treasury Department backs its emergency lending, using money from a fund that contains just \$95 billion. Treasury Secretary Steven Mnuchin on Sunday suggested that the new money in the Republican bill could be leveraged by the Fed to back some \$4 trillion in financing.”

[2] The situation was much like German reparations in the 1920s. (See Michael Hudson, Trade, Development and Foreign Debt).

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About the author:

Paul Craig Roberts, former Assistant Secretary of the US Treasury and Associate Editor of the Wall Street Journal, has held numerous university appointments. He is a frequent contributor to Global Research. Dr. Roberts can be reached at <http://paulcraigroberts.org>

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