Abstract

On March 10th, 1989, U.S. Treasury Secretary Nicholas F. Brady proposed a major shift in the goals of the industrial world's Third-World debt policy. The new policy was to bring about a broad reduction in the outstanding debt by inducing banks to forgive part of it. Since the plan comes from the administration, it is probably the single most important event in the seven-year history of the current LDC debt crisis.

This paper investigates how this change in strategy affects the expectations of investors holding bank equities. Specifically, we try to determine how it affects shareholder wealth and, therefore, to what extent the announcement was good or bad news to the LDC creditors. To the extent that it was good news we can expect that, to some degree, the indebtedness of LDCs will exert lower pressure on the solvency and profitability of the heavily exposed banks in the future.

In short, I find strong evidence that prices of commercial banks fully reflect their exposure in developing countries. I also calculate how the stock market evaluates LDC debt held by banks.

I also find strong evidence that the Brady plan had a positive effect on the stock of financial institutions with exposure in developing countries. The market, however, took 3 to 4 trading days to react to the announcement. The delay in transforming the news into a change in prices can be explained by the fact that the market considered the plan vague because it did not mention figures and there was still uncertainty about the feasibility of the plan and its support from the administration.