Office Memorandum

Mr. Beza

STB JB 10

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.
1989 DEC 29 AM 9 52

TO: Mr. Claudio Loser

DATE: December 28, 1989

FROM: J. V. Surr JVS

SUBJECT: Mexico: Letter of Intent and Draft Decision

1. Draft Letter of Intent

(a) Paragraph 23 of the letter of intent should be redrafted along far more conventional lines, viz:

> "23. The Mexican authorities believe that the policies set forth in this letter are adequate to achieve the objectives of our program but will take any further measures that may become appropriate for this purpose. Mexico will consult with the Fund on the adoption of any measures that may be appropriate, in accordance with the policies of the Fund on such consultation, as specified in our letter of April 11, 1989. On this basis, the Government of Mexico seeks continued Fund support in the form of a modification of the December 1989 target for the net foreign assets of the monetary authorities, and the completion of the review of Mexico's program for 1990 and the establishment of performance criteria for that year. A review with the Fund of the implementation of the economic program for 1990, including the reaching of understandings on the limitation on the public sector's net use of foreign credit for end 1990, will be completed before August 31, 1990 [, and the review for reaching policy understandings for 1991 will be completed before February 28, 1991]" 1/

(b) Because a performance criterion must be established in advance and must be objective and independently verifiable, the adjustments to the March 1990 performance criteria for changes in the structure and timing of financing from commercial banks, as articulated in Paragraph 2 of the Technical Memorandum, must not be based on prospective discussions with the Fund staff, but rather on a formula set out in the Technical Memorandum.

(c) Other less significant comments on the letter and annexed Technical Memorandum of Understanding 1990 are indicated on the attached photocopies of the relevant pages.

1/ Bracketed material optional - already in EFF.

2 Separate Letter of Request

The requests concerning set-asides and augmentation that are now in paragraph 23 of the letter should be put into a separate letter to read as follows to meet the requirements of the Articles and the policies on debt and debt service reduction

"Dear Mr Camdessus

"1 On the basis of the policies described in our letter of December __, 1989, the Government of Mexico seeks Fund support for its debt reduction and debt service reduction operations in the following forms

"(a) That the Fund make available, in accordance with paragraph 2(d) of the extended arrangement, the equivalent of the set-aside amounts involved in the reductions which, pursuant to paragraph 2(d) of the arrangement, (i) were made in respect of the purchases already made under the arrangement and (ii) are to be made in respect of the purchase scheduled to become available on February 28, 1990 under the arrangement,

"(b) That the Fund make available, in accordance with paragraph 2(e) of the arrangement, the equivalent of the set-aside amounts in the reductions to be made, pursuant to paragraph 2(d) of the arrangement, in the purchases scheduled to become available under the arrangement on May 31, 1990, August 31, 1990, and November 30, 1990 and February 27, 1991, 1/ with a corresponding adjustment to the amounts to become available on those dates and a discontinuance of the setting aside under that paragraph 2(d) of amounts for debt reduction with respect to the purchases scheduled to become available under the arrangement on May 31, 1990, August 31, 1990, November 30, 1990 and February 27, 1991,

"(c) That the Fund, in the light of paragraph 3 of Decision No 9162-(89/65), adopted May 26, 1989, augment the amount of the extended arrangement by an amount equivalent to SDR [ ] 2/ million, subject to such phasing of purchases and designation of amounts for debt reduction and debt service reduction, as shall be determined by the Fund, and

---

1/ According to paragraph 2(a) of the arrangement the current annual segment includes only the May 31, 1990 purchase Legal and ETRD will need to confer as to whether the telescoping of the second year review could apply to a telescoping of set asides during, or applicable to, 1990 as well

2/ 40 percent of Mexico's quota

"(d) That the Fund grant any necessary waiver of the limitation in Article V, Section 3(b)(iii) for the purposes of purchases of such additional amount,

"2 For the purposes of the augmented amount whose purchase is requested in paragraph 1(c) above, the Government of Mexico hereby represents that it has a need to make the requested purchase because of impending payments for interest support operations in an aggregate amount of at least US$ __ billion, 1/ and it notifies the Fund that it intends to use, within 90 days, the proceeds of that purchase for depositing them as collateral to secure the payment of bonds with a fixed interest rate which for U S dollar-denominated bonds will be 6 25 percent per annum

"3 For the purposes of the amounts set aside or to be set aside whose purchase is requested in paragraphs 15(a) and (b) above, the Government of Mexico hereby represents that it has a need to make the requested purchase because of impending payments for debt reduction in an aggregate amount of at least US$ __ billion, 1/ and it notifies the Fund that it intends to use, within 90 days, the proceeds of those purchases for direct purchase of its present debts to commercial banks or for deposit as collateral to secure the payment of bonds to be exchanged for its present debt to commercial banks, all at a discount of at least 35 per cent

3 Proposed Decision

The text of a proposed EFF review decision will need to follow, considering the time constraint

Attachments

cc Mr Gianviti (o/r)
Mr Beza
Mr Brau
Mr Liuksila

1/ Please fill in the total amounts from all sources under the financing package for these purposes Together they should be at least US$7 billion

Office Memorandum

Mr. Beza

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TO: The Acting Managing Director DATE: December 28, 1989

FROM: L.A. Whittome, W.E. Holder and S.T. Beza

SUBJECT: Mexico: Request for Technical Services

Mexico wishes to request that the Fund act as Mexico's agent ("Calculation Agent") under the value recovery provisions of Mexico's 1989-1992 Financing Package. The oil value recovery rights corresponding to the bonds to be issued call for Mexico to appoint a Calculation Agent to perform the calculations used in determining the amounts, if any, of "value recovery payments". Value recovery payments would be made by Mexico on a quarterly basis from September 1996 through 2020, on the basis of increases in the event that oil export proceeds exceed an established minimum that is expressed in terms of 1989 U.S. dollar prices for oil. As Calculation Agent, the Fund would receive data monthly from the Mexican authorities on prices and volumes for Mexico's oil exports, would calculate the totals thereof, and would transmit the results through the Mexican authorities to the fiscal agent for Mexico's 30-year collateralized discount and par bonds. The data on which the calculations would be based are readily available, and the calculating and notifying functions are easy and inexpensive to perform.

The staff has reviewed the draft wording of the value recovery rights in this regard, and has suggested changes that would remove any possible implication that the Fund would waive its immunity or submit to any form of arbitral process if it acted as Calculation Agent. Counsel for Mexico has accepted verbally these suggestions.

The Fund is authorized to perform the intended function by Article V, Section 2(b) of the Articles, as indicated in the attached draft paper.

Accordingly, we should like to inform the Mexican authorities that you are prepared to support their request along the lines of the attached draft. After the receipt of the request, the attached draft paper, containing your proposal that the request be accepted, would be issued.

Attachment

cc: The Managing Director (o/r)
Mr. Frenkel
Mr. Gianviti (o/r)
Mr. H. Simpson

1989 DEC 29 AM 10: 44
OFFICE OF THE
DEPUTY MANAGING DIRECTOR

Mr. Beza

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Office Memorandum

TO: Mr. Liuksila

December 22, 1989

FROM: Eduard Brau

SUBJECT: Mexico: Request to Perform Technical Services (Calculating Agent)

(1) While we have had a chance to review the "Terms and Conditions of Value Recovery Rights," I have not seen the "Calculating Agent Agreement." Please let me know the contents of the latter before we proceed further on this matter.

(2) As you note in the proposed memorandum from Messrs. Beza, Whittome, and Gianviti to management, it is not acceptable for the Fund as calculating agent to assume responsibility for the accuracy and reliability of data submitted by Mexico, and to submit to arbitration in this regard. Accordingly, you have requested changes to the relevant provisions of the "Terms and Conditions of Value Recovery Rights." Therefore, it is essential in my view that the draft paper to the Board, requesting approval on a lapse-of-time basis, expressly state that the Fund is exempted from any liability in connection with the performance of calculating agent duties, including vouching for the reliability of data.

(3) Should not the Board paper also have attached to it a copy of the "Calculating Agent Agreement"?

(4) I attach comments written on the draft Board paper and would think that corresponding changes are in order for the note to management, in particular removing the assertion that data are reliable (over 30 years?).

Attachment

cc: Messrs. Beza, Frenkel, and Whittome (on return)

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.
1989 DEC 22 AM 11:30

EBD/89/__

December __, 1989

To Members of the Executive Board

From The Secretary

Subject Mexico - Request for Technical Services

The attached memorandum proposes that the Fund accept a request by Mexico that the Fund become the Calculation Agent under the ~~impending~~ proposed agreement between Mexico and its commercial bank creditors on the 1989-1992 Financing Package for Mexico

a request for discussion ?

In the absence of objection by the close of business on ______________, December __, 1989, the decision proposed in the attached memorandum will be deemed approved by the Executive Board and it will be so recorded in the minutes of the next meeting thereafter

Other Distribution

Department Heads

INTERNATIONAL MONETARY FUND

Mexico - Request for Fund to Perform Technical Services

Prepared by the Legal and Western Hemisphere Departments

(In consultation with other Departments)

Approved by François Gianviti and Sterie T Beza

December __, 1989

Attached is a request from the Government of Mexico that the Fund act as Mexico's agent for the calculation of ~~additional~~ payments ~~in the event that~~ Mexico's oil revenues ~~increase due to an increase in the~~ real price of the Mexican oil mix ~~above~~ $14 per barrel ~~under the forthcoming agreement between Mexico and its commercial bank creditors on the 1989-1992 Financing Package for Mexico The draft of that agreement provides for~~ thirty-year collateralized discount and par bonds to be issued by Mexico in exchange for certain ~~outstanding debt One of the provisions of those bonds would be that if Mexico's oil revenues increase significantly Mexico would make certain~~ supplemental payments ~~("value recovery payments") to the bondholders~~

Each quarter, the Calculation Agent will receive data from the Mexican authorities that will enable it to calculate the prices and volumes of Mexico's exports of petroleum and its by-products The Calculation Agent will then promptly inform Mexico and the Fiscal Agent appointed for the Financing Package of the results of the calculations The data in question are published ~~and are reliable~~, and the calculations proposed are relatively simple and verifiable ~~The~~

calculations proposed are relatively simple and verifiable The requested function would last as long as the bonds were outstanding, or until Mexico designated another Calculation Agent Mexico and the Fund would be called upon to reach agreement on the terms on which the Fund would perform the requested function

The Fund has the authority to accept Mexico's request under Article V, Section 2(b), as the technical service performed by the Fund would be consistent with its purpose Although the potential duration of the service would be 30 years, the cost to the Fund in performing it would be minimal Accordingly, the following decision is proposed for adoption by the Executive Board

The Managing Director is authorized to accept Mexico's request that the Fund act as Mexico's agent for the purposes set forth in the Annex to EBD/89/__, and to make the necessary arrangements therefor

INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

CABLE ADDRESS
INTERFUND

File

December 22, 1989

Reference is made to the Extended Arrangement for Mexico approved by the International Monetary Fund on May 26, 1989.

(1) The Extended Arrangement continues in effect.

(2) As of the date of this letter, Mexico has purchased from the Fund all drawings available under the Extended Arrangement, including a purchase based on the observance of performance criteria as of end-September 1989, for the equivalent of SDR 489.5 million.

Very truly yours,

S.T. Beza
Director
Western Hemisphere Department
International Monetary Fund

Office Memorandum

Mr. Beza

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TO: Mr. S. T. Beza
Mr. L. A. Whittome
Mr. J. A. Frenkel

DATE: December 20, 1989

FROM: Aarno Liuksila

SUBJECT: Mexico - Request for Technical Services

Please let me have your comments on the attached joint memorandum, draft Board paper and draft request by Mexico. I would be grateful if I could receive your comments by close of business Thursday, December 21, 1989.

Attachments

TO The Managing Director
The Deputy Managing Director

DATE December 20, 1989

FROM S T Beza, L A Whittome and F Gianviti

SUBJECT Mexico Request to Perform Technical Services

We expect to receive shortly a request from Mexico for the Fund to act as Calculation Agent under the value recovery provisions of Mexico's 1989-1992 Financing Package As Calculation Agent, the Fund would receive data monthly from the Mexican authorities on prices and volumes for Mexico's oil exports, would calculate the totals thereof, and would transmit the results to the Mexican authorities and the fiscal agent managing the administration of Mexico's 30-year collateralized discount and par bonds The value recovery rights corresponding to the bonds to be issued call for Mexico to appoint a Calculation Agent to perform the calculations used in determining the amounts, if any, of "value recovery payments " Value recovery payments would be made by Mexico on a quarterly basis from September 1996 through 2020, on the basis of increases in oil export proceeds

The staff has reviewed the draft wording of the value recovery rights in this regard, and has suggested changes that would remove any possible implication that the Fund would waive its immunity or submit to arbitration if it acted as Calculation Agent Counsel for Mexico has accepted verbally these suggestions The Fund is authorized to perform the intended function by Article V, Section 2(b) of the Articles, as indicated in the attached draft paper As the data on which the calculations would be based is reliable and readily available from

relatively objective sources, as the calculating and notifying functions are easy and inexpensive to perform, and as the functions proposed would help the Mexican authorities in finalizing the 1989-1992 Financing Package, we recommend that after a request that is substantially in the form of the attached draft has been received by you, the attached Board paper will be forwarded to the Executive Board as your proposal that the request be accepted

Attachment

cc Mr Frenkel
Mr Simpson

EBD/89/__

December __, 1989

To Members of the Executive Board

From The Secretary

Subject Mexico - Request for Technical Services

The attached memorandum proposes that the Fund accept a request by Mexico that the Fund become the Calculation Agent under the impending agreement between Mexico and its commercial bank creditors on the 1989-1992 Financing Package for Mexico

In the absence of objection by the close of business on ______________, December __, 1989, the decision proposed in the attached memorandum will be deemed approved by the Executive Board and it will be so recorded in the minutes of the next meeting thereafter

Other Distribution

Department Heads

INTERNATIONAL MONETARY FUND

Mexico - Request for Fund to Perform Technical Services

Prepared by the Legal and Western Hemisphere Departments

(In consultation with other Departments)

Approved by François Gianviti and Sterie T Beza

December __, 1989

Attached is a request from the Government of Mexico that the Fund act as Mexico's agent for the calculation of additional payments in the event that Mexico's oil revenues increase due to an increase in the real price of the Mexican oil mix above $14 per barrel, under the forthcoming agreement between Mexico and its commercial bank creditors on the 1989-1992 Financing Package for Mexico The draft of that agreement provides for thirty-year collateralized discount and par bonds to be issued by Mexico in exchange for certain outstanding debt One of the provisions of those bonds would be that if Mexico's oil revenues increase significantly, Mexico would make certain supplemental payments ("value recovery payments") to the bondholders

Each quarter, the Calculation Agent will receive data from the Mexican authorities that will enable it to calculate the prices and volumes of Mexico's exports of petroleum and its by-products The Calculation Agent will then promptly inform Mexico and the Fiscal Agent appointed for the Financing Package of the results of the calculations The data in question are published and are reliable, and the calculations proposed are relatively simple and verifiable The

calculations proposed are relatively simple and verifiable The requested function would last as long as the bonds were outstanding, or until Mexico designated another Calculation Agent Mexico and the Fund would be called upon to reach agreement on the terms on which the Fund would perform the requested function

The Fund has the authority to accept Mexico's request under Article V, Section 2(b), as the technical service performed by the Fund would be consistent with its purpose Although the potential duration of the service would be 30 years, the cost to the Fund in performing it would be minimal Accordingly, the following decision is proposed for adoption by the Executive Board

> The Managing Director is authorized to accept Mexico's request that the Fund act as Mexico's agent for the purposes set forth in the Annex to EBD/89/__, and to make the necessary arrangements therefor

E MESSAGE

CLEARY, GOTTLIEB, STEEN & HAMILTON
One State Street Plaza, New York, New York 10004 (212) 344-0600
Telecopy number: (212) 269-4978 (Gps I, II, III)

Fax Number(s): (202) 623-4661
Name: Aarno O. Luksila
Company: International Monetary Fund
City: Washington, D.C.
State/Country: USA
Tel. No.: (202) 623-7797

From: Wanda J. Olson
Date: December 19, 1989
No./Pgs. (incl. cover): 2
Our File Number: 24636-080

IF COPY IS ILLEGIBLE OR INCOMPLETE, PLEASE CALL (212) 344-0600, Extension 2700 or 2738, IMMEDIATELY FOR RETRANSMISSION.

(This space to be used for short or supplemental messages)

Dear Aarno:

As we discussed, there follows a draft letter from Mexico to the Fund requesting that the Fund serve as calculation agent in connection with the value recovery payments to be made in respect of the Discount and Par Bonds described in the 1989-92 Financing Package for Mexico.

Best regards,

Wanda J. Olson

Wanda J. Olson

1989 DEC 19 PM 1

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19 DEC 89 12:56

Draft of December 19, 1989

International Monetary Fund
700 19th Street, N.W.
Washington, D.C. 20431

Attention: ______________________

Dear Sirs:

I am writing on behalf of the United Mexican States to request the assistance of the International Monetary Fund in the implementation of the 1989-92 Financing Package for Mexico.

As you know, one of the elements of the debt reduction and debt-service reduction options set forth in the Financing Package is the right of the holders exchanging existing debt for Discount and Par Bonds to receive, in respect of the period from July 1, 1996 to December 31, 2019, additional payments in the event that Mexico's oil revenues increase due to an increase in the real price of the Mexican oil mix above $14 per barrel. The details regarding the computation of the amount of these additional payments are set forth in pages I-12 to I-14 of the Financing Package and in the draft form of Value Recovery Rights forwarded to you previously.

Mexico hereby requests that, as a technical service to Mexico pursuant to Article V, Section 2(b) of the Fund's Articles of Agreement, the Fund act as Mexico's agent in reference to the calculation of these additional payments.

Very truly yours,

Jose Angel Gurria Trevino
Subsecretario de Asuntos
Financieros Internacionales

Office Memorandum

TO The Managing Director
The Deputy Managing Director

DATE December 19, 1989

FROM S T Beza

SUBJECT Mexico - Recapture Clause of Financial Package

The Mexican authorities have requested that the Fund act as the Calculation Agent in determinating the value of recovery payments resulting from developments in oil prices and volumes to be associated with their future bond obligations The Fund's assumption of this role would facilitate the completion of Mexico's financial package with commercial banks

We are discussing this request with interested Departments and we expect to prepare for your consideration a brief note that could be submitted to the Executive Board on the question of the Fund's assumption of such a role While the matter is likely to be quite managable from the technical standpoint, it would mean a 30 year commitment on the part of the Fund to carry out this particular function, covering the period of the bonds to be issued as part of the financing package

cc Mr Brau
Mr Surr
Mr H Simpson

Office Memorandum

1989 DEC 19 PM 2:44
OFFICE OF THE MANAGING DIRECTOR

STB
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TO: The Managing Director
The Deputy Managing Director

DATE: December 19, 1989

FROM: S. T. Beza

SUBJECT: Mexico - Back to Office Report

The mission that just returned from Mexico negotiated ad referendum the economic program which which would be the basis for the second year of the extended arrangement as well as for the approval and release (including acceleration) of Fund resources for debt and debt service reduction operations.

The authorities requested that the mission negotiate the second year of the arrangement in full rather than restricting itself to the general policy outlook for 1990. All aspects of the program were covered, and there is no need for another mission in early 1990 as had been envisaged earlier.

All performance criteria for September 1989 were met. No difficulties are expected with regard to the end-December targets except for net international reserves, which may not be achieved because of the impact of some capital outflows in November that stemmed from uncertainties about the course of economic policy. These outflows have been arrested, but may not be fully reversed before the end of the year.

The program for 1990 continues the policy stance of 1989. Inflation would decline further and output would continue growing at a moderate pace. The external current account deficit would narrow somewhat and net foreign reserves would decline by US$650 million despite use of US$2.5 billion (including US$1.2 billion from the Fund) to finance enhancements. In view of the vulnerability of the foreign reserve position, a close monitoring of exchange rate policy is envisaged.

The Pact for Economic Solidarity which was initiated in late 1988 was extended through July 1990, with a continuation of the daily depreciation of the peso at an annual rate of some 14 percent. In early December minimum wages were adjusted by 10 percent and public sector prices by some 5-7 percent.

The PSBR and operational fiscal deficit would continue to decline, reflecting lower domestic and foreign interest payments, even with a smaller primary surplus. A fiscal contingency similar to that for 1989 has been incorporated.

Initially the authorities had sought considerable flexibility in dealing with fluctuations in oil prices. In the end, a band was agreed upon, allowing for downward and upward adjustments equivalent to US$1.50 a barrel-- relative to a projected oil price of US$15.

At present the choices under the bank financing package involve enhancements for US$7.5 billion, or US$0.5 billion more than is currently available. The authorities are searching for ways to solve this problem. The mission aims to have the papers ready for Board discussion in late January.

Attachment

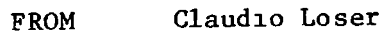
cc: Mr. H. Simpson

Office Memorandum

TO The Managing Director
The Deputy Managing Director

DATE December 19, 1989

FROM Claudio Loser



SUBJECT <u>Mexico - Review Under Extended Arrangement (Nov 30-Dec. 15, 1989)</u>

The mission that just returned from Mexico negotiated, <u>ad referendum</u>, the economic program for 1990 which would constitute the basis for approval of the second year of the extended arrangement, as well as for the release of accumulated set-asides, approval of an augmentation of resources under the arrangement (by 40 percent of quota) and acceleration of disbursements of the set-asides scheduled to become available during the course of 1990.

The mission initially did not expect to discuss the <u>full annual program for 1990</u>. However, the authorities indicated their interest in completing negotiations for 1990, including the establishment of quarterly performance criteria The attached letter of intent and technical memorandum of understanding for 1990 reflect the agreement reached with the Mexican team The Mexican authorities at the highest level agree with the substance of the letter but may suggest some drafting changes in coming days

The negotiations moved quickly and took place in a constructive environment. The mission emphasized the need to protect the net international reserves through tight financial and realistic exchange rate policies, particularly in light of the needs related to acquiring the collaterals for debt-reduction operations The authorities agreed to the need to keep tight control of fiscal and monetary policy. However, they made a <u>strong case against changing the current exchange rate policy</u>, which they consider crucial for the success in slowing down inflation and wage increases They were strongly of the view that under current conditions, a sharp change in the exchange rate would not result in a gain in competitiveness

At the insistence of the mission the authorities agreed to conduct the negotiations on a program based on an oil price of US$15 a barrel (with the limitations described below), as opposed to US$13 in the budget presentation The mission sought a tightening of the fiscal stance but the authorities did not see the need to take actions beyond those in the budget. In the end, they agreed to the incorporation of a <u>fiscal policy contingency</u> similar to that for 1989, which would be triggered by a deterioration in macroeconomic conditions

The authorities sought to have full flexibility in adjusting expenditure if petroleum prices were to increase beyond US$15 a barrel, with only a limited adjustment to expenditure if petroleum prices were to decline The mission expressed reservations about the implications

of such approach, and it was agreed that a band based on movements in petroleum price and excluding interest rates would be established, which is more restrictive than that of 1989

In summary, with the budget defined in terms of an oil price of US$15 a barrel, all resources resulting from a price of oil in excess of US$16.50 would be reflected in a full adjustment of the fiscal target and in net international reserves This provides a band of US$675 million, equivalent to 0 3 percentage point of GDP, within which no adjustment would be made If prices were to decline below US$15 a barrel, the fiscal targets would be adjusted by a maximum of US$2 a barrel (or US$900 million), with full policy adjustment needed to offset lower oil prices thereafter However, the downward adjustment for net international reserves is not to exceed US$675 million

In the final meeting the authorities indicated their interest in having access to contingency financing from the Fund, which would be in parallel with commercial bank support, if external circumstances deteriorated. They did not seem to be interested to make a request immediately, but the possibility of incorporating this mechanism in the future will have to be considered

1 Developments and prospects through end-1989

The performance under the program remains satisfactory All quantitative performance criteria for September 1989 were observed, and it is expected that there would be no difficulty in observing most performance criteria for year-end. However, there may be a shortfall in net international reserves, because of some private capital outflows in late November in response to uncertainties with respect to the financing package and the course of economic policies These pressures were arrested after the announced extension of the Economic Pact (see below). However, reserves may not recover fully by year-end

In early November, the Mexican Government announced the agreement to extend the Pact for Economic Solidarity through July 1990 Within this framework, the peso will continue to be depreciated by one peso a day with respect to the U.S dollar In December minimum wages were increased by 10 percent, while public sector prices, some of which had been increased already in August and September, were adjusted by 5 to 7 percent, gasoline prices were raised by about 7 percent, the first increase since late 1988 Financial markets calmed after the announcement and interest rates stabilized after rising through late November

In November the monthly rate of inflation, measured by consumer prices, was 1 4 percent, and the 12-month rate was about 18 1/2 percent. Because of the adjustments in public sector prices, the 12-month rate of inflation for December could reach 20 percent Economic activity is expanding and real GDP has risen by about

3 percent. The external current account deficit would reach some US$5 5 billion, on account of high imports, financed to a considerable extent by private capital flows.

In 1989 there was a continued pursuit of a tight fiscal policy, with a strong primary surplus offsetting higher than projected interest payments Financial savings increased rapidly reflecting the effect of financial liberalization and increased confidence, allowing for an expansion in credit to the private sector without pressures on external reserves The peso continued to depreciate on a daily basis with respect to the U S dollar, but it has appreciated slightly in real effective terms since early 1989, because of the appreciation of the U.S. dollar (on balance) since early this year

2. The program for 1990

The program for 1990 constitutes a continuation of the policy stance of 1989, within the medium-term strategy of the Mexican Government The key objectives of the program are the consolidation of the process of inflation reduction, increased availability of resources for investment, and a gradual and sustained recovery of economic growth, with particular focus on the poorer segments of the population

For the year real GDP is expected to grow by some 3 1/2 percent, the annual rate of inflation would decline to 15 percent, and the external current account deficit would narrow by US$0 4 billion to some US$5 1 billion, notwithstanding a fall in oil export volumes This excludes the effect of the interest relief of US$2 2 billion provided by the debt reduction exercises Net international reserves would decline by no more than US$650 million, notwithstanding a drawdown for enhancements of US$2.5 billion, including US$1 2 billion from the Fund

There will be continued efforts to increase tax revenues (notwithstanding considerable negative reactions by representatives of both the ruling party and the opposition in Congress) This allows for some increase in capital expenditure and in high priority current expenditure On the basis of an oil price of US$15 a barrel, the primary surplus would decline by about 1 4 percentage points of GDP, to somewhat less than 7 percent The fiscal effort would be consistent with a reduction in the operational deficit of 0 8 percentage point of GDP to 1 percent, and a reduction of more than 1 percentage point of GDP in the PSBR, to about 5 percent

The decline in the PSBR and in the operational deficit would be achieved on the basis of interest relief from abroad and lower domestic interest rates The projected reduction in domestic interest payments of some 2 percentage points of GDP from 1989 and 1990 is conservative, and is accounted for mainly by the effect of the decline that occurred in mid-1989

The economic deficit, i.e , the deficit excluding financial intermediation, would improve by almost 2 percentage points of GDP, although lending by development banks is expected to increase. However, the loans are being made to an increasing extent at market rates Meanwhile the Government will continue its policy of reform and divestiture of public enterprises For 1990 efforts will be focused on the privatization of the telephone company, TFLMEX

The authorities will rely mainly on open market operations for monetary policy, supported by actions to reform the financial system A bill has been presented to Congress aimed at increasing the autonomy of commercial banks, while seeking to modernize other financial intermediaries and increasing bank supervision

The current exchange rate policy is consistent with the macroeconomic objectives of the program but, because of the vulnerability of foreign reserves, developments in this area will need to be monitored closely The authorities view any change in the current system as detrimental to their economic objectives, however, they are ready, if needed, to modify the pace of currency depreciation, and they will examine this issue with the Fund staff in the context of the reviews of the arrangement

At the time of the mission, banks constituting about 90 percent of exposure had replied with regard to their participation in the commercial bank financing package About 10 percent of exposure would go to new money, and the rest would be evenly split between the debt service and the debt-service reduction options With this distribution, the collateral needed would amount to some US$7 5 billion, or US$0.5 more than currently available The authorities are exploring various options of dealing with the shortfall, including a rebalancing of choices toward new money or obtaining some additional financing They also are considering the possibility of reducing the coverage of the guarantee and providing additional own-financing, although these options are highly unlikely It is estimated that the package could be concluded by end-January, with the exchange of debt instruments taking place in March

The ceilings under the program include allowance for the needed additional financing for collaterals However, because of possible delays in obtaining the financing, the net international reserve and related targets for March would be adjusted for those delays No such adjustments are envisaged for subsequent quarters

3 Operational issues

The authorities agreed to maintain quarterly performance criteria for next year The quantitative performance criteria are similar to those of 1989, except for the exclusion of interest payments

from the band A statement has been included indicating the intentions of the authorities to limit their short-term borrowing for the year

The authorities reiterated their interest to replace the concept of the PSBR by a fiscal target that excludes financial intermediation, however, transfers from the Government and realized losses in the balance sheets of the development banks would be included as part of the deficit. This issue would be discussed at the time of the next review, in April or May, and if an adequate methodology is developed, fiscal ceilings could be modified for the second half of the year

The authorities raised the possibility of eliminating the operational deficit as a performance criterion in the future They noted that this concept was useful in the context of high inflation However, with the sharp decline in inflation of the last two years they consider that it is adequate to monitor just the primary outcome and the PSBR. This issue also will be discussed at the time of the next review

On the basis of the current negotiation there would be no need for the visit scheduled for early next year Board discussion could take place in late January or early February The next regular purchase could be made by end-February or March, after completion of the review and observance of performance criteria for end-December

Attachments

cc Mr. Frenkel
Mr. Gianviti
Mr Laske
Mr Tanzi
Mr Van Houtven
Mr Whittome
Mr. H Simpson

Mexico City, Mexico
January --, 1990

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D C 20431

Dear Mr Camdessus:

1. At the time of its inauguration, the Government of Mexico announced a medium-term economic strategy for sustained economic growth and price stability covering the period 1989-94, supported by a three-year extended arrangement from the Fund As stated in our letter of April 11, 1989, the economic strategy for the medium-term encompasses demand management measures, efforts to increase domestic savings both in the public and private sectors, and structural policies necessary to foster economic efficiency The economic program was developed within the context of a significant reduction in the net external resource transfer abroad, a decrease in the debt service burden, and the availability of new external resources within a multiyear horizon In the following paragraphs we describe the progress made to date in the implementation of the medium-term strategy, as well as the policy guidelines for the year 1990

2 Performance in 1989 has been satisfactory Economic activity recovered markedly, with industrial production up by about 6 percent and real GDP growing by some 3 percent The momentum of private sector activity, in the context of a liberalized trade system, was also

reflected in an increase in imports, the bulk of which constituted intermediate and capital goods, financed mainly by greater private capital inflows Hence, despite a large external current account deficit, the net international reserve position was stronger than anticipated, after taking account of substantially lower commercial bank financing The inflation rate, measured by consumer prices, declined from 52 percent during 1988 to about 20 percent during 1989, when measured by producer prices, it declined from 37 percent to 15 percent

3. Underlying these results was a significant strengthening of the public sector finances The primary surplus of the nonfinancial public sector increased from almost 6 percent of GDP in 1988 to about 8 percent of GDP in 1989 This outcome was due to high yields from the income tax reform and a curtailment of noninterest expenditures, as well as more favorable oil prices Domestic interest rates declined sharply in late July from about 4 1/2 percent a month and remained at somewhat over 3 percent in subsequent months following the announcement of the signing of the financing package for 1989-92 with Mexico's commercial bank creditors, however, average interest rates were higher than projected for the year as a whole Nonetheless, their effect on the fiscal balance was more than offset by the strong primary outcome As a result, the public sector borrowing requirement declined from about 13 percent of GDP in 1988 to about 6 percent of GDP in 1989 and the operational deficit from 4 1/2 percent to less than 2 percent of GDP in 1989

4 The public sector received very limited financing from abroad in 1989 and the fiscal deficit was covered primarily through the issuance of government securities placed with the public, facilitated by a strong rise in private sector financial savings, which grew at an annual rate of over 20 percent in real terms This reflected to a large extent the effect of financial liberalization and the improvement in confidence by the public, and allowed for commercial bank credit to the private sector to rise markedly, without putting pressures on reserves

5 The Government of Mexico continued to implement significant structural reform policies in 1989--an effort which it intends to reinforce over the medium term The measures, which have already resulted in increased productivity, include a major overhaul of the tax system, regulatory changes to encourage increased foreign direct investment, an intensified process of public enterprise reform and divestiture, the intensification of the trade liberalization effort, and reforms to raise the efficiency of the financial system, free interest rates, and encourage financial intermediation Furthermore, major efforts have been made to deregulate domestic economic activity, particularly in the areas of transportation, communication and distribution

6 Adequate external financing and a reduction of the net resource transfer have been indispensable for the success of the economic program In this regard, the Government's domestic adjustment efforts have been supported, in addition to Fund resources, by a rescheduling of

official debt service obligations to Paris Club creditors, World Bank assistance in the form of sectoral and project loans, and financing facilities from several official creditors

7 An additional important element in Mexico's financing program is the package with commercial banks Earlier this year, the Government of Mexico reached agreement with the commercial banks' steering committee on a term sheet incorporating a new money option and two debt and debt-service reduction options Banks have responded favorably to the agreement and finalization of the package is expected early next year. The package could result in debt reduction of some US$7 billion, with an additional US$20 billion benefiting from a low fixed contractual interest rate. Gross interest relief arising from these operations could amount to some US$2 2 billion in 1990, and US$1 4 billion a year subsequently, and new money disbursements would total some US$2 billion in the period 1990-92 Thus, after taking account of the restructuring of amortization obligations, the financial package would provide an average annual assistance of some US$3 7 billion for the period through 1994 To finance collaterals for these operations, Mexico expects to draw resources from the Fund, the World Bank, as well as use its own resources, including those freed on account of the funding provided by the Japan Export- Import Bank, these resources are estimated to total some US$7 billion

8 The choices being made by commercial banks within the package will result in a larger than foreseen reduction in debt service obligations

over the medium-term, but the immediate cash flow relief is lower than initially expected, making the domestic effort within the economic plan more demanding In these circumstances, the Government considers that it is crucial to intensify its adjustment efforts in order to achieve the objectives of the multiyear program The objectives and the key aspects of the general economic strategy of the Government of Mexico are reflected in the National Development Plan for 1989-94, which has been designed to help provide an adequate framework of action for the Government and the Mexican society in general, that in turn will help attain an improvement in the quality of life of all Mexicans. In order to attain the required economic recovery, the Government of Mexico will base its policies on the continued stabilization of the economy, increased availability of resources for investment, and a process of economic modernization. These objectives are to be achieved through a consistent and strict management of fiscal, monetary, and exchange rate policies, together with the needed structural reforms in the financial and tax systems, in the context of agreements reached within the Pact for Economic Solidarity (PECE)

9 Within the framework of its medium-term program, the Government aims for the rate of growth of real GDP to increase to 6 percent a year by 1994 The rate of inflation would gradually come down to that of its trading partners National savings would increase by 7 percentage points of GDP from 1989 to 1994, with private savings accounting for 3 percentage points and public sector savings for 4 percentage points

Gross domestic investment would increase by some 4 percentage points of GDP, equally accounted for by the public and private sectors

10 In the context of the general strategy described above, the economic policy for 1990 will be based on four general principles the consolidation of the progress made so far in stabilizing prices, the increase in the availability of resources for investment, the gradual recovery of sustained economic growth, and the improvement of the general well-being of the Mexican people, particularly for the poorer segments of the population Because of existing trends and the need to improve the structure of costs and prices, the reduction of inflation can only be gradual Thus, within the context of firm macroeconomic policies, the rate of inflation is expected to decline to 15 percent in 1990 Following a rebound in 1989, GDP would increase by some 3 5 percent in real terms, in line with a sustained improvement in economic performance

11 The macroeconomic targets would be consistent with an increase in national savings of some 2 percentage points of GDP, mainly reflecting the performance of the public sector and the impact of the debt relief obtained by Mexico Domestic investment would increase by 1 percentage point of GDP after the strong performance shown in 1989 The external current account deficit would decline by some 1 percentage point of GDP, even as the net resource transfer is reduced While net international reserves would fall somewhat, the reduction would be considerably less than the net drawdown of reserves needed to cover the costs of

enhancements for debt reduction operations, reflecting the strengthening of the Mexican economy

12 In December 1989, the Mexican Government and the various sectors of society agreed to extend the PECE through July 1990 Within this framework, the peso continues to be depreciated daily according to a preannounced schedule, minimum wages were increased by 10 percent, and public sector prices and tariffs have been adjusted--most recently by an average 5 percent The extension of the PECE provides the needed framework in which the public sector policy stance will allow for the continued decline in the rate of inflation

13 In 1990, the Mexican Government will be seeking a further strengthening of the public finances while improving the availability of resources for capital and high priority current expenditures On the basis of a petroleum price of US$15 a barrel, the primary fiscal balance would register a surplus amounting to some 7 percent of GDP (or 6 5 percent in the budget approved by Congress on the basis of a price of US$13 a barrel) The fiscal effort as reflected in primary surplus would be consistent with a reduction in the PSBR and the operational deficit by about 1 0 percentage point of GDP to 5 1 and 1 0 percent of GDP, respectively, excluding the capital gains from debt reduction operations The improvement in the public finances would be achieved in circumstances when interest payments of the public sector are expected to decline by more than 3 0 percentage points of GDP on account of the interest relief from the financing package with the commercial banks as

well as the favorable effects on interest rates of lower inflation and greater private sector confidence

14 The budget for 1990 contains a series of measures to improve further the efficiency of the tax system and to strengthen tax administration The marginal tax rates on corporate and personal income will be adjusted to bring them in line with those prevailing abroad while the tax base will be broadened significantly by eliminating the special tax treatment accorded to certain sectors of the economy Tax administration will be strengthened by simplifying payment procedures and strengthening incentives for tax collection These measures are expected to yield an additional increase in tax revenue equivalent to some 1/2 percentage point of GDP However, total public revenues are expected to decline by 0 9 percent of GDP as some nonrecurrent revenues and oil export volumes decline

15 Consistent with its general formulation of policy, the Government of Mexico has made significant adjustments to public sector prices and tariffs helping correct relative prices and strengthening the public finances In October 1989, residential electricity tariffs were increased by an average of 57 percent In December, most public sector goods and services were increased by 5 percent in the context of an extension of the PECE The Government of Mexico will continue to monitor developments in this area, and will take actions as needed in light of the objectives of the program

16. Total expenditure, excluding interest payments, are budgeted to rise by some 1/2 percentage point of GDP in 1990, following several years of decline The increase will be allocated in part to public sector investment in economic infrastructure such as transportation, energy, and communication In addition, the authorities intend to increase outlays on high priority social sectors such as education, health and the environment and to improve the working conditions of the civil service so as to enhance productivity

17. The Mexican authorities will continue to implement vigorously its policy of reform and divestiture of the public enterprises Since the beginning of 1989, the number of enterprises in the public sector has been reduced from about 500 to about 330 These include several big enterprises, such as AeroMexico and Mexicana--the two major domestic airlines--and DINA--a diesel truck manufacturing company For 1990, the Mexican Government has announced its intention to initiate the process of privatization of TELMEX, the telecommunications company, and to streamline the operations of CONASUPO by selling off subsidiaries engaged in industrial activities The privatization program will allow the Government to concentrate its limited resources on areas of high priority

18 Monetary policy will continue to help consolidate the recent gains in reducing inflation, while supporting the macroeconomic objectives of the program, including the attainment of a sustainable balance of payments In order to achieve the monetary targets, the Government will

continue to rely mainly on open market operations, helping increase the efficiency of the financial intermediation process and enhance the prospects for sustained growth in financial savings Furthermore, the deepening of financial markets can be expected to take place as confidence is strengthened, reflecting the completion of the external financing package and continued progress in attaining the objectives of the Mexican economic strategy, which will foster a decline in real interest rates

19 The structural reform of the financial system constitutes a major factor in helping strengthen the savings performance of the economy and the allocation of loanable funds for investment Following a major liberalization of the banking system, financial instruments have been made more flexible and reserve requirements have been reduced and simplified Additional actions will be taken in the coming year in order to enhance the efficiency and profitability of commercial banks by increasing their autonomy while strengthening the supervisory role of the National Banking Commission In addition, draft legislation has been submitted to Congress which seeks a major revamping of the operations of insurance, bonding, and leasing companies, and other credit related institutions, so as to allow for a deepening of financial markets and a lengthening of the terms of financial instruments Actions are also being taken to permit greater participation of foreign investors in Mexican enterprises, while enhancing the role of the stock market in allocating savings The operations of development banks will

be streamlined to help improve resource allocation and further rationalize existing subsidies

20. The maintenance of the country's competitive position vis-a-vis its major trading partners is a key element of Mexico's economic strategy To this end, and as announced in the revision of the PECE for the period through July 1990, the value of the peso will be adjusted daily by one peso against the U S dollar--equivalent to a monthly depreciation of more than one percent As a general principle, the exchange rate policy will continue to be one of small daily adjustments, consistent with the macroeconomic objectives of the program and taking into account developments in key components of the balance of payments (including non-crude oil exports, imports, transfers from abroad, travel related operations, and the behavior of international reserves), as well as forward-looking indicators such as the real effective exchange rate The authorities intend to maintain the policy of permitting free access to the foreign exchange markets and expect that the differential between the exchange rates in the official and free exchange markets will remain low

21 The policies described above, along with anticipated financial assistance from abroad--including in the form of the already agreed rescheduling of official credits under the auspices of the Paris Club and the financing package with commercial banks--are expected to lead to a strengthening of Mexico's underlying balance of payments position Thus, despite the use in 1990 for debt reduction operations of US$2 5

billion of the country's international reserves--including US$1 2 billion from the Fund--the drawdown in net international reserves will be limited to only US$650 million The proposed net international reserve targets provide for a strengthening in the gross reserve position, as well as the purchasing of debt enhancements which may be viewed as effectively constituting prepayments of an important portion of Mexico's external debt and debt service obligations

22 In order to attain the overall balance of payments objective, the current account position is programmed to improve by some US$0 4 billion, before taking account of interest relief of US$2 2 billion provided by the debt reduction exercises, and despite a projected drop in exports of crude oil This improvement is to be achieved in the context of further improvements in the efficiency of the trade system which has already been subject to substantial liberalization The external debt position is projected to improve substantially, reflecting both the reduction of claims and contractual interest rates under the financing package with commercial banks, the reduced level of private sector external debt, and the reduced pace of new debt creation

23 The Mexican authorities believe that the policies and measures for 1990 described in this letter and the results of Mexico's financing package with its commercial bank creditors are adequate to achieve the objectives of the economic strategy, but will take additional measures that may become appropriate for this purpose On this basis, the Government of Mexico seeks continued Fund support in the form of

approval of the second year of the extended arrangement The Government of Mexico also requests the release of accumulated set-asides, approval of an augmentation of resources available under the arrangement (by 40 percent of quota) and acceleration of disbursement of the set-asides scheduled to become available during the course of 1990 The authorities of Mexico and the Fund will consult periodically, in accordance with the policies on such consultations, as specified in our letter of April 11, 1989 A review with the Fund of the implementation of the economic program for 1990 will be completed before August 31, 1990, and the review for reaching policy understandings for 1991 will be completed before February 28, 1991

Yours truly,

/s/
Pedro Aspe Armella
Secretary of Finance and
Public Credit of Mexico

/s/
Miguel Mancera Aguayo
Director General
Banco de Mexico

Technical Memorandum of Understanding 1990

1 In accordance with the economic strategy described in the letters dated April 11, 1989, and January --, 1990, the following performance criteria have been established for 1990 Establishment of performance criteria for 1991 and their phasing will be determined on the occasion of the reviews described in paragraph 28 of the letter dated April 11, 1989, and paragraph 23 of the letter dated January --, 1990

2 Adjustments to performance criteria will be made as described below in the event of deviations from the projected evolution of the price of oil To the extent that the structure and timing of the financial package with commercial banks differ from those assumed in the formulation of the performance criteria contained in this memorandum, the performance criteria for March 1990 also will be adjusted, on the basis of discussions with the Fund staff, for changes in the external financial flows associated with the bank package, including those flows related to the purchase of debt enhancements

I Foreign Financing

3 The public sector's net use of foreign credit (excluding foreign trade lending operations by the Banco de Comercio Exterior) is estimated at US$1,294 billion in 1989 The public sector's net use of foreign credit will not exceed US$6,580 million for the period January-March 1990, US$7,040 million for the period January-June 1990, and US$7,190 million for the period January-September 1990 An

indicative ceiling of US$7,370 million has been established for the period January-December 1990, the ceiling for end-1990 will be specified at the time of the forthcoming review of the arrangement. Notwithstanding the use of foreign credit specified above, the stock of public sector debt is not expected to increase because of the favorable effect of debt-reduction operations Within the ceilings on use of foreign credit, the authorities intend to limit the net use of foreign credit with maturities of less than one year to US$450 million for the period January-December 1990

II Public Finance

4 The overall public sector borrowing requirement, "PSBR" (i e , the economic deficit of the nonfinancial public sector on a cash basis plus the financial intermediation conducted by the national development banks and official trust funds, excluding FICORCA), is estimated at Mex$30,500 billion in 1989 The PSBR will not exceed Mex$6,500 billion in the period January-March 1990, Mex$14,200 billion in the period January-June 1989, Mex$21,350 billion in the period January-September 1990, and Mex$31,050 billion in the period January-December 1990 These limits will be adjusted in accordance with the provisions described in paragraphs 11 through 13

5 The operational deficit of the nonfinancial public sector is estimated at Mex$8,900 billion in 1989 The operational balance will register a surplus of no less than Mex$1,000 billion in the period January-March 1990 It will register a deficit of no more than Mex$1,490 billion in the period January-June, 1990, Mex$2,850 billion in the period

January-September 1990, and Mex$6,150 billion in the period January-December 1990 These limits will be adjusted in accordance with the provisions described in paragraphs 11 through 13

6 The primary surplus of the nonfinancial public sector is estimated at Mex$41,000 billion in 1989 The primary balance will register a surplus of at least Mex$12,550 billion in the period January-March 1990, Mex$23,050 billion in the period January-June 1990, Mex$33,500 billion in the period January- September 1990, and Mex$41,900 billion in the period January-December 1990 These targets will be adjusted in accordance with the provisions described in paragraphs 11 through 13

7 Should macroeconomic objectives of the program (defined for this purpose as (a) the inflation rate as measured by the CPI, and (b) the external current account net of crude oil exports) not be achieved in spite of the observance of the fiscal targets stated above, the Mexican authorities, in consultation with the Fund staff, will strengthen their fiscal stance with additional policy measures These policy measures, which will be of a permanent nature, will aim at increasing the fiscal primary surplus to a level that would assure achievement of the macroeconomic objectives of the program

III Banco de Mexico Operations

8 The net international reserves of the Banco de Mexico are estimated at US$1,090 million on December 31, 1989 The net international reserves of the monetary authorities will not decline by

more than US$1,130 million in the period January-March 1990, by more than US$1,090 million in the period January-June 1990, by more than US$920 million in the period January-September 1990, and by more than US$650 million in the period January-December 1990 These targets will be adjusted in accordance with the provisions of paragraphs 11 through 13

9 The net domestic assets of the Banco de Mexico are estimated at Mex$13,980 billion on December 31, 1989 The net domestic assets of the Banco de Mexico will increase by no more than Mex$2,730 billion in the period January-March 1990, by no more than Mex$3,110 billion in the period January- June 1990, by no more than Mex$2,920 billion in the period January-September 1990, and by no more than Mex$5,540 billion in the period January-December 1990 These limits will be adjusted in accordance with the provisions of paragraphs 11 through 13

10 The Banco de Mexico's net claims on the public sector are estimated at Mex$31,880 billion on December 31, 1989 The Banco de Mexico's net claims on the public sector will not exceed Mex$32,370 billion during the period January-March 1990, Mex$33,040 billion during the period January-June 1990, Mex$33,510 billion during the period January-September 1990, and Mex$34,250 billion during the period January-December 1990 These limits will be adjusted in accordance with the provisions of paragraphs 11 through 13

IV Oil Price Adjustments

11 Performance criteria will be adjusted for deviations in the price of oil, as specified below The adjustment, based on the

cumulative effect of the movements in this variable, will be made on all performance criteria with the exception of the public sector's net use of foreign credit, which will not be subject to this adjustment. The oil price adjustment to quantitative performance criteria in any calendar quarter beginning January 1, 1990 will be calculated as the value that results from multiplying the reference volume of crude oil exports 1/ by the difference between the mean price of Mexican oil exports in the respective quarter 2/ and US$15 a barrel

12 Upper-end adjustment If in any calendar quarter beginning January 1, 1990 the cumulative effect of higher than projected oil prices (as defined in paragraph 11), exceeds a threshold value of US$675 million on an annual basis 3/ the target for the Banco de Mexico's net international reserves for the same quarter will be adjusted upward by the value of the excess over the threshold for that quarter In addition, the corresponding limits on the net domestic assets of the Banco de Mexico, on the net credit from the Banco de Mexico to the public sector, on the PSBR, on the operational deficit of the nonfinancial public sector will be lowered, and the target for the

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1/ The reference volume of crude oil exports is defined to be 1 23 million barrels a day

2/ For purposes of this adjustment, the mean price of oil in any calendar quarter is defined as the average price of Mexican exports of Maya, Isthmus, and Olmeca crudes in that quarter, weighted by their respective shares in exports, as reported by PEMEX

3/ For the March 31, 1990, June 30, 1990, and September 30, 1990 testing dates, the relevant threshold value will be limited to 25 percent, 50 percent, and 75 percent, respectively, of US$675 million

primary surplus of the nonfinancial public sector will be raised, by the Mexican peso equivalent 1/ of the adjustment to the net international reserve target.

13 Lower-end adjustment If in any calendar quarter beginning January 1, 1990, there is a cumulative effect of lower than projected oil prices (as defined in paragraph 11), the target for the Banco de Mexico's net international reserves for the same quarter will be adjusted downward by that value In addition, the corresponding limits on the net domestic assets of the Banco de Mexico, on the net credit from the Banco de Mexico to the public sector, on the PSBR, and on the operational deficit of the nonfinancial public sector will be raised, and the target for the primary surplus of the nonfinancial public sector will be lowered, by the Mexican peso equivalent of the adjustment to the net international reserve target. For purposes of adjusting Banco de Mexico's net international reserve target and net domestic assets limit, the lower-end adjustment will be limited to US$675 million (or its Mexican peso equivalent) on an annual basis 2/ For purposes of adjusting the limit on the net credit from the Banco de Mexico to the public sector, on the PSBR, on the operational deficit of the nonfinancial public sector, and the target for the primary surplus of

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1/ For purposes of the oil price adjustment, the Mexican peso equivalent will be calculated on the basis of the average exchange rate for the corresponding period

2/ For the March 31, 1990, June 30, 1990, and September 30, 1990 testing dates, the relevant limit will be 25 percent, 50 percent, and 75 percent, respectively, of US$675 billion (or its Mexican peso equivalent)

the nonfinancial public sector, the lower-end adjustment will be limited to the Mexican peso equivalent of US$900 million on an annual basis 1/

V Other

14 Exchange rate developments will be kept under careful monitoring in accordance with the macroeconomic objectives of the program, on the basis of the principles contained in paragraph 20 of the letter dated January __, 1990 This issue will be examined with the Fund staff in the context of discussions under the arrangement

1/ For the March 31, 1990, June 30, 1990, and September 30, 1990 testing dates, the relevant limit will be 25 percent, 50 percent, and 75 percent, respectively, of the Mexican peso equivalent of US$900 million

tbmex073 (12-19-89)

Table 1 Mexico Selected Economic Indicators

	1986	1987	1988	Proj 1989	Proj 1990
(Annual percentage change)					
Real GDP	-3 8	1 5	1 1	2 5	3 5
Consumer prices (average)	86 2	131 8	114 2	20 2	17 8
Consumer prices (end-of-year)	105 7	159 2	51 7	20 0	15 0
(In billions of U S dollars)					
External sector					
Current account (deficit -)	-1 2	3 9	-2 9	-5 5	-5 1
Of which exports (f o b)	17 3	22 3	23 0	25 9	27 8
imports (f o b)	-11 4	-12 2	-18 9	-22 8	-24 9
interest payments	-8 3	-8 4	-8 9	-9 6	-9 4
Official capital (net)	-0 5	3 9	0 4	0 8	1 0
Private capital (net)	0 5	-1 1	-4 4	3 9	3 4
Net reserve movement (increase -)	1 2	-6 6	6 9	0 7	0 6
(In percent of GDP)					
Nonfinancial public sector					
Primary balance	2 3	5 0	5 9	8 3	6 9
Operational balance	-1 8	2 0	-4 4	-1 8	-1 0
Public sector borrowing requirement	15 6	15 9	12 9	6 2	5 1
Savings and investment					
Gross domestic investment	18 1	18 6	20 4	22 8	23 6
Public sector	5 2	5 3	5 0	4 8	5 1
Private sector	12 9	13 3	15 4	18 0	18 5
Gross national savings	17 2	21 3	18 8	20 0	22 2
Public sector 1/	3 7	7 4	0 7	3 1	4 2 2/
Private sector	13 5	13 9	18 0	16 9	18 0
External savings	0 9	-2 7	1 6	2 7	1 3 2/
Memorandum items					
Nominal GDP (millions of U S dollars)	129 9	141 2	176 7	200 7	217 7
Velocity of M4 (GDP/M4)	3 3	3 3	3 6	3 0	2 7

Sources Mexican authorities, and Fund staff estimates

1/ Adjusted for the inflationary component of interest payments on domestic debt

2/ Adjusted for interest relief accruing in 1989 and 1990

Table 2 Mexico Performance Under Extended Arrangement for 1989 1/

	Est March	Targets and Ceilings June	Sept	Dec
(In billions of Mexican pesos)				
Overall public sector borrowing requirement 2/3/	6 437	13 214	19 449	
Ceiling				
Unadjusted	7 740	15 400	25 400	33 900
Adjusted 4/	7 628	14,175	23 417	31 010
Excess (-)/Margin (+)	1 192	961	3,968	
Nonfinancial public sector operational balance 2/5/	2,478	2 533	5 761	
Ceiling				
Unadjusted	3 110	5 600	8 920	12 130
Adjusted 4/	2 998	4 375	6 937	9 240
Excess (-)/Margin (+)	521	1 842	1 176	
Changes in net domestic assets of the monetary authorities (effective flows) 2/3/6/	-1 407	1,298	1 029	
Ceiling				
Unadjusted	--	3 330	1 120	-985
Adjusted 4/	-112	2 105	-863	-3 875
Adjusted 7/8/	-112	5 539	4 213	4 479
Excess (-)/Margin (+)	1 295	4 241	3 184	
Net credit to the nonfinancial public sector by the monetary authorities 9/	34,406	33,292	29 604	
Ceiling				
Unadjusted	32 686	33 910	34 210	34 520
Adjusted 4/	32 574	32 685	32 227	31 630
Adjusted 7/8/	32 574	36,119	37 303	39 984
Excess (-)/Margin (+)	-1 832	2 827	7 699	
Primary surplus	11,793	25 746	35 970	
Target 2/3/				
Unadjusted	9 250	19 700	27 600	35 350
Adjusted 4/	9,362	20 675	29 087	37 163
Excess (-)/Margin (+)	2 432	5,071	6,883	
(In millions of U S dollars)				
Net foreign borrowing by the public sector 2/	-579	-783	-564	
Ceiling				
Unadjusted	-440	900	3 710	6 650
Adjusted 7/8/	-440	900	1 950	3,210
Excess (-)/Margin (+)	139	1 683	2 514	
Change in net international reserves of the monetary authorities 2/	-49	-910	-788	
Target				
Unadjusted	-200	-1 010	-40	1,490
Adjusted 4/	-152	-493	781	2 664
Adjusted 7/8/	-152	-1 942	-1 320	-730
Excess (-)/Margin (+)	103	1 031	532	

Sources Mexican authorities and Fund staff estimates

1/ Limit tested at the end of each period starting June 30
2/ Cumulative changes from end-1988
3/ Effective flows of financing measured on a cash basis
4/ Adjustments relating to provisions under oil price and/or interest rate mechanisms adjustments for December estimated on an average oil price of US$15 a barrel and LIBOR of 9 0 percent for the period October-December
5/ Defined as the difference between the overall public sector borrowing requirements excluding cumulative changes in financial intermediation and the inflation component of interest payments on the domestic public sector debt denominated in local currency
6/ Net domestic assets of the Bank of Mexico for purposes of the ceiling are defined as the difference between note issue and net international reserves of the Bank of Mexico
7/ Ceiling adjusted for changes in timing of gross external financing
8/ Ceiling adjusted for operations aimed at reducing external debt
9/ Effective stocks calculated by adding effective flows to the nominal stock of Mex$31,464 billion outstanding as of the end of 1988

tbmex094 (12-19-89)

Table 3 Mexico Quantitative Performance Criteria for 1990 1/

	1990			
	March 2/	June	Sept	Dec
(In billions of Mexican pesos)				
Overall public sector borrowing requirement 3/ 4/ 5/				
Ceiling	6 500	14 200	21 350	31 050
Nonfinancial public sector operational deficit 3/ 5/ 6/				
Ceiling	-1 000	1 490	2 830	6 150
Changes in net domestic assets of the monetary authorities (effective flows) 3/ 4/ 5/ 7/				
Ceiling	2 730	3 110	2 920	5 540
Net credit to the nonfinancial public sector by the monetary authorities 5/ 8/				
Ceiling	32 370	33 040	33 510	34 250
Primary surplus				
Target 3/ 4/ 5/	12 550	23 050	33 500	41 900
(In millions of U S dollars)				
Net foreign borrowing by the public sector 3/				
Ceiling	6,580	7 040	7 190	7 370 9/
Change in net international reserves of the monetary authorities 3/ 5/				
Target	-1 130	-1 090	-920	-650

Source Technical Memorandum of Understanding 1990

1/ Limit tested at the end of each period
2/ End-March performance criteria will be adjusted to the extent that the structure and timing of the financial package and associated flows differ from those assumed in the formulation of the performance criteria
3/ Cumulative changes from end-1989
4/ Effective flows of financing measured on a cash basis
5/ Adjustments relating to provisions under oil price adjustments as described in paragraph 11-13 of Technical Memorandum of Understanding
6/ Defined as the difference between the overall economic deficit and the inflation component of interest payments on the domestic public sector debt denominated in local currency
7/ Net domestic assets of the Bank of Mexico for purposes of the ceiling are defined as the difference between note issue and net international reserves of the Bank of Mexico
8/ Effective stocks calculated by adding effective flows to the nominal stock of MexS31 880 billion outstanding as of the end of 1989
9/ Indicative ceiling

tbmex072 (12-19-89)SR

Table 4 Mexico Financial Flows

(In trillions of Mexican pesos, unless otherwise indicated)

	1987	1988	1989 Prog	1989 Proj	1990 Prog
Total sources of funds	53 0	52 7	46 6	61 2	67 7
Growth of M-4	51 9	52 3	31 0	57 5	48 3
(percentage real annual growth)	(--)	(6 7)	(4 5)	(19 1)	(10 0)
Foreign borrowing by public sector	6 7	1 4	15 6	4 7	19 4
(billions of U.S. dollars)	(4 9)	(0 6)	(6 3)	(1 8)	(7 1)
Other deposits	-5 6	-1 0	--	--	--
Total use of funds	53.0	52 7	46 6	62 2	67 7
International reserve accumulation	9 0	-15 6	3 7	-1 7	-1 6
(billions of U S dollars)	(6 6)	(-6 9)	(1 5)	(-0 7)	(-0 7)
Public sector borrowing requirement	30.6	51 2	33 9	30.5	31 1
(percent of GDP)	(15 9)	(12 9)	(7 0)	(6 2)	(5 1)
Enhancements for debt reduction operations	--	--	--	--	20 1
(billions of U S dollars)	(--)	(--)	(--)	(--)	(7 5)
Commercial bank credit to private sector	13 4	17 0	9 0	33 4	18 2
(percentage real annual growth)	(-0 6)	(17 2)	(4 2)	(52 0)	(8 0)
Memorandum items					
Exchange rate (pesos per dollar)					
end of period	2,199	2,259	2,469	2,640	3,005
period average	1,367	2,250	2,398	2,594	2,822
GDP	195.6	408 9	484 2	491 9	605 3

Sources Bank of Mexico, and Fund staff estimates

Table 5 Mexico Summary of Public Sector Operations

(In percent of GDP)

	1987	1988	1989 Prog	1989 Proj	Prog 1990
Public sector borrowing requirement	15 9	12 9	7 0	6 2	5 0
Financial intermediation	0 9	1 6	1 2	0 5	1 2
Overall economic balance	-15 0	-11 3	-5 8	-5 7	-3 8
Statistical discrepancy 1/			--	0 1	--
Interest payments	20 0	17 2	13 1	14 0	10 8
External	4 6	3 9	4 1	3 9	2 5
Domestic	15 4	13 3	9 0	10 1	8 2
Primary balance (total)	5 0	5 9	7 3	8 4	6 9
Primary balance (extrabudgetary)	-0 6 2/	-1 3 2/	-0 3	0 1	0 2
Primary balance (budgetary)	5 6	7 2	7 6	8 3	6 7
Receipts under budgetary control	29 6	28 5	27 3	28 3	27 4
Petroleum	12 0	9 9	8 4	9 0	8 5
Nonpetroleum	17 6	18 6	18 8	19 3	18 9
Public enterprises 3/	8 0	7 9	6 7	6 6	6 5
Federal government	9 6	10 7	12 1	12 7	12 4
Taxes	8 5	9 5	10 4	10 4	10 5
Nontax revenue	1 1	1 2	1 6	2 3	1 9
Outlays within primary balance	24 0	21 4	19 7	20 0	20 7
Programmable outlays	20 6	17 8	16 2	16 7	17 2
Wages	6 0	5 3	4 8	5 1	5 4
Transfers	3 3	2 6	2 4	2 6	2 6
Investments	3 7	3 0	2 7	2 5	2 7
Other 4/	7 6	6 9	6 3	6 5	6 5
Nonprogrammable outlays	3 0	3 3	3 5	3 4	3 5
Unclassified	0 3	0 2	--	-0 1	--
Inflation component of interest payments	17 0	6 9	3 3	3 9	2 9
Operational balance	2 0	-4 4	-2 5	-1 8	-0 9
Memorandum items					
Nonoil primary balance	-1 0	2 5	4 5	5 0	4 0

Sources Secretariat of Finance and Public Credit, Secretariat of Programming and Budget and Fund staff estimates

1/ Arises from differences between the monetary accounts and the accounts of the Secretariat of Finance and Public Credit in the measurement of the overall fiscal balance

2/ Includes statistical discrepancies

3/ Includes gross receipts from sales

4/ Includes enterprises' operating expenditure other than wages and salaries

Table 6 Mexico Summary Balance of Payments 1987-90

(In billions of U S dollars)

	1987	1988	1989 Prog	1989 Scen	Prog 1990
Current account	3 9	-2 9	-4 8	-5 5	-5 1
Merchandise trade f o b	10 0	4 1	4 3	3 0	2 9
Exports	22 2	23 0	25 0	25 9	27 8
Petroleum and derivatives	8 6	6 7	6 5	7 7	7 3
Other	13 6	16 3	18 5	18 1	20 5
Imports	-12 2	-18 9	-20 8	-22 8	-24 9
Public sector	-2 8	-3 6	-3 8	-3 8	-3 8
Private sector	-9 4	-15 4	-16 9	19 0	-21 1
Factor income	-7 3	-7 6	-9 5	-8 5	-7 9
Interest on public debt	-6 3	-7 0	-8 9	-7 6	-8 0
Other interest payments	-2 1	-1 9	-1 7	-2 0	-1 4
Other	1 0	1 3	1 1	1 1	1 5
Other services and transfers	1 1	0 6	0 4	--	--
Travel	1 5	1 4	1 6	1 2	1 3
Border transactions	-0 4	-0 6	-0 6	-0 8	-0 9
Other	--	-0 2	-0 6	-0 4	-0 4
Capital account	2 7	-4 0	6 3	4 7	4 4
Official capital	3 9	0 4	6 1	0 8	1 0
Commercial banks 1/	4 4	-1 5	4 3	-0 2	4 1
Multilaterals	0 4	0 9	1 4	0 8	2 9
Bilaterals and suppliers 2/	1 7	0 8	1 2	1 5	2 6
Other (including short term)	-2 6	0 2	-0 8	-1 3	-8 6 3/
Private capital	-1 1	-4 4	0 2	4 0	3 4
Interest earnings abroad	-1 2	-1 5	-1 5	-1 7	-1 5
Direct investment 4/	3 3	2 6	2 1	2 6	3 5
Net external credits	-2 2	-1 9	-0 9	-1 3	--
Other payments errors and omissions	-0 9	-3 6	0 5	4 4	1 4
Net international reserves (increase -)	-6 6	6 9	-1 5	0 7	0 7
Memorandum items					
As percent of GDP					
Nonpetroleum exports	9 6	9 2	9 2	9 1	9 4
Merchandise imports	8 7	10 7	10 3	11 4	11 4
Current account balance	2 7	-1 6	-2 4	-2 7	-2 3
Gross international reserves 5/					
In months of					
Merchandise imports	12 1	3 1	4 2	2 7	2 6
Imports plus interest payments	7 2	2 1	2 8	1 9	2 0
Crude oil export volume (millions/bpd)	1 3	1 3	1 3	1 3	1 2
Average crude oil price (US$/bbl)	16 0	12 3	12 0	15 4	15 0

Sources Bank of Mexico and Fund staff estimates

1/ Including impact of rescheduling and in 1990 interest relief from debt and debt-service reduction operations
2/ Including CCC and Paris Club rescheduling
3/ Including outflows in support of enhancement operations for debt and debt-service reduction
4/ Including debt-equity operations
5/ Excluding gold payments agreements and proceeds from 1989 official bridge facility

Table 7 Mexico Medium-Term Growth Scenario

	Est 1989	Projection 1990	1991	1992	1993	1994	1995
	(Annual percentage change)						
Real GDP	2 5	3 5	4 5	5 5	6 0	6 0	6 0
Consumer prices (average)	20 2	17 8	12 4	8 6	6 0	6 0	6 0
Consumer prices (end of year)	20 0	15 0	10 0	8 0	6 0	6 0	6 0
	(In billions of U S dollars)						
External sector							
Current account (deficit -)	-5 5	-5 1	-2 7	-2 4	-2 1	-1 9	-1 6
Of which exports (fob)	25 9	27 8	30 9	33 9	37 3	41 1	45 3
imports (fob)	-22 8	-24 9	-27 1	-29 8	-33 1	-36 7	-40 7
interest payments	-9 6	-9 4	-8 0	-8 0	-8 0	-8 0	-8 0
Official capital (net)	0 8	1 0	0 8	0 7	0 6	0 3	0 1
Private capital (net)	3 9	3 4	2 1	2 5	2 4	2 6	2 8
Net reserve movement (increase -)	0 7	0 6	-0 3	-0 8	-0 9	-1 0	-1 3
	(In percent of GDP)						
Nonfinancial public sector							
Primary balance	8 3	6 9	6 0	5 4	4 9	4 4	4 0
Operational balance	-1 8	-1 0	0 2	0 8	0 7	0 6	0 7
Public sector borrowing requirement	6 2	5 1	2 7	1 7	1 3	1 2	1 1
Savings and investment							
Gross domestic investment	22 8	23 6	24 4	24 9	26 5	27 2	28 2
Public sector	4 8	5 1	5 2	5 4	5 9	6 1	6 3
Private sector	18 0	18 5	19 2	19 6	20 6	21 1	21 9
Gross national savings	20 0	22 2	23 3	24 0	25 7	26 5	27 7
Public sector 1/	3 1	4 2 2/	5 6	6 4	6 8	7 0	7 2
Private sector	16 9	18 0	17 6	17 7	18 9	19 6	20 5
External savings	2 7	1 3 2/	1 1	0 9	0 8	0 6	0 5
Memorandum items							
Nominal GDP (in millions of U S dollars)	200 7	217 7	236 4	264 1	273 7	301 7	332 6
Velocity of M4 (GDP/M4)	3 0	2 7	2 6	2 6	2 6	2 6	2 6

Sources Mexican authorities and Fund staff estimates

1/ Adjusted for the inflation component of interest payments on domestic debt
2/ Adjusted for interest relief accruing in 1989 and 1990

Cable Room ID: MC1B0610 Page: 1	Distribution
Processed: December 11, 1989 14:43 Sender: Banco de Mexico Mexico (Mexico)	ORIG: TRE CC: MRS. FILARDO WHD

STB
CL
JB
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FJ

INCOMING MESSAGE

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.
1989 DEC 12 PM 4:25

1775805 BMCOME
1QXQWXIO QECWWCTI

T 26232 MEXICO DF 11 DEC 1989 RVL LFCP
TO: INTERNATIONAL MONETARY FUND
WASHINGOTN, D.C.
TREASURY DEPARTMENT
ATT'N.: MRS. LYNN/ MR. R. VECUTINI
SDR DEPARTMENT

NO. 73

IN REFERENCE TO OUR TELEPHONE CONVERSATION OF TODAY, WE HEREBY REQUEST TO BUY 30,000,000 SDR (THIRTY MILLION SPECIAL DRAWING RIGHTS), VALUE DECEMBER 14, 1989. AT THE RATE FIXED ON DECEMBER 11, 1989. WE WILL WAIT FOR YOUR INSTRUCTIONS IN ORDER TO EXECUTE THE OPERATION.

BEST REGARDS,

BANCO DE MEXICO

BANXICO

11/12/89 13:24:39

64203 IMF UW

1775805 BMCOME

Note:
*** Test Accepted ***

Office Memorandum

Mr. Beza
mexico

STB
CL
JB
IO
Files

CONFIDENTIAL

TO: The Managing Director
The Deputy Managing Director

DATE: November 28, 1989

FROM: François Gianviti F. G.

SUBJECT: Mexico and the 1989-1992 Financing Package - Use of Proceeds of Future Purchases from the Fund to Secure an Irrevocable Stand-By Letter of Credit to be issued by a Group of Banks Including the Citibank N.A., as Agent

This is to inform you that, in accordance with the Fund's constant practice, we have refused to accept irrevocable instructions from Mexico for the purpose of securing an irrevocable stand-by letter of credit to be issued by a group of banks including Citibank N.A., as agent. This letter of credit, pending delivery by the official sources of collateral funds, would secure discount bonds and/or par bonds to be issued in exchange of eligible debt under the Financing Package.

Together with the incoming facsimile message requesting our advice, I attach a copy of Mr. Liuksila's reply to counsel for Mexico.

Attachments

cc: Mr. Beza
Mr. Whittome
Mr. Laske
Mr. Simpson

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.
1989 NOV 28 PM 3: 21

FACSIMILE MESSAGE

RECEIVED
IMF CABLE ROOM
1989 NOV 22 PM 2 31

CLEARY, GOTTLIEB, STEEN & HAMILTON
One State Street Plaza, New York, New York 10004 (212) 344-0600
Telecopy number: (212) 269-4978 (Gps I, II, III)

Fax Number(s): (202) 623-4661
Name: Aarno Liuksila
Company: International Monetory Fund
City: Washington
State/Country: D.C.
Tel. No.: (202) 623-7797

From. Jeffrey Lewis
Date: November 21, 1989
No./Pgs. (incl. cover): 9
Our File Number: 24636-080

IF COPY IS ILLEGIBLE OR INCOMPLETE, PLEASE CALL (212) 344-0600, Extension 2700 or 2738, IMMEDIATELY FOR RETRANSMISSION

(This space to be used for short or supplemental messages)

Re: U.M.S. 1989-1992 Financing Package

Dear Mr. Liuksila:

At the request of Ana Demel, I am sending herewith Sherman & Sterling's drafts of letters of instruction relating to the disbursement of funds provided by the IMF as collateral for the Discount and Par Bonds. We would appreciate it if you would review the letters to the extent that they relate to the IMF

Please call me if you have any questions or comments.

Sincerely,

Jeffrey Lewis

cc: Mark Walker

23 NOV 89 12:53

[Letterhead of Secretaria de Hacienda y Credito Publico]

____________, 19__

The International Monetary Fund
700 19th Street, N.W.
Washington, D.C. 20431
Attn: ________________________

Gentlemen:

We refer to the purchases (each such purchase being a "Purchase") remaining to be made by the United Mexican States ("Mexico") from The International Monetary Fund (the "IMF") under the Extended Arrangement approved by the Executive Board of the IMF on May 24, 1989 in the amount of SDR [_____] billion

As you are aware, under the Discount and Par Bond Exchange Agreement dated ___________, 1989 among Mexico, as issuer, Citibank, N A., as closing agent, and others (the "Discount and Par Bond Exchange Agreement", terms being used herein as therein defined), Purchasers will commit to exchange on the Exchange Date all or a portion of their Eligible Debt for Discount Bonds and/or Par Bonds. As a condition to the occurrence of the Exchange Date, Mexico will be required to deliver U S $7 billion to _______________, as the Collateral Agent for the Discount and Par Bonds (the "Collateral Agent"), to secure the principal of and a portion of the interest payable on, the Discount and Par Bonds Mexico will provide U S $1 3 billion of the U.S. $7 billion on the Exchange Date from its own resources Mexico will obtain from the IMF, the IBRD and the Export-Import Bank of Japan (the "Official Sources") approximately U.S. $5 7 billion of the funds to be used for the purchase of the collateral over the period 1989-92 It is expected that U.S. $5 8 billion (U.S $4.5 billion of funds from the Official Sources and U.S. $1 3 billion provided by Mexico from its own resources) will be made available for the purchase of collateral on or before the Exchange Date, with the balance to be made available no later than March 31, 1992.

Pending delivery by the Official Sources of the remaining funds, the shortfall in funded collateral will be covered by committed amounts under irrevocable standby letters of credit (the "Letters of Credit") to be issued, for the account of Mexico, by a group of commercial banks in favor of the Collateral Agent for the Discount and Par Bonds. Citibank, N.A. (the "L/C Agent") has agreed to act as agent for such banks.

In connection with the foregoing, Mexico, acting through the Secretaria de Hacienda y Credito Publico, hereby irrevocably instructs you to deposit the proceeds of each

Purchase in a special account of Banco de Mexico with the Federal Reserve Bank of New York (the "FRBNY") account no. ________ (the "Special Account")

As you are aware, Banco de Mexico has separately instructed the FRBNY that amounts on deposit in the Special Account will be applied to satisfy our obligation to fund the shortfall in funded collateral referred to above or, in certain circumstances, to satisfy our obligations with respect to amounts payable under the Letter of Credit and Reimbursement Agreement dated as of ______, 1989 (the "Letter of Credit Agreement")

Further, all deposits in the Special Account shall be made in U S Dollars. For this purpose, the IMF is hereby instructed to use the proceeds of any Purchase under the Extended Arrangement to obtain U S. Dollars under such terms and conditions as the IMF shall determine.

We are not aware of any third party claims upon the proceeds of any Purchase.

We acknowledge that your action on this irrevocable instruction will be taken in conformity with the relevant provisions of the Extended Arrangement and such action shall not be construed in any way as a waiver of any right which you may have thereunder.

THE UNITED MEXICAN STATES,
acting through Secretaria
de Hacienda y Credito Publico

By ______________________
Title:

[Letterhead of IMF]

____________, 19__

Citibank, N A., as agent
under the Letter of Credit
and Reimbursement Agreement
dated as of ________, 1989

Gentlemen:

We refer to a letter dated _______, 19__ from the United Mexican States, acting through the Secretaria de Hacienda y Credito Publico, to us attached hereto as Exhibit A (the "Letter", terms used but not defined herein being used herein as therein defined) At the request of Mexico, we are pleased to advise you that in connection with the 1989-92 Financing Package (as defined in the Discount and Par Bond Exchange Agreement) the Executive Board of The International Monetary Fund approved on May 24, 1989 an Extended Arrangement (the "Financing") in the aggregate amount of SDR _____ billion.

The Financing provides for [_____] purchases by Mexico against receipt of ________ (each such purchase being a "Purchase"). The first Purchase of U.S. $[1 204] billion was made on ______________ and the remaining Purchases are expected to be made, subject to the applicable conditions therefor, on or before the dates and in the amounts set forth below:

Date	Amount
03/31/91	U.S $ 88 million
06/30/91	U.S. $ 88 million
09/30/91	U S. $ 88 million
12/31/91	U.S. $ 88 million
03/31/92	U.S. $ 88 million

Accordingly, we hereby confirm that the irrevocable instructions set forth in the Letter are acceptable to us and that we will comply in all respects with these irrevocable instructions. We also confirm that we will continue to comply with such instructions unless and until we receive a notice signed by you instructing us otherwise.

THE INTERNATIONAL
MONETARY FUND

By __________________
Title.

[Letterhead of Banco de Mexico]

____________, 19__

The Federal Reserve Bank of New York
23 Liberty Street
New York, NY 10045
Attn: ______________________

Gentlemen:

We refer to the purchases (each such purchase being a "Purchase") by the United Mexican States ("Mexico") from The International Monetary Fund (the "IMF") under the Extended Arrangement [and ________] approved by the Executive Board of the IMF on May 24, 1989 in the aggregate amount of SDR [_____] billion

As you are aware, under the Discount and Par Bond Exchange Agreement dated __________, 1989 among Mexico, as issuer, Citibank, N A., as closing agent, and others (the "Discount and Par Bond Exchange Agreement", terms being used herein as therein defined), Purchasers will commit to exchange on the Exchange Date all or a portion of their Eligible Debt for Discount Bonds and/or Par Bonds. As a condition to the occurrence of the Exchange Date, Mexico will be required to deliver U S. $7 billion to ______________, as the Collateral Agent for the Discount and Par Bonds (the "Collateral Agent"), to secure the principal of and a portion of the interest on, the Discount and Par Bonds Mexico will provide U S. $1.3 billion of the U.S. $7 billion on the Exchange Date from its own resources. Mexico will obtain from the IMF, the IBRD and the Export-Import Bank of Japan (the "Official Sources") approximately U.S. $5 7 billion of the funds to be used for the purchase of the collateral over the period 1989-92. It is expected that U.S. $5.8 billion (U S. $4 5 billion of funds from the Official Sources and U.S $1.3 billion provided by Mexico from its own resources) will be made available to Mexico on or before the Exchange Date with the balance expected to be made available no later than March 31, 1992.

Pending delivery by the Official Sources of the remaining funds, the shortfall in funded collateral will be covered by committed amounts under irrevocable standby letters of credit (the "Letters of Credit") to be issued, for the account of Mexico, by a group of commercial banks in favor of the Collateral Agent for the Discount Bonds and Par Bonds. Citibank, N.A. (the "L/C Agent") has agreed to act as agent for such banks.

In connection with the foregoing, Mexico has irrevocably instructed the IMF to deposit the proceeds of each Purchase in a special account of Banco de Mexico, account no ______ maintained by you at [23 Liberty Street, New York, New York 10045] (the "Special Account"). In connection with the foregoing, Banco de Mexico, acting at the behest of the Secretaria de Hacienda y Credito Publico, hereby irrevocably instructs you to deposit, promptly upon receipt thereof, all amounts in the Special Account in the Collateral Agent's account, account no ________ located at ________. Such deposits are being made to satisfy our obligation to fund the shortfall in funded collateral referred to above Notwithstanding the foregoing, upon your receipt of written instructions from the L/C Agent substantially in the form of Exhibit A, you shall thereafter deposit all amounts in the Special Account to the L/C Agent's account, account no. ________ located at _____ (the "L/C Agent's Account"). Such deposits will be made to satisfy our obligations with respect to amounts payable under the Letter of Credit and Reimbursement Agreement dated as of _______, 1989 (the "Letter of Credit Agreement"). Further, you shall continue to deposit all amounts in the Special Account in the L/C Agent's Account unless and until you receive a notice signed by the L/C Agent instructing you otherwise.

BANCO DE MEXICO

By ______________________
Title:

Exhibit A

[Letterhead of Citibank, N A]

____________, 19__

The Federal Reserve Bank of New York
23 Liberty Street
New York, NY 10045
Attn: ____________________

Gentlemen:

We refer to

(i) the letter of instructions (the "Letter") dated as of ____________, 19__ from Banco de Mexico (terms being used herein as therein defined) to you regarding the deposit of all amounts on deposit in the Special Account,

(ii) the Letter of Credit no. ____________ (the "Letter of Credit") issued in favor of ____________, pursuant to the Letter of Credit Agreement, and

(iii) the letter dated ____________, 19__ from you to us, as L/C Agent confirming that the instructions in the Letter and the IMF Letter (as defined therein) are acceptable to you.

We hereby advise you that on ____________, 19__ a drawing in the amount of U.S. $____________ was made under the Letter of Credit. We further advise you that U S. $[____________] of such drawing has not been repaid by Mexico.

In accordance with the Letter, we hereby instruct you to deliver all amounts on deposit in the Special Account to our account no. __________ located at __________ until we instruct you otherwise.

CITIBANK, N A., as L/C Agent

By ____________________
Title:

[Letterhead of FRBNY]

____________, 19__

Citibank, N.A., as agent
under the Letter of Credit
and Reimbursement Agreement
dated as of _________, 1989

Gentlemen:

We refer to a letter dated ______, 19__ from Banco de Mexico, acting at the behest of the Secretaría de Hacienda y Credito Publico, to us attached hereto as Exhibit A (the "Letter", terms used herein as therein defined), the letter dated _________, 19___ from Mexico, acting through the Secretaría de Hacienda y Credito Publico to the IMF (the "IMF Letter") instructing the IMF to deposit the proceeds of each Purchase in the Special Account and to the letter dated ________, 19___ from the IMF in response thereto.

At the request of Banco de Mexico, we hereby confirm that the irrevocable instructions set forth in the Letter and, insofar as such instructions affect us, in the IMF Letter, are acceptable to us and that we will comply in all respects with these irrevocable instructions. We also confirm that we will continue to comply with these irrevocable instructions unless and until we receive a notice signed by you instructing us otherwise

THE FEDERAL RESERVE
BANK OF NEW YORK

By ____________________
Title.

WASHINGTON D C 20431

CABLE ADDRESS
INTERFUND

November 27, 1989

Dear Mr Lewis,

I refer to your facsimile message dated November 22, 1989 requesting my comments on a proposed exchange of letters between Mexico's Secretaria de Hacienda y Credito Publico and the Fund It was very kind of you to let us have a glance, at this early stage, at the draft letters which are intended to implement a part of the 1989-92 Financing Package of Mexico Our comments are as follows

The purported instructions contained in the two draft letters would not be effective vis-a-vis the Fund on the terms stated therein for three main reasons

(1) Secretaria de Hacienda y Credito Publico is not the fiscal agency appointed by Mexico to serve as an appropriate channel for dealings with the Fund under Article V, Section 1 of the Fund Agreement The cited provision states that "Each member shall deal with the Fund only through its Treasury, Central Bank, stabilization fund, or other similar fiscal agency, and the Fund shall deal only with or through the same agencies "

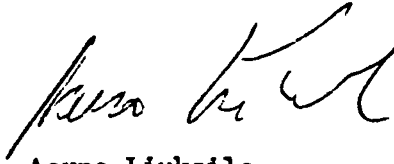
Therefore, the United Mexican States, the member, would have to act through Banco de Mexico that has been designated Mexico's fiscal agency under the provision quoted above

(2) Even if the instructions were passed through Banco de Mexico, they could not be formulated so that Banco de Mexico "irrevocably instructs [the Fund] to deposit the proceeds of each purchase in a special account of Banco de Mexico with the Federal Reserve Bank of New York (the "FRNY) account no -- (the "Special Account") (Emphasis added)

Under the policy and practice of the Fund, the Fund acts always on the basis of the latest instructions when it engages in an exchange transaction with a member which is "for the purpose of supplying a member, on the initiative of such member, with special drawing rights or the currencies of other members from the general resources of the Fund, in exchange for the currency of the member" (Article V, Section 2(a)) The structure of the Fund and the legal nature of such exchange transactions require that the Fund act on the basis of a member's latest instructions in order to effect a sale to the member of currencies of other members

I hope that you will find these comments helpful, but if there are any points that need further clarification, I will be happy to discuss them with you

Sincerely yours,



Aarno Liuksila
Assistant General Counsel

Jeffrey Lewis, Esq
Cleary, Gottlieb, Steen & Hamilton
One State Street Plaza
New York, New York 1004

(or SDRs) for an equivalent amount of the currency of the purchasing member, such a transaction cannot be carried out except against the concurrent transfers of equivalent amounts to the operational accounts of Mexico and the Fund at respective depositories of the Fund That is, the Fund would accept Mexico's currency to its account at Banco de Mexico and provide other members' currencies to Mexico at the depositories where the Fund holds such other members' currencies that it would select at the time of each exchange transaction

As regards the draft letter from the Fund to Citibank, it follows that the Fund would not be authorized to "confirm that the irrevocable instructions, set forth in [a letter submitted through the Banco de Mexico] are acceptable to us and that we will comply in all respects with these irrevocable instructions"

(3) Again, for the reason that Banco de Mexico is the fiscal agency of Mexico, it is not open to the Fund to confirm that "we will continue to comply with such instructions [of Banco de Mexico] unless and until we receive a notice signed by [Citibank, N A , as agent under the Letter of Credit and Reimbursement Agreement dated as of ----, 1989] instructing us otherwise" Fiscal agency functions cannot be delegated under the Fund's Articles

While these legal objections above prevent the Fund from accepting irrevocable instructions, it is open to any member of the Fund, including Mexico, to agree with its creditors that particular instructions of its fiscal agency to the Fund will not be later modified Nevertheless, the Fund will not be a party to such collateral arrangements, and therefore, to prevent the impression that the Fund would accept irrevocable instructions for the benefit of a third party, it has been the policy and practice of the Fund to advise the member's fiscal agency on the true legal situation along the following lines

> "Under the law and practice of the Fund, the International Monetary Fund must act upon the latest duly authenticated request from [member] for any purchase It follows that, for the Fund to Act upon the instructions contained in your cable, those instructions would need to be confirmed in the formal request for purchases by [member] which is to be received prior to the actual purchase "

Office Memorandum

TO: The Acting Managing Director

DATE: November 27, 1989

FROM: S.T. Beza

SUBJECT: Mexico--Briefing for Mission

Attached is the briefing for the special review mission to Mexico which was established for the purpose of examining whether the set-asides could be accelerated and augmentation made available. For this purpose, the mission will assess developments under the 1989 program and discuss with the authorities their policy intentions and prospects for 1990. Positive action on the part of the Board in respect of the possible Fund support referred to above also would depend on the adequacy of the financing package as it reflects the choices made by banks among new money, and debt reduction options.

The paper has been reviewed by the following departments:

Exchange and Trade Relations - Mr. Brau
Fiscal Affairs - Ms. Ter-Minassian
Legal - Mr. Surr
Research - Mr. Aghevli
Treasurer's - Mr. Kar
Western Hemisphere - Messrs. Caiola, Quirk and myself

Mr. Loser's last day in the office will be Friday, December 1.

Attachments

cc: The Managing Director (o/r)
Mr. H. Simpson

1989 NOV 27 PM 1:03
OFFICE OF THE
DEPUTY MANAGING DIRECTOR

MEXICO

Summary of Briefing Paper

1. Mission head Mr. Loser

2 Date of mission December 4-15, 1989

3 Purpose of the mission·

Review of program for 1989 as well as policy intentions and prospects for 1990 Approval and eventual release of set-asides and resources available under a possible augmentation of the extended arrangement are dependent on understandings on key economic policies for 1990 and adequacy of the financing package, as it reflects choices made by banks among new money and debt reduction options.

4 Background

Economic performance so far in 1989 has been good and preliminary information suggests that Mexico has observed all quantitative performance criteria for end-September. Economic activity has recovered and the 12-month rate of inflation was down to 18 percent in October While domestic interest rates declined sharply in July, they remain somewhat higher than projected The fiscal targets were observed on the strength of the primary surplus. The external current account deficit has been higher than projected as increased private inflows helped finance higher imports

5. Issues

- As contemplated at the time of the recent review, the end-1989 net international reserve target and related performance criteria will need to be adjusted for delays in completing the bank package now expected to be finalized in early 1990.

- The target for the end-1989 primary fiscal surplus will be observed but the targets for the PSBR and operational fiscal balance may not be achieved because of higher than programmed interest rates, a waiver may be needed for end-year (but this will not be determined until early next year).

- The authorities budget for 1990 is based on some modifications of public prices, a continued crawl of the exchange rate, and a modest increase in wages. An improvement of 1 1/2 percentage points of GDP is contemplated in the operational balance and PSBR with an unchanged oil price. A projected decline in interest payments would permit a lower primary surplus However because the financing package will put strains on resources and because private demand is growing strongly the mission will seek a smaller reduction (preferably no change) in the primary surplus.

Partial indications, including developments in the real effective exchange rate, suggest that the current exchange rate policy is broadly adequate. Notwithstanding this, the mission will evaluate the policy stance in light of developments and prospects in the external sector, including movements in the trade account, tourist spending, etc

Partial indicators--including developments in the real effective exchange rate and some key non-petroleum exports--suggest that the current exchange rate policy is broadly adequate. Notwithstanding this, the mission will evaluate the policy stance, taking account of overall balance of payments prospects with a focus on the trade account, tourist spending, and available financing. In this light, the mission will discuss whether the current exchange rate rule should be modified in favor of a more agressive approach, while continuing to seek to reduce the rate of inflation to levels consistent with those prevailing in Mexico's main trading partners.

e. External accounts

The program's external position is tighter than had been expected because of lower than expected commercial bank cash flow support. Accordingly, policies for 1990 need to protect the balance of payments position apart from the impact of interest relief--particularly because Mexico's reserves will be used early in the year to finance enhancements for the debt-reduction operations. The authorities' projections allow for a reduction of net international reserves of some US$1 billion (at an assumed oil price of US$15), after taking account of payments of US$1.3 billion from Mexico's own-resources for the debt-reduction operations. This would result in a slight decline in the import coverage of gross international reserves--from about 2.5 months in 1989 to 2.4 months by end-1990.

Within the overall balance of payments target, the composition of the balance of payments between current account and capital account will depend in large part on the level of private sector flows and related import expenditures. The authorities project for 1990 an external current account deficit that amounts to more than US$5 billion if the relief on interest obligations is excluded from the current account and assuming an oil price of US$15 a barrel. The authorities recognize that the current account outcome could only materialize if private flows support it, given the international reserve objective.

f. Definition and coverage of performance criteria

The authorities have requested that for 1990 the definition of the PSBR exclude financial intermediation by development banks as this extension of credit now takes place largely at market interest rates. The deficit would continue to include any transfer made by the public sector to cover losses incurred by the development banks, as well as other losses that are not yet being covered by the central government. The mission will help develop procedures to monitor the program on the basis of the new definition.

The staff will propose that relevant targets for the 1990 program be adjusted for developments in oil prices. In view of the tight

?But the development banks have a government guarantee--isn't that a justification for including in the PSBR?

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

Briefing for Mission to Mexico

Prepared by the Western Hemisphere Department

(In consultation with the Exchange and Trade Relations, Fiscal Affairs, Legal, Research, and Treasurer's Departments)

Approved by S T Beza and Eduard Brau

November 27, 1989

A staff mission consisting of Messrs. Loser (Head), Bonvicini, Khor (all WHD), and El-Erian (ETR), Ms Rojas-Suarez (RES), and Mrs Uston (Secretary, AFR) is scheduled to visit Mexico City for about two weeks beginning November 30, 1989 to review developments under the extended arrangement with Mexico Messrs Loser and Bonvicini will join the mission on December 4

During this special review mission the staff will discuss developments and prospects for the remainder of 1989 as well as policy intentions and prospects for 1990, following the discussions with the Mexican authorities held earlier this month 1/ Eventual release of set-asides and approval of a possible augmentation of resources available under the arrangement (by 40 percent of quota) are dependent on an adequate financing package and reaching understandings on key policies for 1990 under the arrangement As scheduled, a regular review mission for the second year of the program will take place in early 1990

On May 26, 1989, the Fund approved a three-year extended arrangement for the equivalent of SDR 2,797 2 million (240 percent of quota) As of October 31, 1989 Mexico had purchased the equivalent of SDR 326 34 million under the arrangement, Fund credit to Mexico, including drawings under the EFF, the CCFF, and the enlarged access policy, stood at SDR 3,872 0 million 2/

I Background and Developments Under the Program

Economic performance in 1989 has been good and on the basis of preliminary information it appears that Mexico observed all quantitative performance criteria for end-September Economic activity has recovered markedly, with industrial production about 6 percent higher in the first eight months of the year than in the same period of 1988, and real GDP

1/ See the back-to-office report (11/15/89)
2/ Details of Mexico's financial relations with the Fund are presented in Attachment I

expected to grow by some 2 1/2 percent in 1989 The 12-month rate of consumer price increase was 18 percent in October, down from 52 percent in December 1988 The peso depreciated by 14 percent relative to the U S dollar in the first ten months of the year and has appreciated slightly in real effective terms (Chart 1)

The public finances have strengthened markedly so far in 1989 Preliminary data suggest that the primary surplus of the nonfinancial public sector exceeded the target under the EFF of 8 2 percent of GDP in the first three quarters of the year 1/ This reflected in part higher oil prices and high yields from income tax reform, as well as lower than originally projected outlays excluding interest payments Domestic interest rates declined sharply in late July from around 4 1/2 percent a month, and stabilized at over 3 percent, which is somewhat higher than projected in the program The strong primary outcome appears to have been more than sufficient to offset the high interest payments, and the targets for the PSBR and the operational deficit for end-September are likely to have been met

To date, the PSBR has been covered primarily through the issuance of government securities placed with the private sector, as a result, Bank of Mexico's net credit to the nonfinancial public sector and net domestic assets were well within program limits (Table 1) Commercial bank credit to the private sector rose more rapidly than projected but private sector financial savings have been growing at an annual rate of over 20 percent in real terms, reflecting in part domestic financial reintermediation and external private capital reflows As a consequence, net international reserves through September fell by US$788 million, or US$531 million less than programmed, in October net international reserves rose by US$50 million

In the first eight months of the year the merchandise trade balance was in surplus by around US$2 3 billion, substantially less than programmed Nonpetroleum exports were somewhat lower than projected mostly due to lower mineral exports and the adverse impact of weather conditions on agriculture, while private sector imports were markedly higher, offset only partially by higher crude oil exports The external current account deficit is estimated at US$3 7 billion in the first three quarters of the year, compared with a programmed deficit of US$3 3 billion The higher current account deficit was more than financed by increased private capital inflows, which resulted in a lower than expected decline in net international reserves

In support of the Mexican program the Paris Club agreed in May to a rescheduling of principal and interest, and in June the World Bank approved three loans totaling US$1 5 billion A bridge loan from the

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1/ The program targets for fiscal performance are adjusted for developments in the price of oil and international interest rates

United States and other official sources to Mexico for some US$1 7 billion was made in September 1989 It is to be repaid fully by February 1990 on the basis of Fund purchases and IBRD disbursements

The Government of Mexico reached agreement with the commercial bank steering committee on September 13, 1989 on a term sheet for a financing package incorporating a new money option and two debt and debt-service reduction options Available information indicates that the choices by banks among the three options may give rise to results that would require resources for enhancement of debt reduction operations in excess of the US$7 billion available, such a pattern of choices by commercial banks would also affect adversely the cash flow relief provided by the package. The financing package is expected to be completed by February

II Policy Issues

1 Prospects for end-1989

The outcome for 1989 may be somewhat different than previously projected Economic activity is expected to recover at a stronger pace than expected while the rate of inflation may be 20 percent, reflecting in part some corrective adjustments The external current account deficit might reach some US$5 2 billion, which is some US$200 million higher than projected in the program because of higher imports

The program for 1989, particularly the external targets, was based on the assumption that the financing package with commercial banks would be finalized before the end of the year As the completion of the package has been delayed, relevant targets would have to be adjusted for delays in financing from commercial banks The most recent review of Mexico's EFF anticipated these adjustments, hence further Board action is not required 1/

The fiscal primary surplus is expected to reach some 8 percent of GDP for 1989 against a target of 7 6 percent However, the targets for the PSBR and the operational deficit possibly may be exceeded, although by no more than 0 1 and 0 3 percentage point of GDP, respectively These excesses would be the result of higher than projected domestic interest rates Provided that an appropriately strong fiscal stance is adopted for 1990, a waiver may be considered at the time of the review contemplated for early next year

2 Policies for 1990

The discussions on policy intentions and prospects for 1990 would form the basis of Board consideration of the acceleration of set-asides

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1/ See EBS/89/178 (9/1/89)

and augmentation of the arrangement in conjunction with the implementation of Mexico's agreement with commercial banks The mission would seek agreement on policy objectives for 1990, but as noted earlier the full specification of the program including phasing would take place at the time of the review for the second year of the arrangement

In these discussions of policy, account will be taken of the tighter than envisaged external financing due to the likely structure of the commercial bank financial package for 1989-92 In addition, the authorities' policy stance needs to be sufficiently strong to facilitate a smooth transition out of the current wage-price pact (which has been in place with some modifications since late 1987)

The special review will take place against the background of the authorities' November 15 submission to Congress of the macroeconomic objectives and budget for 1990 These were discussed with the staff on a preliminary basis earlier this month The targets for 1990, as presented by the authorities, are based on a projected price of oil of US$13 a barrel (currently US$15 a barrel) and a LIBOR of 9 percent (about 8 1/2 currently) The rate of inflation is projected to come down to some 15 percent in 1990 with real GDP growing by some 3 1/2 percent

The authorities are expecting to reach understandings on wages and prices for the period beyond March, with modifications to the current pact Public sector prices and tariffs would be adjusted late this year and next year for a total of 10 percent on average A depreciation by Mex$1 a day with respect to the U S dollar would continue, consistent with the projected rate of inflation No agreement exists on minimum wages and wages in the public sector, but the increases are expected to be consistent with price projections

a Fiscal policy

The authorities are planning for 1990 an improvement in the fiscal performance of about 1 percentage point of GDP at the operational and PSBR levels to deficits of 1 2 percent and 5 3 percent of GDP respectively, reflecting the expected favorable effect on domestic interest payments of lower inflation and the positive effects of the financing package with commercial banks (see Table 2) However, total revenue is projected to decline by 1 percentage point of GDP as continued efforts to widen the tax base would be more than offset by a decline in nontax revenue because of the lag in adjusting prices in the public sector and lower oil prices, total expenditures are expected to rise reflecting an increase of investment in real terms On this basis, the primary surplus would decline by 1 1/2 percentage points of GDP to 6 1/2 percent in 1990 If oil prices were to remain at US$15 a barrel, the primary surplus would be some 1/2 percentage point higher and the operational deficit and the PSBR lower by that amount

The fiscal targets included in the budget are consistent with the medium-term projections included in the most recent staff report However, external resources will be strained due to the choices being made by banks within the financial package, and private demand is growing strongly The staff expressed concern about these developments when it visited Mexico recently The budget reflects some adjustment efforts, but the mission will seek a smaller reduction (preferably no change) in the primary surplus with the view to protecting program objectives, including the eventual exit from the wage-price pact In this context, the mission will press for adjustments in public sector prices beyond the average 10 percent now being considered At a minimum, the mission will discuss a contingent fiscal package which could be implemented if conditions in the economy diverge from those now being projected Moreover, the mission will seek the introduction of automatic adjustments to quantitative targets that would ensure that revenues resulting from oil prices in excess of US$13 a barrel would not be reflected in increased expenditure

b Monetary and credit policy

With the expected continued growth in financial savings and an adequate fiscal stance, credit to the private sector can be expected to continue to expand in 1990 The mission will set a target for credit expansion that is based on a realistic growth of financial savings and that is consistent with the objective to reduce inflation and protect the balance of payments The rate of real financial savings underlying the program in 1990 would be expected to be well below the rate of over 20 percent being experienced in 1989

c Wage and pricing policies

Wage increases granted so far in 1989 have been somewhat below the inflation rate of 20 percent A continued moderate stance will be required to allow the inflation rate to decline to 15 percent during 1990 The authorities expect that minimum wages will be increased by less than 10 percent, which would be consistent with a lowering of inflation In general, the mission will discuss with the authorities their strategy for moving away from price and wage controls

d Exchange rate

The peso has appreciated slightly in real effective terms during the first three quarters of the year, reflecting the appreciation of the U S dollar relative to other major currencies The current policy of depreciating daily by Mex$1 per U S dollar would be sufficient to maintain the present level of external competitiveness, provided the rate of inflation stays under 1 1/2 percent a month and the U S dollar remains stable against other major currencies

Partial indicators--including developments in the real effective exchange rate and some key non-petroleum exports--suggest that the current exchange rate policy is broadly adequate Notwithstanding this, the mission will evaluate the policy stance, taking account of overall balance of payments prospects with a focus on the trade account, tourist spending, and available financing In this light, the mission will discuss whether the current exchange rate rule should be modified in favor of a more agressive approach, while continuing to seek to reduce the rate of inflation to levels consistent with those prevailing in Mexico's main trading partners

e <u>External accounts</u>

The program's external position is tighter than had been expected because of lower than expected commercial bank cash flow support Accordingly, policies for 1990 need to protect the balance of payments position apart from the impact of interest relief--particularly because Mexico's reserves will be used early in the year to finance enhancements for the debt-reduction operations The authorities' projections allow for a reduction of net international reserves of some US$1 billion (at an assumed oil price of US$15), after taking account of payments of US$1 3 billion from Mexico's own-resources for the debt-reduction operations This would result in a slight decline in the import coverage of gross international reserves--from about 2 5 months in 1989 to 2 4 months by end-1990

Within the overall balance of payments target, the composition of the balance of payments between current account and capital account will depend in large part on the level of private sector flows and related import expenditures The authorities project for 1990 an external current account deficit that amounts to more than US$5 billion if the relief on interest obligations is excluded from the current account and assuming an oil price of US$15 a barrel The authorities recognize that the current account outcome could only materialize if private flows support it, given the international reserve objective

f <u>Definition and coverage of performance criteria</u>

The authorities have requested that for 1990 the definition of the PSBR exclude financial intermediation by development banks as this extension of credit now takes place largely at market interest rates The deficit would continue to include any transfer made by the public sector to cover losses incurred by the development banks, as well as other losses that are not yet being covered by the central government The mission will help develop procedures to monitor the program on the basis of the new definition

The staff will propose that relevant targets for the 1990 program be adjusted for developments in oil prices In view of the tight

international reserve position of Mexico, oil prices higher than those assumed in the budget should result in a larger fiscal primary surplus, a lower PSBR and operational deficit and a larger accumulation of net international reserves Oil prices below those assumed in the program would need to be offset by additional fiscal actions

Attachments

cc Mr Frenkel
Mr Gianviti
Mr Laske
Mr Tanzi
Mr Van Houtven
Mr Whittome
Mr H Simpson

Table 1 Mexico Performance Under Extended Arrangement for 1989

	Estimate March	Targets and Ceilings June	Prel September	December
	(In billions of Mexican pesos)			
Cumulative overall public sector borrowing requirement 1/2/3/	6 537	13 217		
Ceiling				
Unadjusted	7 740	15 400	25 400	33 900
Adjusted 4/	7 628	14 175	23 417	30 908
Excess (-)/Margin (+)	1 092	958		
Cumulative nonfinancial public sector operational balance 1/2/5/	2 340	2 645		
Ceiling				
Unadjusted	3 110	5 600	8 920	12 130
Adjusted 4/	2 998	4 375	6 937	9 138
Excess (-)/Margin (+)	658	1 730		
Cumulative changes in net domestic assets of the monetary authorities (effective flows) 1/3/6/	-1 407	1 297	1 030	
Ceiling				
Unadjusted	--	3 330	1 120	-985
Adjusted 4/	-112	2 105	-667	-3 977
Adjusted 7/8/	-112	5 539	4 212	2 557
Excess (-)/Margin (+)	1 295	4 242	3 182	
Net credit to the nonfinancial public sector by the monetary authorities 2/9/	34 406	33 292	29 914	
Ceiling				
Unadjusted	32 686	33 910	34 210	34 520
Adjusted 4/	32 574	32 685	32 227	32 528
Adjusted 7/8/	32 574	36 119	37 302	38 062
Excess (-)/Margin (+)	-1 832	2 821	7 388	
Cumulative primary surplus	12 033	27 118		
Target 1/2/3/				
Unadjusted	9 250	19 700	27 600	35 350
Adjusted 4/	9 362	20 675	29 087	37 265
Excess (-)/Margin (+)	2 672	6 442		
	(In millions of U S dollars)			
Cumulative net foreign borrowing by the public sector 1/	-579	-783		
Ceiling				
Unadjusted	-440	900	3 710	6 650
Adjusted 7/8/	-440	900	1 950	3 950
Excess (-)/Margin (+)	139	1 683		
Cumulative change in net international reserves of the monetary authorities 1/2/	-49	-910	-788	
Target				
Unadjusted	-200	-1 010	-40	1 490
Adjusted 4/	-152	-493	781	2 706
Adjusted 7/8/	-152	-1 942	-1 319	52
Excess (-)/Margin (+)	103	1 031	531	

Sources Mexican authorities and Fund staff estimates

1/ Cumulative changes from end-1988
2/ Limit tested at the end of each period starting June 30
3/ Effective flows of financing measured on a cash basis
4/ Adjustments relating to provisions under oil price and/or interest rate mechanisms adjustments for December estimated on an average oil price of US$15 a barrel and LIBOR of 9 0 percent for the period October-December
5/ Defined as the difference between the overall public sector borrowing requirements excluding cumulative changes in financial intermediation and the inflation component of interest payments on the domestic public sector debt denominated in local currency
6/ Net domestic assets of the Bank of Mexico for purposes of the ceiling are defined as the difference between note issue and net international reserves of the Bank of Mexico
7/ Ceiling adjusted for changes in timing of gross external financing adjustments for September and December based on assumptions described in EBS/89/178 Section II 4 and Table 8
8/ Ceiling adjusted for operations aimed at reducing external debt
9/ Effective stocks calculated by adding effective flows to the nominal stock of Mex$31 464 billion outstanding as of the end of 1988

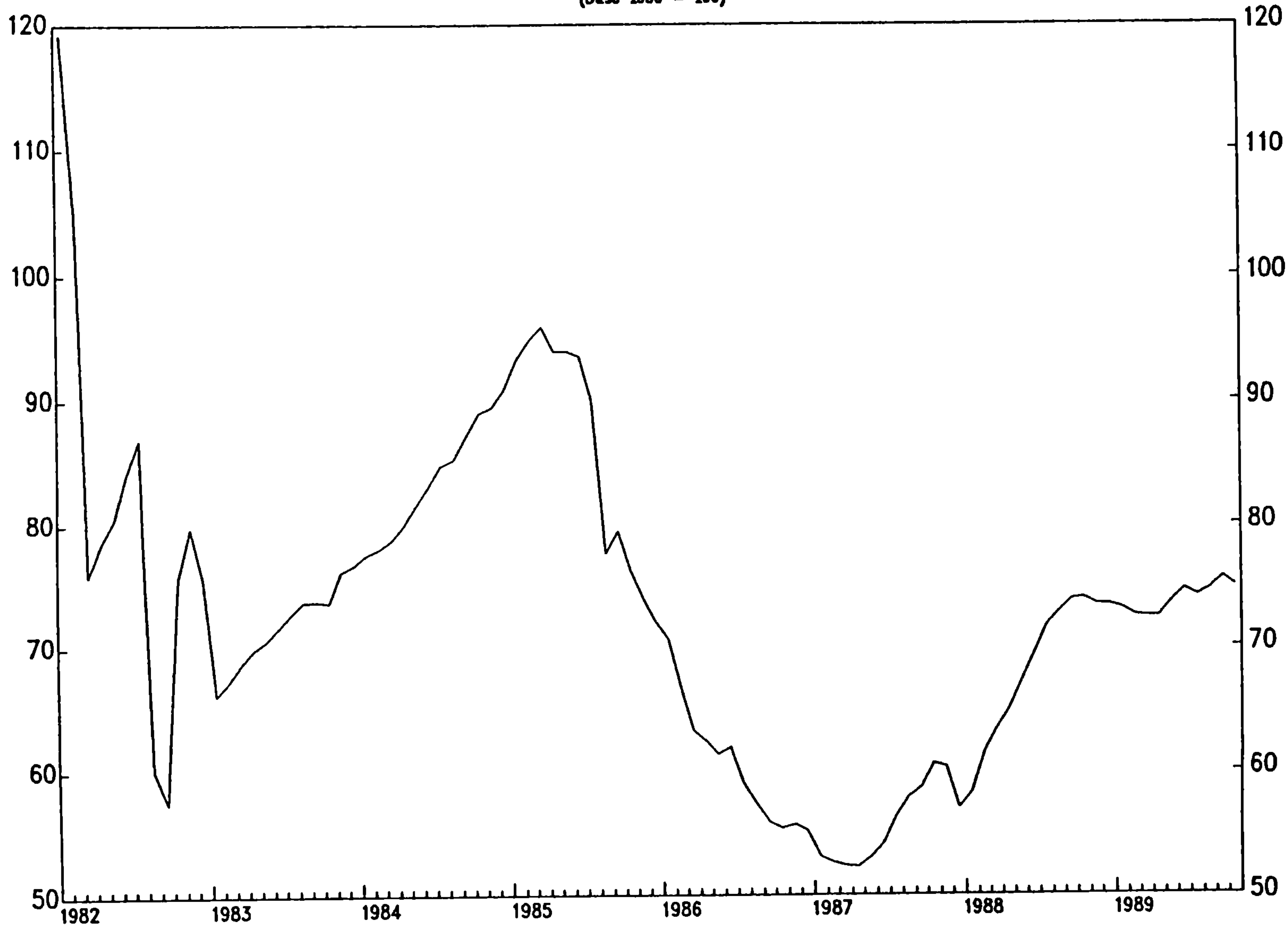
Table 2 Mexico Selected Economic and Financial Indicators

	1985	1986	1987	Prel 1988	1989 Prog	1989 Proj	Budget 1/ 1990
(Annual percentage change unless otherwise specified)							
Income and prices							
Real GDP	2 6	-3 8	1 5	1 1	1 5	2 5	3 5
GDP deflator	56 7	74 4	139 3	103 8	21 1	20 7	18 9
Consumer prices (end of year)	63 7	105 7	159 2	51 7	18 0	20 0	15 3
Consumer prices (average)	57 7	86 2	131 9	114 2	20 3	20 2	18 7
Consumer prices (monthly average)	4 2	6 2	8 3	3 6	1 4	1 6	1 2
External sector							
Exports (f o b)	-9 5	-24 4	28 5	3 3	8 9	11 8	5 1
Export volume	-4 6	7 4	11 7	8 2	4 7	2 0	
Imports (f o b)	17 4	-13 5	6 9	54 7	9 8	16 4	9 0
Import volume	17 2	-11 7	2 8	46 5	5 6	10 9	
Terms of trade	-5 3	-28 2	10 5	-9 5	—	5 6	—
Nominal effective exchange rate							
Average (depreciation -)	-28 7	-59 3	-57 8	-40 4	-6 5	1 5 2/	
End of period	-48 0	-61 8	-55 5	-9 2	-8 5	-3 4 2/	
Real effective exchange rate							
Average (depreciation -)	2 9	-30 0	-8 1	23 2		9 0 2/	
End of period	-20 6	-23 5	3 3	28 7		2 0 2/	
Nonfinancial public sector							
Receipts	56 1	62 7	135 5	100 0	12 3	22 3	20 4
Outlays	66 4	89 3	139 3	84 9	-2 0	14 2	10 6
Money and credit 3/							
Domestic credit (net)	58 0	89 3	120 5	73 3	15 2	21 1	
Public sector (net)	44 9	81 1	75 9	29 3	4 3	-14 1	
Private sector	23 5	29 3	62 9	39 2	11 3	30 5	
Money and quasi-money (M-2)	46 3	94 4	141 0	42 2	10 3	17 4	
Velocity (GDP/M-2)	4 3	4 1	4 4	5 3	5 2	5 1	
Real growth in M-4	-7 2	0 5	-0 1	6 7	4 5	25 0	14 1
Velocity (GDP/M-4)	3 7	3 4	3 4	3 7	3 3	3 0	2 6
Interest rate on 1-month treasury bill (percent per month)	5 0	6 6	7 8	5 8	3 1	3 8	2 9
(Percent of GDP)							
Public sector savings	-2 7	-9 3	-9 6	-6 2	-0 7	-0 7	2 4
Public sector savings (adjusted) 4/	4 9	3 7	7 4	0 7	2 6	3 1	5 3
Public sector economic deficit	-8 6	-14 8	-15 0	-11 3	-5 8	-6 0	-3 6
Primary balance	3 3	2 3	5 0	5 9	7 3	7 8	7 0
Operational balance	-1 0	-1 8	2 0	-4 4	-2 5	-2 0	-0 7
Public sector borrowing requirement	9 5	15 6	15 9	12 9	7 0	6 5	4 8
Gross domestic investment	21 2	18 1	18 6	20 4	21 3	23 2	24 2
Gross national savings	21 6	17 2	21 3	18 8	18 9	20 6	22 8
Current account deficit (-)	0 4	-0 9	2 7	-1 6	-2 4	-2 6	-1 5
Public external debt (including IMF) 5/	38 6	57 8	59 5	47 2	44 8	43 9	42 4
Interest payments on public debt 6/	4 1	4 7	4 3	4 0	4 4	4 3	4 3
(In percent of exports of goods and nonfactor services)							
Public debt service 6/							
Before rescheduling	66 6	78 2	89 9	86 8	69 8	64 9	53 2
After rescheduling	39 8	44 3	41 9	49 0	41 6	38 3	38 9
(In billions of U S dollars)							
Overall balance of payments	-3 4	-1 1	6 6	-6 9	1 5	-1 0	-0 9
Gross official reserves (months of imports)	5 6	7 4	13 5	4 2	4 5	2 5	2 4

Sources Bank of Mexico Secretariat of Programming and Budget and Fund staff estimates

1/ Adjusted to reflect an oil price averaging US$15 per barrel
2/ Estimated through October
3/ Changes are effective flows adjusted for exchange rate changes in relation to total liabilities to the private sector at the beginning of the period
4/ Adjusted for the inflation component of interest payments which is treated as debt amortization but includes inflation tax
5/ Includes short-term debt
6/ Includes debt service on use of Fund credit

CHART 1
MEXICO
REAL EFFECTIVE EXCHANGE RATE
(Base 1980 = 100)

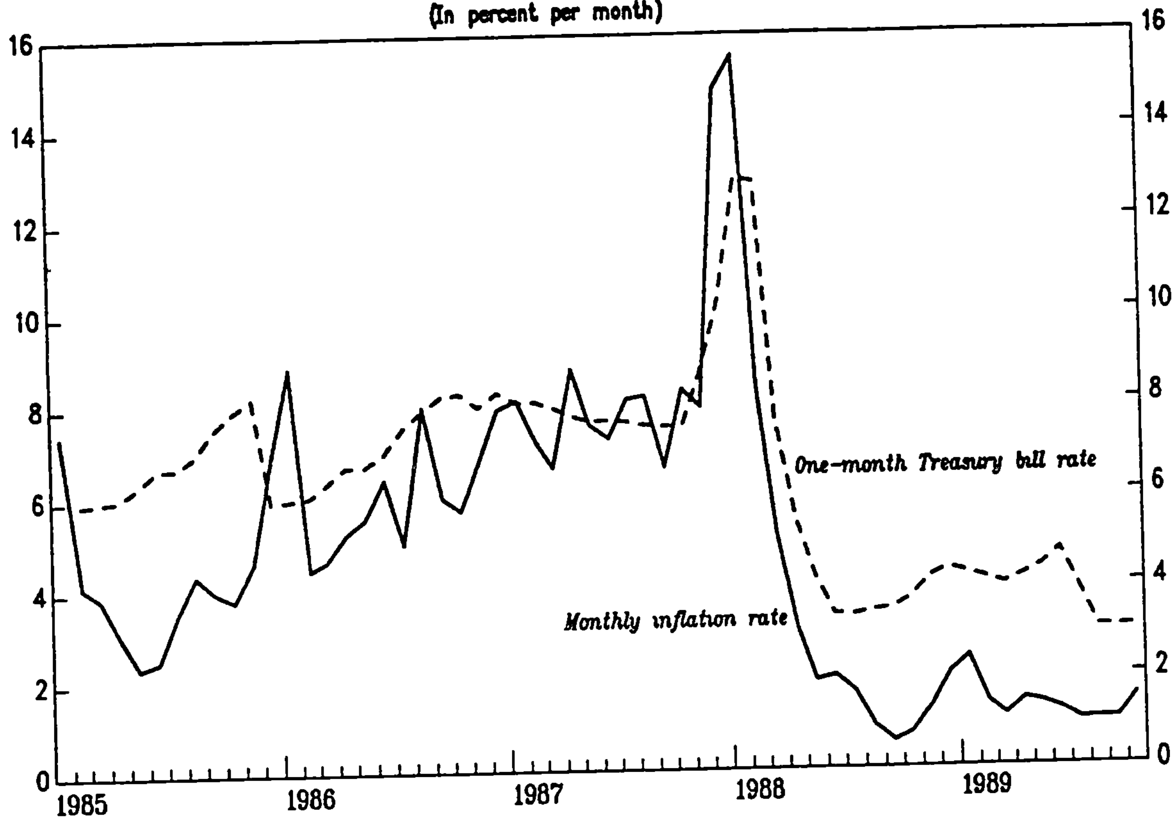


Sources: Bank of Mexico, and Fund staff estimates.

CHART 2
MEXICO

INFLATION AND INTEREST RATE DEVELOPMENTS

(In percent per month)



Sources: Bank of Mexico; and Fund staff estimates.

ATTACHMENT I

Fund Relations with Mexico
(As of October 31, 1989)

I Membership Status

(a) Member since December 31, 1945
(b) Status - Article VIII

A Financial Relations

II General Department (General Resources Account)

(a) Quota SDR 1,165.5 million
(b) Total Fund holdings of Mexican pesos
SDR 5,037 5 million
(c) Fund credit SDR 3,872 0 million or 332.2 percent of quota
Of which SDR 564.9 million or 48.5 percent of quota under credit tranche
SDR 1,190 7 million or 102 2 percent of quota under EFF
SDR 1,662 9 million or 142 7 percent of quota under FAR
SDR 453.5 million or 38.9 percent of quota under CCFF
(d) Reserve tranche position None

III Stand-by or Extended Arrangement and Special Facilities

(a) Current extended arrangement
(i) Duration May 26, 1989 until May 25, 1992
(ii) Amount SDR 2,797 2 million
(iii) Utilization SDR 326 3 million
(iv) Undrawn balance SDR 2,470 9 million
(b) Compensatory and contingency financing facility
(i) Purchased on June 1, 1989
(ii) Amount SDR 453.5 milion
(iii) Utilization SDR 453.5 million
(c) Previous stand-by arrangement
(i) Duration November 19, 1986 until April 1, 1988
(ii) Amount SDR 1,400 million
(iii) Utilization SDR 1,400 million
(d) Emergency assistance
(i) Purchase in January 1986
(ii) Amount SDR 291 4 million
(iii) Utilization SDR 291.4 million
(e) Previous extended arrangement
(i) Duration from January 1, 1983 to December 31, 1985
(ii) Amount SDR 3,410 6 million
(iii) Utilization SDR 2,502.7 million
(iv) Undrawn balance 907.9 million

IV. SDR Department

(a) Net cumulative allocation SDR 290 million
(b) Holdings SDR 379 8 million or the equivalent of 131 0 percent of net cumulative allocation

V Financial Obligations due to the Fund (In millions of SDRs) 1/

	Overdue Financial Obligations (10/31/89)	Principal and Interest Due			
		11/1-12/31 1989	1990	1991	1992
Principal					
Repurchases	--	161 5	877 1	807 4	631 9
Trust Fund Repayments	--	--	--	--	--
Charges and Interest including SDR and TF (provisional)	--	49.1	364 4	384 2	388 4
Total	--	210 6	1,241 5	1,191 6	1,020.3

B. Nonfinancial Relations

VI. Exchange rate arrangement Since August 5, 1985 two official markets have been operative in Mexico a controlled market covering specified transactions amounting to about 80 percent of all trade and payments transactions, and a free market The controlled market rate is determined under a managed float system guided by a set of indicators, whereas the free market rate is established by market forces. Parties eligible to utilize the controlled market (with the exception of offices and agencies of the public administration) can choose to complete any transaction at a "retail rate" agreed between the parties and the financial institutions authorized to operate in this market, or at the "equilibrium exchange rate" of the day The daily "equilibrium exchange rate" is determined each day at a fixing session at the central bank, where representatives of the various financial institutions operating in the market exchange bids for purchases and sales of foreign exchange, the Central Bank may also submit bids in these sessions For transactions exceeding US$50,000, the parties concerned may make completion of the transaction

1/ Projected on the basis of transactions through October 31, 1989 on the assumption that all currently programmed purchases (including the augmentation) are made as scheduled.

contingent upon the equilibrium exchange rate achieving a particular minimum or maximum value. As of November 14, 1989 the "controlled market equilibrium exchange rate" was Mex$2,598 per U S. dollar, the average "free" rate was Mex$2,634 5 per U S dollar, and the differential between the ratio in the controlled and the free market was about 1 1/2 percent

VII. Last Article IV consultation and review under EFF The last Article IV consultation, requests for Extended Fund Arrangement for 1989-92, and purchase under the CCFF were completed by the Executive Board on May 26, 1989 (EBM/89/65). The relevant supporting documents were EBS/89/91, Supplement 1, SM/89/94, EBS/89/66, and EBS/89/94. For consultation purposes Mexico is on the 12-month cycle. The first review under the EFF was completed on September 14, 1989. The relevant supporting documents were EBS/89/178 and correction 1

VIII. Technical Assistance In October 1988, a technical team provided assistance in the area of external debt and international banking

INTERNATIONAL MONETARY FUND

STP

November 21, 1989

Mexico

Mr. Beza:

For your information.

Attachments

Claudio M. Loser

Mr Loser

INTERNATIONAL MONETARY FUND

November 21, 1989

Messrs Whittome, Boorman,
Leddy, Brau, Loser, Watson
and Baumgartner

You may be interested in the attached memo on the Japanese and British banks' responses to the Mexican and Philippine term sheets

Attachment

Mark Allen

Mark Allen

Office Memorandum

TO Mr. Allen November 21, 1989

FROM Charles Collyns CMAC

SUBJECT Japanese and British Banks Responses to Mexican and Philippine Term Sheets

You requested a note on the somewhat unexpected responses of Japanese banks to the Mexican and Philippine term sheets. To recap, in the Mexican case, it is reported in the Japanese press that banks representing about 65 percent of Japanese exposure opted for the discount exchange and the rest for the par exchange or a mixture of the two. It had been expected that some Japanese banks would have chosen new money and that the par exchange would be more popular than the discount exchange because of its greater degree of enhancement and the fact that it would allow losses to be spread over time With respect to the Philippine offer, it would seem that only the Bank of Tokyo has opted for new money, with most of the rest offering to participate in the buyback This was in contrast to the pre-market screening when most Japanese banks had indicated that they would participate with new money

The shift of Japanese preferences to discount exchanges and buybacks seems to reflect indications from the Ministry of Finance in early October that banks participating in the Mexican exchanges would be able to claim tax writeoffs equal, in the first instance, to the difference between the face value of the new bond and the face value of the old loan. Moreover, banks would subsequently be able to deduct any difference between the face value of the bonds and the market value of the bonds when they are floated on the Luxembourg Stock Exchange. This was reported in the Japanese press and in International Finance Review (IFR) This indication was in line with the earlier reports obtained by the Capital Markets mission to Tokyo, that the MOF was in the process of relaxing its policy of opposition to banks' obtaining writeoffs from debt exchanges or sales. Japanese bank contacts have reported to us that a similar indication has been provided for the Philippine buyback, although no official announcement has been made

Once it is clear to Japanese banks that they may obtain tax advantages as well as reduce their problem country exposure through debt and debt service reduction operations, it is not surprising that they have chosen to follow this route given the strict limits on provisioning (up to 15 percent, of which only 1 percent is tax deductible) and their relative profitability This would be particularly true for the long-term credit banks, which do not have extensive business interests in the debtor countries The preference for the discount exchange over the par exchange in the Mexican case seems to be related to a greater degree of uncertainty about the market value of the par bonds, and thus the loss to be allowed by the tax office With the discount exchange the loss would be at least the reduction in face value, while with the par exchange (involving a reduced fixed interest rate) the extent of the

loss would depend on the market price of the bond, and hence the market view about future rates of interest

It is not entirely clear what has been the motivation of the Japanese authorities It may be that they did not feel able to resist bank pressures for tax writeoffs arising from losses to be realized on officially sanctioned operations at market prices Moreover, IFR reports a Ministry of Finance official as commenting that the decision represented Japan's contribution to the agreement at the G-7 to remove administrative impediments to the implementation of the strengthened debt strategy. At the same time, the Japanese authorities have been pushing hard for par exchanges, possibly in the hope that politically embarrassing tax writeoffs could be minimized. While it would now seem that this policy has been unsuccessful, it is not yet clear that they will be ready to recognize this at the Fund Board

With regard to the Philippines in particular, a contact with a Japanese bank suggested that to an extent the banks may also have been responding to a degree of resentment at the way the Co-chairmen of the Steering Committee (Manufacturers Hanover and the Bank of Tokyo) handled the package, in particular in asking Japanese banks to contribute more than their fair share of new money This contact suggested that the announced results of the pre-market screening may not have been an accurate representation of the Japanese banks' positions Nevertheless, it seems likely that the tax angle was still an important element in bank decisions.

With regard to British banks, it is reported that they have also tended to opt for the discount rather than the par exchange option in the Mexican deal Again, this seems to be related to tax considerations It has been reported that the Inland Revenue will be more inclined to allow tax breaks for the discount than the par exchange, although the decision is not yet a firm one It may be recalled that the Bank of England's proposed regulatory treatment of the exchanges is broadly neutral (see memo from Mr El-Erian to Mr Allen, October 30, 1989, attached)

Attachment

cc ICMD economists

Office Memorandum

TO Mr Allen

October 30, 1989

FROM Mohamed A El-Erian

SUBJECT Provisioning Treatment of Mexico's Financing Package

I spoke to Mr Nick Pardoe (011-44-1-601-5080) at the Bank of England regarding the treatment, for provisioning purposes, of the three options in the Mexican commercial bank package

Banks' exposure under the three options--new money, discount bonds, and reduced interest par bonds--would be considered Mexican risk As regards new money, the Bank of England is providing no provisioning concessions. Accordingly, banks would be required to increase their loan-loss reserves in line with the higher exposure and the matrix requirements Banks opting for the discount bond would need to record the loss (35 percent of face value), thereby using up existing provisions However, no further provisioning would be required Under the reduced interest par bond, provisioning would be based on the full face value of the bond, and consistent with the matrix requirements for new money exposure, in practice, therefore, banks would not be required to increase provisioning levels despite the reduction in the contractual interest rate At the same time, the Bank of England will not make allowances at this stage for reduced event risk due to the principal and interest guarantees inherent in the bonds Mr Pardoe indicated that, as the value of the principal collateral grows over time, the authorities may envisage reducing provisioning requirements on the bonds--assuming no deterioration in Mexico's economic and financial situation

cc Mr Leddy
Mr Brau
Mr Watson

Office Memorandum

CONFIDENTIAL

TO The Managing Director
The Deputy Managing Director

November 17, 1989

FROM K Saito and T Leddy

SUBJECT Philippines--Bank Financing Package and Other

This memorandum presents (i) a report on the banks' response so far to the Philippine financing package, and (ii) our preliminary thinking on the issues involved

We plan to send for your approval the staff report on the Article IV consultation and the program review by November 22 and, in that context, will seek your specific guidance on these issues, as well as on the question of informing the Board in an informal session We believe that it would be useful to inform Board members of the situation before issuance of the paper around November 30

1 Bank financing package

Banks were given until last weekend to respond to the term sheet sent out in mid-October, which sought a commitment from banks either to provide new money or offer assets for a cash buyback As of yesterday, the amount of new money, around $600 million, fell substantially short of the figure of close to $1 billion indicated during the market screening in September By contrast, some $1 8 billion of bank claims have been offered for the cash buyback, well in excess both of the amount suggested by the market screening ($1 2-1 4 billion) and the maximum of $1 3 billion the Philippine authorities were prepared to buy back

The unanticipated outcome reportedly reflects the situation of banks that had been expected to provide some $300 million of new money, based on the market screening These include many Japanese banks (new money from Japanese banks was supposed to reach $300 million) which opted instead for the buyback

David Pflug of Manufacturers Hanover, the Chairman of the Bank Advisory Committee, believes that the amount of new money would eventually not exceed $650 million, while Governor Fernandez seems to be somewhat more optimistic Although many details are yet to be clarified, the pattern, however, is reasonably clear new money will be well below the expected amount of close to $1 billion, while the buyback offer will substantially exceed $1 3 billion

2. This situation gives rise to several issues for the program

a. With new money of only $600-650 million, the reserve buildup would be from a level of 2 2 months of imports in 1989 ($2 7 billion) to only 2 3/4 months ($3 7 billion) rather than the envisaged 3 months ($4 0 billion) in 1990 A stronger reserve increase would then be programmed for the remaining two program years (1991-92), at a price of somewhat larger financing gaps (a total increase of $150 million). Despite somewhat bigger current account deficits now expected in 1991-92, the financing gap (total of $850 million) in this two-year period would nonetheless remain significantly smaller than originally envisaged under the program ($1 35 billion) and would be further reduced by second round debt operations The lower exceptional financing need is due to larger official lending

b. The authorities would like to take maximum advantage of the buyback offer, and we believe this would be appropriate if it could be reasonably financed On present plans, the Philippines could not finance a buyback larger than the proposed $1.3 billion at a discount of 50 percent Of the $650 million required, $370 million would come from front-loaded set-asides of $120 million from the Fund, a first tranche of $150 million of a stand-alone loan from he Bank, and around $100 million from JEXIM The remaining $280 million would come in the first instance from reserves (already built into the $3 7 billion figure mentioned above for end-1990), but could eventually be replenished from disbursements from later Fund set-asides (about $90 million), Bank disbursements ($50 million) and JEXIM (up to $200 million)

c The shortfall in new money could have repercussions in Manila that might threaten the program, though this could be mitigated by a larger buyback An important test will be the oil price increase planned for December 1 Pressure may also build on the Government to take some action against banks Governor Fernandez has said that so far he is not worried about the political situation and that for now he would concentrate his efforts on increasing the amount of new money and ensuring resources for as large a buyback as possible

d The shortfall of new money has some parallels with the Mexican case and bank's resistance to the size of the gap in the Venezuelan case The Philippines is another case raising the question of how best to assure the adequacy of financing to protect Fund programs The banks' reaction on the Philippines could raise questions about the filling of future gaps Yet it would seem very difficult not to proceed as scheduled in the Philippines case, given the voluntary nature of the approach taken by the Philippines and the banks, the relatively small effects of the shortfall on the reserve target, and the recent conclusion of the review discussions with the Philippines If this is correct, we should concentrate on the Philippines' effort to get more new money and to find financing to carry out a buyback larger than $1 3 million On the latter, perhaps the Japanese can be prevailed upon

to do more frontloading of JEXIM money in view of the unexpected pro-buyback attitude of their banks The Japanese have also hinted at the possibility of additional quick disbursing cofinancing with the Bank Larger support may also be possible from the United States although their civilian grant support, including MAI funds, is already heavily concentrated on 1990 (an amount of $300 million compared with projected $220 million in 1991)

3 Mr Erb's question on monetary policy and the exchange rate

Mr Erb wondered whether the expected slight depreciation of the peso in November-December is consistent with the monetary program for the fourth quarter While monetary policy in the fourth quarter would be tighter than in the first half and more restrictive than originally foreseen, it would not be as tight as in the third quarter when interest rates rose to record heights Furthermore, expected larger inflows of foreign financing in the fourth quarter would satisfy much of the public sector financing need, thus allowing interest rates to fall On the basis of these factors we believe that some exchange rate depreciation would be consistent with a monetary program aiming at suppressing inflation As you know, the reserve money target can be exceeded for NIR overperformance up to a limit of ₱ 3 billion (4 percent of base money)

cc Mr H Simpson

Office Memorandum

STB
CL
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TO: The Managing Director
The Deputy Managing Director

DATE: November 15, 1989

FROM: William E. Holder WEH

SUBJECT: Mexico - Collateral Account - Reply to Mr. Gurria

As you requested, I attach a draft reply to Mr. Gurria which adds an additional sentence to the last paragraph.

Attachment

cc: Mr. Whittome
Mr. Beza
Mr. H. Simpson

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.
1989 NOV 15 AM 8:13

INTERNATIONAL MONETARY FUND
WASHINGTON, D C 20431

MANAGING DIRECTOR

CABLE ADDRESS
INTERFUND

Dear Mr Undersecretary

I refer to your letter of November 6, 1989, in which you asked whether the Fund could agree to a possible request by Mexico that it act as Collateral Agent for the Par and Discount Bonds to be issued by Mexico in connection with its 1989-92 Financing Package I wish to thank you for extending this invitation to the Fund The success of Mexico's economic program and financial package is of utmost importance to all members of the Fund Furthermore, it would be appropriate, in principle, for the Fund to perform the proposed financial service for Mexico

For several reasons, however, I cannot recommend to the Executive Board that the Fund consent to the application of domestic law and submit itself to the jurisdiction of domestic courts, as you have requested Even a limited waiver by the Fund would place at risk the assets of the Fund held in its other accounts, because of its submission to domestic law and judicial process In light of its Articles of Agreement, the Fund should not put itself in such a situation It follows that I am not in a position to recommend to the Executive Board that the Fund accede to your request

Finally, let me assure you that my refusal should not be taken as a signal of any lessened commitment by the Fund to Mexico Indeed, I would like to make it quite clear that, despite my negative response to your request, as formulated, I would be prepared to support the establishment of a collateral account for Mexico that would not involve waiver of the Fund's immunity from judicial process

Sincerely yours,

Michel Camdessus
Chairman of the Executive Board
and
Managing Director

Lic Jose Angel Gurria Treviño
Undersecretary for International Financial Affairs
Ministry of Finance
Mexico

Office Memorandum

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.

1989 NOV 22 AM 11: 52

To: Mr. Bonvicini

November 21, 1989

From: Bijan B. Aghevli

Subject: Briefing for Mission to Mexico

A number of us--Messrs. Dooley, Montiel, Borensztein, and myself--have read this brief. We have no major problems with the proposed program, which seems to be working reasonably well. However, since a key objective of the staff visit to Mexico is to seek agreement on policy objectives for 1990, some issues deserve further discussion.

1. An important question is how serious is the overall impact on the economy of the lower-than-expected commercial bank cash flow support? It is not clear how the tighter than anticipated financing for 1990 would affect Mexico's prospects for a sustainable recovery. In particular, the recent evolution of the Mexican financing package seems to indicate that many commercial banks are not willing to invest new funds in the Mexican economy. As a result, one wonders how this lack of improvement in the international perception about Mexico's creditworthiness might affect domestic confidence and therefore the behavior of interest rate and investment.

2. Closely related to the above is the disturbing persistence of high domestic interest rates--real interest rates are projected to decline but still remain in excess of 20 percent a year in 1990. One would have expected that the removal of uncertainties regarding the financing package with commercial banks as well as the economic policies under the current stabilization program in 1990 would have led to real interest rates that are more consistent with long-term growth. It is difficult to envisage how the projected growth can be achieved in the presence of such high real rates of interest. This issue requires further elaboration.

3. What are the projections of private capital flows in 1990 and how is the behavior of those flows related to the evolution of the Mexican financing package? Will the lower-than-projected cash flow from commercial banks have a negative impact on private capital inflows? Moreover, if private capital inflows drastically decline in 1990, will this affect imports and growth?

cc: Mr. Frenkel
Mr. Beza
Mr. Gianviti
Mr. Laske
Mr. Tanzi
Mr. Brau

Office Memorandum

1989 NOV 15 PM 5:57
OFFICE OF
THE MANAGING DIRECTOR

TO The Managing Director
The Deputy Managing Director

DATE November 15, 1989

FROM M. Caiola

SUBJECT Mexico - Back to Office Report

The mission that just returned from Mexico reviewed the draft budget for 1990 as well as developments and prospects under the program

Developments under the program are satisfactory, on the basis of preliminary information it appears that Mexico has observed all quantitative performance criteria for end September. When adjusted for delays in the bank financing package it is likely that Mexico will observe the net international reserves target and related performance criteria for end 1989. There may be some overruns with regard to the operational fiscal deficit and the PSBR, because the margins provided by the primary surplus may not offset fully the effect of high domestic interest rates.

Detailed information on fiscal policy for 1990 will be available after the draft budget is submitted to Congress this week. The authorities indicated that they would reduce inflation to some 15 percent by end-1990 and expect that real GDP would grow by 3 1/2 percent. On the basis of current oil prices, the external current account balance would improve by an amount equivalent to the interest relief for 1989-90 (all of which would become available in 1990) or by US$2 billion.

The authorities are planning an improvement in the PSBR and operational fiscal accounts of somewhat more than 1 percentage point of GDP in 1990 on the basis of oil prices of US$13 a barrel, compared with the current price of US$15 a barrel. Without a change in oil prices the improvement in these balances would be 1 1/2 percentage points of GDP from 1989 to 1990. Because of the projected decline in domestic and foreign interest payments from 1989 to 1990, these results would be consistent with a reduction in the primary surplus from around 8 percent of GDP in 1989 to 7 percent of GDP in 1990.

Notwithstanding the expected improvement in the operational and overall fiscal balances, the mission questioned the advisibility of permitting the primary surplus to fall as projected, given the momentum of private sector activity. The authorities responded that they are staying within the medium-term projection for the primary balance that had been discussed earlier and that was presented in the staff report. They acknowledged, however, the need to be prepared to act if needed to protect the overall balance of payments

With regard to the financing package, 215 banks representing about 55 percent of total exposure to Mexico have replied to date. As of now, 9 percent of banks (in terms of exposure) have chosen new money, 51 percent debt reduction, and 40 percent debt-service reduction. With this distribution, total enhancements required would be US$7.6 billion. The authorities noted that many large banks had not yet responded, and that these banks might come in more heavily with new money. The package is expected to be completed in early 1990.

cc Mr. H. Simpson

Office Memorandum

TO	The Managing Director The Deputy Managing Director	DATE	November 15, 1989
FROM	C. Loser		
SUBJECT	Mexico - Staff Visit (November 9-13)		

The mission that just returned from Mexico reviewed the main features of the draft budget for 1990 to be presented to Congress today, as well as the developments and prospects under the extended arrangement. It was agreed that a full mission would return to Mexico in late November to set annual targets for the macroeconomic program for 1990 in order to provide the basis for the special review needed for the release of set asides and possible augmentation of the current extended arrangement.

The mission found that economic developments under the program remain satisfactory, and that on the basis of preliminary information, Mexico has observed all quantitative performance criteria for end September. The 12-month rate of inflation in October was 18 percent and economic activity has picked up, with GDP expected to grow by up to 3 percent in 1989. The external current account deficit has widened with respect to earlier projections, being financed to a large extent with higher private flows, and net international reserves declined by less than programmed through October.

The net international reserves target and related performance criteria for end-1989 can be observed, once allowance is made for the delays in completing the financing package with commercial banks, now expected in early 1990 Some problems may arise with regard to fiscal performance. The primary surplus is expected to reach some 8 percent of GDP, against a target of 7 6 percent. However, the targets for the PSBR and the operational deficit may not be observed because of the effect of higher than projected domestic interest rates. In this regard, a waiver may be needed at the time of the review of the detailed program for 1990, in March or April of next year.

The Mexican team, headed by the Undersecretary of Finance and Public Credit, Mr. Ortiz, discussed the expected path for macroeconomic and fiscal policies. However, they were not in a position to provide the mission with detailed information of the draft budget ahead of its presentation to Congress.

The authorities expect to consolidate recent gains, with inflation in 1990 coming down to some 15 percent and GDP growing by some 3 1/2 percent. The external current account deficit would narrow by only some 1/2 percentage point of GDP, reflecting interest relief of US$2 billion for 1989-90, equivalent to 1 percent of GDP. The Mexican projections are based on an oil price of US$13 a barrel, or US$2 below

current prices. On the basis of current oil prices the current account would improve by the amount of the interest relief

The macroeconomic policies are being framed within a continuation of the existing price wage pact, which may be extended beyond March. Public sector prices and tariffs would be adjusted late this year and next year for a total of 10 percent on average, the peso would continue to be depreciated at one peso a day with respect to the U.S. dollar, consistent with the expected rate of inflation No agreement exists with respect to minimum wages and wages in the public sector but the increases may remain low.

The authorities are planning an improvement in the fiscal performance of 1 percentage point of GDP at the operational and PSBR level reflecting the expected favorable effect on interest payments of lower inflation, greater confidence, and the financing package with commercial banks. Measures are being taken to widen the income tax base, with tax revenues expected to rise by about 1/2 percentage point of GDP. However, the lag in prices in the public sector may reduce revenues by 3/4 percentage point of GDP and there will be an increase in investment in real terms. This would be partly offset by a decline in current expenditure in relation to GDP. On this basis, the primary surplus would decline by 1 1/2 percentage points of GDP to 6 1/2 percent in 1990. If oil prices were US$15 a barrel, the primary surplus would be some 1/2 percentage point higher, and the operational deficit and the PSBR lower by an equivalent amount.

Notwithstanding the expected improvement in the operational and overall fiscal balance, the mission expressed doubts about the advisibility of permitting the primary surplus to decline as planned, particularly given the momentum of private sector spending. The authorities indicated that they were making a significant fiscal effort, and that this was consistent with the previously discussed medium-term projections that had been presented in the staff report. They recognize, however, the need to act to protect the overall balance of payments if needed

The authorities project an external current account deficit that amounts to more than US$6 billion if the relief from lower interest payments is excluded from the current account. The deficit would be somewhat more than US$5 billion, the same level as in 1989, if oil prices are assumed to remain at current levels. However, the authorities recognize that the current account outcome could only materialize if private flows can support it, given the overall balance of payments objective.

The authorities informed the mission that 215 banks, representing about 55 percent of total exposure to Mexico, have replied to the request for participation in the financing package. As of now, 9 percent of the banks (in terms of exposure) have chosen new money,

51 percent debt reduction, and 40 percent debt-service reduction. With this distribution, total enhancement requirements would be US$7.6 billion The authorities noted that a number of large banks had not yet responded and that these banks might come in more heavily with new money.

The authorities requested that the definition of the public sector borrowing requirement be changed for the 1990 program to exclude financial intermediation by development banks. They would be willing to include as part of the deficit any transfer made by the public sector to cover losses incurred by the development banks, as well as other losses that are not yet being covered by the central government. This modification could be incorporated without major difficulty.

cc Mr. Frenkel
Mr. Gianviti
Mr. Laske
Mr. Tanzi
Mr. van Houtven
Mr. Whittome
Mr. H. Simpson

INTERNATIONAL MONETARY FUND

November 15, 1989

TO: Mr. Beza

SUBJECT: Mexico - Collateral Account - Reply to Mr. Gurria

As you received the incoming fax, please arrange for this to be faxed to Mr. Gurria, with a copy to Mr. Mark Walker of Cleary Gottlieb (fax no. 212-269-4978). Mr. Walker has telephoned me several times today on this matter, as he urgently needs a reply for Mr. Gurria.

Attachment

Aarno Liuksila

INTERNATIONAL MONETARY FUND
WASHINGTON, D C 20431

FACSIMILE NUMBERS
(202) 623 4661
(202) 623 4662
(202) 623 7491

FACSIMILE INQUIRIES
(202) 623 6775

Facsimile Service Cover Sheet
(TYPE)

MSG NO (For Cable Room use only)	DATE November 15, 1989	PAGE 1 OF 2

TO

NAME Lic. José Angel Gurria Treviño
Undersecretary for International Financial Affairs
AGENCY Ministry of Finance

CITY/COUNTRY Mexico City, Mexico

FACSIMILE TELEPHONE NO

(Country Code)	(City Code)	(Number)
52	5	542-4581

TEXT

INTERNAL DISTRIBUTION

Copy has been faxed to Cleary Gottlieb, Attn. Mr. Mark Walker.

FROM

NAME M Caiola

DEPT /DIV Western Hemisphere Department, Immediate Office

ROOM NO 10-100	EXTENSION 8634	ACCOUNT CODE

AUTHORIZED BY *(TYPE)* M. Caiola	SIGNATURE

SEC 56 REV 2
2 18 88

INTERNATIONAL MONETARY FUND
WASHINGTON D C 20431

FACSIMILE NUMBERS
(202) 623 4661
(202) 623 4662
(202) 623 7491

FACSIMILE INQUIRIES
(202) 623 6775

Facsimile Service Cover Sheet
(TYPE)

MSG NO (For Cable Room use only)	DATE November 15, 1989	PAGE 1 OF 2

TO

NAME Lic. José Angel Gurria Treviño
Undersecretary for International Financial Affairs
AGENCY Ministry of Finance

CITY/COUNTRY Mexico City, Mexico

FACSIMILE TELEPHONE NO 52 (Country Code) 5 (City Code) 542-4581 (Number)

TEXT

Copy has been faxed to Cleary Gottlieb, Attn.
Mr. Mark Walker.

INTERNAL DISTRIBUTION

FROM

NAME M. Caiola

DEPT /DIV Western Hemisphere Department, Immediate Office

ROOM NO 10-100	EXTENSION 8634	ACCOUNT CODE

AUTHORIZED BY *(TYPE)* M Caiola

SIGNATURE [signature]

SEC 56 REV 2
2 18 88

INTERNATIONAL MONETARY FUND
WASHINGTON, D. C. 20431

MANAGING DIRECTOR

CABLE ADDRESS
INTERFUND

Dear Mr. Undersecretary:

I refer to your letter of November 6, 1989, in which you asked whether the Fund could agree to a possible request by Mexico that it act as Collateral Agent for the Par and Discount Bonds to be issued by Mexico in connection with its 1989-92 Financing Package. I wish to thank you for extending this invitation to the Fund. The success of Mexico's economic program and financial package is of utmost importance to all members of the Fund. Furthermore, it would be appropriate, in principle, for the Fund to perform the proposed financial service for Mexico.

For several reasons, however, I cannot recommend to the Executive Board that the Fund consent to the application of domestic law and submit itself to the jurisdiction of domestic courts, as you have requested. Even a limited waiver by the Fund would place at risk the assets of the Fund held in its other accounts, because of its submission to domestic law and judicial process. In light of its Articles of Agreement, the Fund should not put itself in such a situation. It follows that I am not in a position to recommend to the Executive Board that the Fund accede to your request.

Finally, let me assure you that my refusal should not be taken as a signal of any lessened commitment by the Fund to Mexico. Indeed, I would like to make it quite clear that, despite my negative response to your request, as formulated, I would be prepared to support the establishment of a collateral account for Mexico that would not involve waiver of the Fund's immunity from judicial process.

Sincerely yours,

Michel Camdessus
Chairman of the Executive Board
and
Managing Director

Lic. José Angel Gurria Treviño
Undersecretary for International Financial Affairs
Ministry of Finance
Mexico

Office Memorandum

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TO: The Managing Director
The Deputy Managing Director

DATE: November 14, 1989

FROM: William E. Holder WEH

SUBJECT: Mexico - Collateral Account - Reply to Mr. Gurria

As you requested this morning, Mr. Liuksila has drafted the attached reply to Mr. Gurria for your review and signature. The text of the reply reflects comments from Messrs. Beza and Whittome.

Attachment

cc: Mr. Whittome
Mr. Beza
Mr. H. Simpson

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.
1989 NOV 15 AM 6:00

INTERNATIONAL MONETARY FUND
WASHINGTON D C 20431

MANAGING DIRECTOR

CABLE ADDRESS
INTERFUND

November 14, 1989

Dear Angel

I refer to your letter of November 6, 1989, in which you asked whether the Fund could agree to a possible request by Mexico that it act as Collateral Agent for the Par and Discount Bonds to be issued by Mexico in connection with its 1989-92 Financing Package I wish to thank you for extending this invitation to the Fund The success of Mexico's economic program and financial package is of utmost importance to all members of the Fund Furthermore, it would be appropriate, in principle, for the Fund to perform the proposed financial service for Mexico

For several reasons, however, I cannot recommend to the Executive Board that the Fund consent to the application of domestic law and submit itself to the jurisdiction of domestic courts, as you have requested Even a limited waiver by the Fund would place at risk the assets of the Fund held in its other accounts, because of its submission to domestic law and judicial process In light of its Articles of Agreement, the Fund should not put itself in such a situation It follows that I am not in a position to recommend to the Executive Board that the Fund accede to your request

Finally, let me assure you that my refusal should not be taken as a signal of any lessened commitment by the Fund to Mexico

Sincerely yours,

Michel Camdessus
Chairman of the Executive Board
and
Managing Director

Lic José Angel Gurria Treviño
Undersecretary for International Financial Affairs
Ministry of Finance
Mexico

Office Memorandum

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.
1989 NOV 13 AM 11:45

Mr. Beza STB CL JB IO F

Mexico

TO: The Managing Director
The Deputy Managing Director

November 13, 1989

FROM: L.A. Whittome

SUBJECT: Completion of the Mexican Package

You asked us to reflect further on steps that might be taken to proceed with implementation of the Mexican package. Bank responses, thus far, suggest that either or both of the following problems may need to be addressed:

-- a shortfall in overall subscription to the package;

-- a pattern of response that would imply a need for more than $7 billion in enhancements. Mr. Beza addressed the basic issues in his note of November 2 and set out the quantitative implications of different selections by banks.

1. Overall shortfall

The term sheet appears to foresee that the package could be implemented before all banks have selected an option to participate. Specifically, issuance of the discount and par bonds can take place following amendment of the old agreements by only 90 percent of the banks (by value of claims held) or 80 percent if half the banks that have committed to these bonds so agree. But if Mexico continues to pay full interest to the nonparticipants, a financing shortfall would arise.

One possibility is that Mexico might cease to pay full interest to the "free riders," and instead pay them in part in cash and in part in bonds on the same terms as the new money in the package. (This would not trigger the collateral accounts because interest on the par and discount bonds would be paid in full.) The "free riders" would then in effect substitute for new money banks, possibly resulting temporarily in a little more financing than originally projected.

The question thus arises how the "free riders" should be treated by Mexico, by the agent banks channeling interest payments, and indeed by the Fund for the purposes of policy on payments restrictions. In terms of immediate tactics and of incentives for future conduct of the debt strategy, it would on balance be best to make nonparticipants contribute. Mexico would thus provide the agent banks (for the old agreements) in future with amounts of interest that are in effect net of new money, together with "new money" bonds in respect of the balance. The agent banks would distribute cash and bonds in accordance with the sharing provisions of the old agreements. This would be a major departure.

Because the old agreements had not been formally modified, the part cash payment, while nominally fair," would give rise to arrears Mexico might be sued for nonpayment In that event, the Fund could be asked to protect Mexico legally under Article VIII, Section 2(b) At that stage the Fund could consider this Participating banks may also be sued, at least for conspiracy with the borrower

2 <u>Oversubscription of enhancements</u>

The term sheet makes clear that the amount of enhancements available is fixed at $7 billion, and sets rules to allocate any shortfall, essentially by cutting back interest cover to as little as eighteen months It is possible that banks' risk perceptions, and indeed the intervening changes in interest rates and secondary market prices could nonetheless leave the discount and par bonds--especially the latter--so relatively attractive that the enhancements available are oversubscribed

As noted earlier by Mr Beza, one possible line of action could be to put pressure on banks to revise their portfolio choices so that the package can be implemented as foreseen, a further possibility would be to adjust the pricing in light of supply and demand so that bank participation is more evenly distributed, e g , by proposing to reduce the number of months of interest enhancement, even below eighteen months--but this would certainly reopen the entire package If eventually Mexico decided--as on the financing gap--to foster the goodwill of the banking community and enhance further bonds, the question is who should provide the financing The following lines of action, or some combination of them, might be considered

-- Mexico could undertake somewhat stronger adjustment to generate the needed margin of reserves,

-- Mexico might seek to raise funds from a combination of banks and/or officials through issuing bonds differentiated from its existing debt (e g , placements of short term notes with surplus country central banks, or placements with financial institutions of notes cofinanced with the World Bank or J-EXIM), this option raises the issue of burden-sharing,

-- The Fund could contemplate some contingency financing, which would allow Mexico to operate with a lower level of reserves and thus itself contribute to more enhancement, but unless this could be coupled with agreement by the banks also on contingency financing (e g , in the ratio banks 2 to IMF 1), it would again raise the issue of appropriate burden-sharing It is questionable whether the banks would do this

As a somewhat separate point, further augmentation by the Fund is clearly undesirable in that it will set a potential precedent, lead to more accusations of bailing out the banks, and reopen the guidelines,

it would also appear fundamentally unjustifed if the above arguments on pricing are accepted We believe that the World Bank feels the same However, apart from the undesirability of being pushed backwards, there is nothing especially sacrosanct about the various percentages agreed by the Fund for debt reduction

cc Mr Beza
Mr Frenkel
Mr Touré
Mr Van Houtven
Mr H Simpson

Office Memorandum

RECEIVED
INTERNATIONAL
MONETARY FUND
1989 NOV 10 PM 6:56
OFFICE OF
THE MANAGING DIRECTOR

TO: The Managing Director
The Deputy Managing Director

DATE: November 10, 1989

FROM: L. Whittome, F. Gianviti and G. Laske

SUBJECT: Mexico - Collateral Account - Reply to Mr. Gurria - Your Options

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.
1989 NOV 15 PM 3:01

Your options are:

1. To send a reply acceding to all the terms of Mr. Gurria's request;

2. To send a reply stating that you could support Mexico's request for a collateral account, provided it did not involve the granting of a waiver of immunity and the application of a domestic law, and suggesting, for their consideration, an alternative approach along the lines of the Legal Department's memorandum to you dated November 2, 1989 (power of attorney); or

3. To send a negative reply.

In our opinion, the following considerations are relevant:

Under the terms of the request, the Fund's role would be limited to that of a custodian of the collateral, acting in accordance with instructions given by Mexico for the selection of investments in the account. The Fund's immunities would protect the collateral against claims by parties other than the bondholders. It has been indicated to counsel for Mexico that, subject to mutually satisfactory detailed arrangements for holding and investing the collateral to reduce the cost of performing the financial service for Mexico, the request for the opening of the account could be granted by the Fund.

There is authority in Article V, Section 2(b) for establishing a collateral account at the request of Mexico, but there is a legal risk in acceding to the terms of Mr. Gurria's request. According to his request, the Fund should agree to the following three conditions: "limited" waiver of immunity, application of New York law, and liability for gross negligence or willful misconduct. Assuming that these conditions are accepted, what would be the chances of the Fund preventing an attachment of its assets in the General Resources Account, after a judicial finding of gross negligence in the management of the collateral account?

Under the Fund's Articles, assets in the GRA cannot be used to discharge liabilities incurred in the management of an administered account. However, under New York law, a trustee or agent is personally

liable, on his assets, for the mismanagement of resources administered by him, and cannot use the administered assets to discharge his liability Therefore, a New York court would conclude, based on New York law, that assets other than those in the administered account will have to be used to discharge the Fund's liability Moreover, gross negligence could be a basis for the award of punitive damages against the Fund ("treble damages") in addition to damages for the actual loss to the creditors Upon the attachment of its assets in the GRA, the Fund could raise a defense based on the mandatory separation of assets and liabilities between each administered account and the GRA under the Articles However, the obvious answer to that defense would be that, after agreeing to the three conditions above, the Fund could not subsequently deny any legal effect to its contractual obligation by relying on a restrictive interpretation of its Articles that would put its assets beyond the reach of the creditors As for making this interpretation clear from the outset in the contract, it would probably deter the creditors from agreeing to the proposed scheme, and, in any case, there would be no assurance that a judge would not disregard this limitation as inconsistent with the assumption of legal liability under New York law Thus, by agreeing to a "limited" waiver of immunity, the Fund could find itself in a situation of exposing assets in the GRA in connection with the management of an administered account, contrary to the provisions of the Articles

There is also an inherent political risk in acceding to the request While recognizing the powers of the Fund to establish accounts in service of member countries, some Executive Directors have previously voiced policy reservations on establishing a collateral account in the Fund in connection with debt and debt-service reduction agreements In a situation in which Fund disbursements in support of the eventual Mexican financing package may require flexibility on the part of the Board in the application of the guidelines on the Fund's involvement in the debt strategy, and also where there may be a need for concurrent modification of Mexico's EFF program, these Directors may be ready to focus any unease with the extent of the needed flexibility and modifications on the issue of the collateral account for Mexico, and oppose it They could see this as a relatively costless way to vent any unease as they can argue that the account can be readily established elsewhere It would, therefore, be useful to consult informally with certain Directors if you conclude to proceed with ~~the collat~~eral account

Finally, the reasons for Mexico's request are not unique to Mexico and therefore it is highly likely that other countries coming under the strengthened debt strategy will seek the Fund's financial services on the same terms and conditions that would be adopted for Mexico

cc Mr S T Beza
Mr H Simpson

Office Memorandum

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.
1989 NOV 13 AM 7:26

Mr. Beza

mexico

10-100 STB CL JB IO F

TO: The Managing Director
The Deputy Managing Director

DATE: November 10, 1989

FROM: Jacob A. Frenkel J.F.

SUBJECT: Lessons from the Mexican Negotiations

1. The initial reaction of banks to the Mexican financing package raises two issues that will have to be addressed in this and future packages. The first is the participation of banks in the package. A low participation rate raises the fundamental question of the treatment of banks that hold out. The second is the composition of participating banks' bids for various options offered in the package.

2. The participation issue is probably more important in terms of the overall debt strategy. In order to evaluate this problem, it is important to remember that a debtor country that has remained current on interest payments to commercial banks at considerable sacrifice is very likely to want to remain current on new obligations that emerge from a debt reduction financing package.

It follows that an estimate of the level of debt service on remaining bank debt, (plus service on the new official debt incurred to finance buy-backs or enhacements) that is consistent with program growth objectives is the key element in the negotiations among the debtor, the Fund and the banks.

3. The banks will want to set this payment level as high as possible for two reasons. First, they will reason that the debtor and the Fund will build in some margin for error and the banks would prefer that the country be kept on a short leash. Second, they reason that if the debtor is unable to meet a higher level of cash payments that official creditors will be forced to provide resources to keep the program on track.

4. For historical reasons we usually talk about the difference between such payments and the debtor's contractual debt service obligations rather than about the level of payments that can be made to banks consistent with growth objectives. Thus, larger programed payments mean a smaller "financing gap." This means, of course, that ceteris paribus banks want smaller "financing gaps" (higher payments), while the debtor and the Fund, in effect, usually want larger financing gaps (lower payments). Although this is well understood by all parties, it is worth noting that in designing and approving an adjustment program, the Fund de facto endorses a level of payments to the banks. There is nothing new about this, and it is not unique to programs involving debt reduction.

5. If individual banks are slow in committing to the debt reduction offer even though the terms have been approved by the Fund and agreed to by the debtor and the bank advisory committee, it seems clear that we must insist that the debtor sticks to the agreed rate of payment.

To do otherwise is equivalent to saying that hold out banks have the right to reduce growth from the agreed target Such banks should be paid as if they had agreed to the new money option This will, of course, generate arrears In the Mexican case, holdouts would get effective cash payments amounting to 3 to 4 percent of their eligible debt (the residual contractual interest receivable would, at least initially, be arrears)

6 If participation rate is satisfactory, the composition of banks' bids for financing options might exhaust available collateral Moreover, the amount of official lending for collateral is not easy to increase after the negotiations are underway and therefore constrains the amount of debt reduction possible It follows that the debtor must limit the options given to creditors in electing debt reduction instruments so that its resources are not exhausted In the Mexican case, this was not done and since the debt reduction bonds have become more desirable as compared to new money since the terms were set (interest rates have fallen and the secondary market price of Mexican paper has fallen, both factors increasing the value of bonds relative to new money), it is not surprising that banks seem to have moved in the direction of debt or debt service reduction and away from new money

7 Although the par exchange and new money were priced equivalently when the terms were set, they are not equivalent now Such changes in circumstances are bound to occur in other cases There are two lessons here First, in future negotiations, either the maximum amount of any buy-back or exchange should remain at the debtor's discretion as in the Philippine agreement or the share of each option should be set as in the Costa Rican agreement Second, for those banks that have elected debt or debt service reduction rather than the new money option, it is not reasonable to say that they have not been living up to their side of the Mexican agreement

8 One alternative would be to have Mexico reduce the enhancement on the par bond, say to 12 to 15 months and make a new offer This seems a bad idea as the whole deal could unravel

9 Another alternative would be to force the banks to take more of the new money option in order to get the debt reduction instruments Again, while this might be a good idea in the future, it requires that the existing offer be revoked and a new one negotiated The risks seem pretty high relative to the costs of providing additional funds that might be needed

10 It seems likely that the best alternative, at this point, is to arrange for additional official financing to support the offer as it stands At the same time it would be important to emphasize that for future cases, safeguards discussed in item 7 above are in place

cc Mr Beza ✓
Mr Toure
Mr Van Houtven
Mr Whittome
Mr I' Simpson

The Watergate Hotel

Mexico

MD STF
DMD JL
Mr H Simpson JB IO F

FAX COVER SHEET

DATE November 9, 1989

TO Mr Beza

ATTENTION OF Mr Beza

FAX NO. 6237499

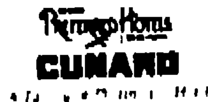
FROM Mr Flores

NUMBER OF PAGES FOLLOWING THIS COVER SHEET (1)

COMMENTS

Please contact The Watergate Hotel at (202) 965-2300 Extension 4434 if pages are incorrect or if Fax is not legible. Thank you.

2650 Virginia Avenue Northwest Washington D C 20037 (202)965-2300



CARLOS SALINAS DE GORTARI
PRESIDENTE CONSTITUCIONAL DE LOS ESTADOS UNIDOS MEXICANOS

Los Pinos, 9 de noviembre de 1989.

Estimado Señor Presidente:

Me dirijo a usted para manifestarle el interés que tiene el gobierno de México en el proceso de reposición de cuotas en el Fondo Monetario Internacional.

Como lo expresamos los Presidentes del Grupo de Río en la declaración final de nuestra reciente reunión en Ica, Perú, el Fondo Monetario Internacional juega ahora un papel positivo fundamental en la renegociación de la deuda externa de nuestros países, papel que podrá acrecentarse en la medida en que se fortalezca su capacidad financiera.

Por lo anterior, México apoya el proyecto de duplicación de cuotas en ese organismo y vería con gran satisfacción el respaldo que su gobierno pudiera dar a esta iniciativa.

Aprovecho esta oportunidad para hacerle llegar la expresión de mi más atenta consideración.

Excelentísimo Señor
George Bush
Presidente de los
Estados Unidos de América

RECEIVED
1989 NOV -8 PM 6: 16
OFFICE OF
THE MANAGING DIRECTOR

Office Memorandum

TO: The Managing Director
The Deputy Managing Director

DATE: November 8, 1989

FROM: S.T. Beza

SUBJECT: Mexico--Staff visit

As I had indicated in my note of November 3, we were expecting a small group of Mexican officials to visit us next week to discuss the budget ahead of its presentation to Congress on November 15.

Mr. Ortiz, the Undersecretary of Finance and Public Credit, called me today to indicate that the members of the Mexican economic team are ready to discuss their economic policies. However, because of the tight schedule that they are confronting in preparing the draft budget and other financial legislation, they have requested that a small staff team visit Mexico this week.

For this purpose, Messrs. Loser and Kalter (both WHD) will travel to Mexico tomorrow. This would reestablish a plan we had before the Mexican officials offered to come to Washington.

cc: Mr. Frenkel
Mr. Whittome
Mr. Tanzi
Mr. H. Simpson

Office Memorandum

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CONFIDENTIAL

TO: The Managing Director
The Deputy Managing Director

DATE: November 7, 1989

FROM: François Gianviti F.G.

SUBJECT: Mexico - Letter from Mr. Gurria on Collateral Account (November 6, 1989)

The letter you have received from Mr. Gurria, Undersecretary for international financial affairs (Mexico), expresses the interest of his authorities in the possible appointment of the Fund as collateral agent for holding the bonds, cash and investments securing the principal and interest of Mexico's debt under the 1989-92 Financing Package. To that effect, the Fund would have to agree to (i) a waiver of its immunity from judicial process, and (ii) the application of New York law to its obligations to creditor banks, as conditions for being appointed collateral agent under the Mexican financial package.

This matter has been discussed extensively with counsel for Mexico, and, as you may recall, no agreement was reached between our staff and counsel for Mexico.

The letter restates the case for a waiver and application of New York law and contains some statements attributed to our staff. It may be worth noting, however, that, in the discussions with counsel for Mexico, the following points were made by our staff:

(a) The risks of a "limited" waiver were pointed out to counsel for Mexico, particularly the danger of an extensive judicial interpretation, which, contrary to Article V, Section 2(b), would expose the assets of the General Resources Account for operations of the collateral account. We are aware, in this regard, of the difficulties encountered by the U.S. Government in having its own courts respect its own interpretation of its legislative waiver of immunity from judicial process.

(b) A waiver of immunity is not the only technique, in our opinion, for safeguarding the creditor banks' interests, should the Fund fail to release the collateral. We have indicated that an irrevocable power of attorney could be given by the Fund, empowering, for instance, the fiscal agent to dispose of the collateral in that case. The fiscal agent or, alternatively, a surrogate collateral agent authorized to act in the circumstances would then have direct access to the collateral without involving the Fund in a judicial process.

(c) Counsel for Mexico was informed that the Fund has waived its immunity from judicial process and agreed to the application of a domestic law only in the case of borrowing from SAMA for the General Resources Account, never for an administered account. True, a proposal for a waiver was attached to the Managing Director's proposal for a

Substitution Account, but the proposal failed (essentially for other reasons)

The main concern of counsel for Mexico seems to be that, unless creditor banks are provided with the same certification as in the case of the Morgan Guaranty Trust Company Collateral Pledge Agreement (1988)--which is governed by New York law--, they will insist on the appointment of a commercial bank as collateral agent, and charge the cost to Mexico

Before preparing a response from you to Mr Gurria, we would appreciate having your guidance on these points

cc Mr Beza
Mr Whittome
Mr Laske
Mr H Simpson

mexico

MD
DMD
Mrs Filardo
Mr Gianviti
Mr Brau
WHD
Mr H Simpson

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INTERNATIONAL MONETARY FUND

WASHINGTON, D. C

MR TED BEZA

PLEASE DELIVER THE FOLLOWING TELEFAX TO MR MICHEL CAMDESUS
MANAGING DIRECTORY, AND COPY FOR YOU

THANK YOU

TELEFAX / FACSIMILE.

MINISTRY OF FINANCE.
UNDERSECRETARY FOR INTERNATIONAL FINANCIAL AFFAIRS.
M E X I C O .

DATE: NOVEMBER 6, 1989

NUMBER OF PAGES
(INCLUDING COVER SHEET):

TO NAME OF ADDRESSEE:

MR MICHEL CAMDESSUS,
MANAGING DIRECTOR,
INTERNATIONAL MONETARY FUND,
WASHINGTON, D C

TELEFAX/FACSIMILE TELEPHONE NUMBER:

FROM: NAME OF SENDER:

LIC JOSE ANGEL GURRIA TREVIÑO
MEXICO

TELEFAX/FACSIMILE TELEPHONE NUMBER. (905) - 542-45-81.

PLEASE DELIVER COPY TO MR BEZA

THANK YOU

IF THERE IS ANY PROBLEM WITH THE TRANSMISSION, PLEASE CALL BACK:
(905) - 542-13-00, 522-56-22, 542-39-04 AND 542-98-39.

SECRETARIA
DE
HACIENDA Y CREDITO PUBLICO

November 6, 1989

Mr Michel Camdessus,
Managing Director,
International Monetary Fund,
Washington, D C

Dear Michel

As you know, representatives of Mexico have engaged in discussions with management and staff of the International Monetary Fund with regard to the Fund's acting as Collateral Agent for the Par and Discount Bonds to be issued by Mexico in connection with its 1989-92 Financing Package In this capacity the Fund would hold the zero-coupon bonds securing the repayment of the principal of the Bonds and the cash and the investments securing 18 to 24 months of interest on the Bonds We believe that the Fund is ideally suited to perform the role of Collateral Agent for a number of reasons

The Fund is uniquely capable of carrying out the investment and reinvestment of a large multicurrency pool of resources in financial centers around the world, and it could provide superior service to Mexico at considerable savings, as compared to the multimillion dollar fees proposed by commercial banks In addition, Mexico's resources would (if held by the Fund) enjoy a degree of immunity that they would not otherwise have Finally, were the Fund to act in this capacity it would not only provide further support for Mexico's Financing Package but would also underscore its leadership role in defining and implementing the Brady Plan

Over the last several weeks our counsel have had discussions with counsel for the Fund as well as with counsel for the Bank Advisory Committee While the Banks are receptive to the idea of the Fund's acting as Collateral Agent, we understand that their acceptance will be subject to two conditions First, the Fund must grant a limited waiver of its immunities from legal process to enable Mexico's bondholders to conclude that if it ever became necessary they could require the Fund to comply with its undertakings Second, the agreement governing the Fund's obligations as Collateral Agent must be governed by local (in particular, New York) law Both issues, although of little practical consequence, are of vital importance to the Banks

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GHI

SECRETARIA
DE
HACIENDA Y CREDITO PUBLICO

First, without a limited waiver of immunities the bondholders will find themselves without legal remedies in the event the Fund were, willfully or for reasons of gross negligence, to fail to periorm its limited, ministerial contractual obligations as Collateral Agent Absent a waiver, for example, the bondholders would have no legal means to require the Fund to deliver the proceeds of the zero-coupon bonds if the Fund improperly refused to do so Obviously the likelihood of the Fund breaching its obligations or acting with gross negligence is remote, but it would be imprudent of the Banks to agree that bondholders would have no legal remedies in that event Were a private party to act as Collateral Agent, the bondholders would clearly have meaningful remedies to require performance and to seek redress for gross negligence They cannot be expected to abandon these rights altogether

After consultation with counsel for the Fund, our counsel have informed us that it would be possible to draft a narrow waiver of immunities that would preserve the legitimate interests of the Fund

The question of choice of law is also of critical importance Not only does international law (the Fund's preferred choice) provide no guidance as to how to perfect a security interest in collateral, but it also gives Banks inadequate comfort as to the meaning and enforceability of their rights Your counsel has advised us that there is precedent for the Fund agreeing to local law In addition, it is worth noting that, as between Mexico and the Fund, international law will continue to govern

We appreciate the Fund's interest in acting as Collateral Agent for the Bonds as a tangible sign of support for Mexico and, more generally, for the efforts being made to resolve the debt problem I trust that the Fund can address the specific issues before us with the greatest flexibility so as to ensure that legal technicalities of little practical import do not prevent the Fund from providing an important service to Mexico and facilitating the successful completion of our Financing Package

Very truly yours,

JOSE ANCEL CURRIA TREVIÑO
UNDERSECRFTARY FOR INTERNATIONAL
FINANCIAL AFFAIRS

COPY TO
MR RICHARD ERB - DEPUTY MANAGING DIRECTOR
MR MARK WALKER - PARTNER CLEARY, GOTTLIEB, STEEN & HAMILTON
MR TED BEZA - DIRECTOR WESTERN HEMISPHERE

TIEV MEX

Office Memorandum

RECEIVED
INTERNATIONAL
MONETARY FUND
1989 NOV -3 PM 6:02
OFFICE OF
THE MANAGING DIRECTOR

TO: The Managing Director
The Deputy Managing Director

DATE: November 3, 1989

FROM: S.T. Beza

SUBJECT: Mexico

We are expecting a small group of Mexican officials to visit us next week to discuss the budget ahead of its presentation to Congress. Subsequently, a mission will visit Mexico City in late November to conduct a broader discussion on policies for 1990, to provide the basis for the special review needed for the accelerated use of set-asides and augmentation of the existing extended arrangement. This mission date was postponed at the request the authorities and it cannot be completed until early January, at the earliest. However, the financing package with commercial banks is unlikely to be ready before end-January or February.

The information that we have available indicates that performance under the program continues to be satisfactory, but President Salinas, in his State of the Nation address to the Mexican Congress on November 1, drew attention to the rapid growth of private demand and suggested that offsetting actions might be needed. The address did not include any major announcement of changes in policy.

The Mexican officials are currently examining policies for 1990, including the budget, public pricing policies, the exchange rate, and incomes policies for the private sector. To continue to lower inflation and to assure a satisfactory balance of payments, further reductions in the operational deficit and overall public sector deficit seem to us to be needed. We have heard that some members of Mexico's economic team are considering fixing the exchange rate of the peso as a means of moving away from the wage-price pact without triggering an upturn of inflation. Such course of action would have to be approached with caution, given the need to maintain competitiveness and a satisfactory balance of payments.

cc: Mr. Frenkel
Mr. Whittome
Mr. Tanzi
Mr. H. Simpson

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mexico

DEPARTMENT OF TREASURY
FACSIMILE COVER SHEET
15TH & PENNSYLVANIA AVE., N.W.
WASHINGTON' D.C. 20220

FAX MESSAGE NUMBER——————— DATE 11/2/89

NUMBER OF PAGES TO FOLLOW: ———————

TO: Elliott Kalter

ADDRESSEE'S FAX NUMBER: 623-7499

ADDRESSEE'S CONFIRMATION NUMBER———————

FROM: CHRIS McCoy - Dept. of TREASURY

TELEPHONE NO: 566 8521

SENDER'S FAX NUMBERS: (202) 566-5066 (202) 535-[illegible] (202) 535-[illegible] 786-8418

SENDER'S CONFIRMATION NUMBER: (202) 566-8114

COMMENTS/SPECIAL INSTRUCTIONS:

UNCLASSIFIED

First State of the Nation Report

Carlos Salinas de Gortari

The crisis showed us that a larger State is not necessarily a more capable State; a State that owns more is today not a fairer State The reality is that in Mexico a larger State has resulted in less capacity to respond to the social demands of our fellow citizens and, in the end, greater weakness of the State itself. As the public sector's productive activities grew, its attention to potable water supply, health, rural investment and food supply, housing, the environment and justice decreased. The size of the State was growing while the well-being of the people was deteriorating.

This distancing of government from attention to social demands came about not only because the growing parastate enterprises monopolized financial resources, but also because they distracted the government's political attention. As the facts show, the State concerned itself more with administering its properties than with meeting pressing social needs.

Therefore, we are carrying out a reform of the State in order to return to the original concept proposed by the Mexican Revolution a State that is able to guarantee our nation's sovereignty and at the same time provide justice for our fellow citizens. This decade of crisis has damaged the living standards of the population in an unprecedented way and destroyed the jealously guarded myths of a minority that enjoyed the benefits of State gigantism with little care for

the lot of millions of its fellow citizens, the suffocation of social initiative and the bureaucratization of political tasks.

The theory that associates statism with progress emerged in the world as a result of the failure of the excessive individualism of the twenties, the failed self-regulation of the market and the Great Depression that followed. It was a theory that was undoubtedly valid during the thirties and forties. In its time it was a just banner. But today it only defends the privileges of the old guard that clings to the status quo

The notable successes of State intervention in the past, which contributed to the development of nearly four decades of sustained growth, were clouded by a tendency to make the State almost exclusively responsible for management of the entire economy; this prevented its effective regulation of the mixed economy As has already been indicated, in a society as complex as ours, there are constitutional and economic obligations that the State must fulfill because of market insufficiencies and social inequalities. In fact, popular causes are only defended and promoted by a modern State that guarantees sovereignty and makes justice a reality, within a framework of freedom, by promoting organized participation by the people and maintaining its basic alliance with those who have least.

Every week I visit low-income neighborhoods, Indian communities, rural villages, the country's most depressed areas The demands I receive are persistent: they need services, they need security, they need considerate attention on the part of public servants. Faced with these demands, what are the fundamental responsibilities of a State that today is

is stronger; its capacity for mediating is greater; its message to the world is clearer and more effective.

Heedful of our borders, my administration has sought to establish new bases for Mexico's relations with neighboring countries: the United States of America to the north; Guatemala and Belize to the south; and Cuba, whose patrimonial waters border on ours. These relations are especially important for increasing our security and projecting our aims.

Relations with the United States of America are of special significance to Mexico. We reject confrontation as being senseless, and submission as being offensive to our firmest convictions. We view the future with assurance, without ignoring a difficult past.

Relations with such a powerful neighbor, with the most complex common border in the world and a history burdened by acts of extreme aggression, will never be easy. Nevertheless, there is no reason for our relations always to be bad or tense.

The cordiality that exists today is understandable because matters of common interest require concerted actions. Our market is now more open than that of the United States: this allows us to engage in a positive offensive in trade relations. We are fighting drug trafficking energetically as a matter of State and to protect the health of Mexican families, since this issue is of major concern to our northern neighbor, our coinciding viewpoints on combatting it are mutually beneficial. The renegotiation of the debt was as much in our interest as in theirs: thus, they became a source of assistance. We want a cleaner environment, from the interior

of the country to our borders: our concerns also coincide in that regard. We promote the defense of Mexicans working in the United States, who are indispensable to the economy of that country. We are both aware of the political, economic and cultural changes in the world, and Mexico firmly upholds the principles of nonintervention and self-determination of peoples, especially in Latin America.

A positive, respectful atmosphere in our relations therefore does not stem from a change in our principles, but from a change in circumstances. When this has occurred, we have been able, with political will, to extend the ambit of shared viewpoints, reciprocity in exchanges and cordiality in our attitudes, under the steadfast norm of respect for our principles and our differences. As part of this new spirit, in October I accepted the invitation extended by President George Bush to make a State visit to his country. We have been able to translate that spirit into specific agreements which are of direct benefit to Mexicans. We are securing broader, more certain access of our products to the United States market, currently in the fields of iron and steel, textiles and the Generalized System of Preferences, and shortly in reducing non-tariff barriers for our priority sectors.

We are working together with labor organizations and state governments on both sides of the border to devise new mechanisms for protecting the human and labor rights of migrant workers We have expanded the exchange of information in our common struggle against drug trafficking, in the understanding that the responsibility for carrying out operations on our territory lies exclusively with Mexicans. We have established effective mechanisms to preserve the environment on the border and in Mexico City We have moved on from consultations aimed

at resolving old differences to making decisions aimed at creating new opportunities: for Mexico, reciprocity with regard to our liberalization of trade, greater investment and more employment are the results of the new accord.

I visited the border zone of Guatemala and held cordial and positive talks with the President of that respected friend and neighbor. During my talks with the Prime Minister of Canada, I was able to confirm that country's new interest in Mexico and Latin America and the considerable potential for cooperation between our countries. With Cuba, we seek to increase economic and cultural relations; in the field of finance, we agreed to respond sensitively and responsibly to conditions in both countries. A few days ago, I received a visit from the Prime Minister of Jamaica; our meeting confirmed the desire of both nations to broaden our exchanges. It is in Mexico's interest to promote a more active presence in the Caribbean, owing both to its economic and tourism potential and to its strategic location

Our priority relations with Latin America have also been renovated The Permanent Mechanism for Political Consultation and Cooperation, known as the Group of Rio, has been institutionalized, without bureaucratic inflexibility, as a framework for dialogue and joint initiatives. This is increasingly allowing our countries to speak as one in international forums. During the Presidential Meeting of this Group, held in Ica, Peru, last October, we defined specific projects for greater cultural exchange and for improving the physical integration of the region. We recognized that exchange rate stability and trade liberalization are the real conditions for the economic integration of Latin America. We agreed to define deadlines and commitments for reducing trade

3. ECONOMIC RECOVERY WITH PRICE STABILITY

The National Agreement for Economic Recovery with Price Stability has served as a framework for the government's and society's economic activities over the past 11 months. In the 1989-1994 National Development Plan, we have decided to sustain growth in three primary areas: consolidation of economic stability, expansion of resources for development, and modernization of the productive plant. Today we have clear goals, resources to make them viable and the will to persevere until we reach them.

Continuous and just growth requires price stability. Mexicans have rejected the option of living with high inflation. We have found a strategic answer to this problem in the Pact It has not been an easy or flattering answer, but it is working because we have been able to complement concerted social agreement with fiscal discipline. Thus, the annual cumulative increase in the consumer price index was reduced from almost 200 percent in December 1987 to 17 3 percent in September of this year, the lowest level in more than a decade

In the first six months of the year, Mexico's production grew 2 4 percent in relation to the same period last year. This evolution enables us to predict that the growth goal of 1 5 percent for 1989 will be surpassed and that we will achieve a rate of 2.5 to 3 percent in real terms. The number of people enrolled in the Mexican Social Security Institute (IMSS) has increased by 8 percent annually and the total earnings of workers in the manufacturing industry have grown 14 percent in

real terms. The development of production has not been artificially induced. The strictest discipline has been imposed on public finances. Monetary, financial and credit policies have been applied in accordance with the evolution of markets. More dynamic demand has resulted from greater confidence among investors and greater consumer capacity, although this varies in different sectors and regions of the country. Thus, we are resuming growth at a faster rate than expected and even at a faster pace than is desirable. We cannot force the rate of recovery because the lack of investment in infrastructure during the years of the crisis would now lead to bottlenecks and inflationary pressures.

Consequently, economic policy seeks to moderate the pace of demand and, at the same time, encourage expansion in supply. As envisaged in the National Development Plan, reaching an annual growth rate of 6 percent by the end of my administration is an ambitious but realistic goal. In order for such growth to be sustained, we must achieve it gradually.

Without balance in public finances there would be no permanent price stability. During the first half of the year, the public financial deficit was reduced 60 percent in real terms as compared to the deficit one year ago. The reduction in interest rates, resulting from lower inflation and the renegotiation of the foreign debt contributed to this reduction. The primary surplus, which is the difference between public revenue and expenditures excluding debt servicing, rose 31 percent in real terms during the same period Public spending was maintained at levels consistent with the need to consolidate reductions in inflation and support renegotiation of the debt, but its allocation has been oriented toward social priorities.

Income tax revenues between January and June increased by almost 23 percent in real terms as compared to the same period in 1988. The two-percent tax on corporate assets has contributed to the goal of more being paid by those who have more and, since it is deductible from income tax, it does not generally have an impact on taxpayers who fulfill their obligation The reduction in marginal tax rates, tax simplification and improved collection systems are encouraging voluntary compliance. But, without wishing to persecute, we have not hesitated to punish tax fraud with the full force of the law.

Exchange policy has reconciled the reduction in inflation with the competitiveness of the peso. Cumulative slippage was 13 percent between January and September. If we add international inflation to this figure, the increase in the prices of commodities from abroad is greater than the increase in domestic prices to the producer, which was 10 3 percent.

International oil prices have become firmer. Non-oil exports in July grew more than 8 percent over July 1988. Owing to the effects of the opening of trade and dynamic economic activity, imports are maintaining high, though decreasing, growth rates: thus, the annual growth rate of imports fell from 50 percent in January to 14 percent in July. The trade surplus amounted to 381 million dollars during that period of time.

As a result of the performance of various components of the balance of payments, the country's international reserves in the Banco de México amounted, as of yesterday, to 7 billion 324 million dollars With these reserves, the peso maintains solid backing in exchange markets.

Mexico

5-...

STB
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cc. Mr Loser
Mr Leddy
Mr Brau
Mr Allen
Mr Dooley
Mr El Erian/k

Bankers Trust Company
250 Park Avenue, New York, New York 10015

THIS TRANSMISSION CONSISTS OF 6 PAGES (INCLUDING COVER)

FOR: Max Watson
IMF - Room 5100

FAX #: 202-623-4661

FROM: Lawrence J. Brainard

DATED: Nov 3, 1989

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INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.
1989 NOV -3 PM 3:44

1989 NOV -6 PM 12:48

Valuation of the Mexican Debt Reduction Bonds

Background

Under the agreement reached with the Bank Advisory Committee, existing medium and long term bank debt will be exchanged for two debt reduction bonds The terms and conditions of each bond are.

	Discount Bond	Par Bond
Principal	35% discount from par	no discount
Interest Rate·	6-mo LIBOR+13/16% floating	6 1/4% fixed
Tenor	30 yrs, bullet maturity	30 yrs, bullet maturity

Mexico will purchase enhancements for each bond The principal payment of each bond will be secured by a 30-year U S Treasury zero-coupon bond, and interest payments will be secured with between 18 and 24 months of interest collateral The interest collateral will remain intact for the entire 30 years unless drawn upon in the event of an interest payment default In other words, the interest collateral "rolls" forward so long as Mexico makes each 6-month interest payment. In addition, each bond includes a "value recapture mechanism" This feature triggers additional payments to bondholders beginning in 1996, if Mexican oil revenues exceed a specified level Special terms and restrictions apply to these payments

Valuation

We value the bonds by summing the discounted present values of each of their component parts

11 03 89 04 25PM *BT CRED'T POLICY P02

Secured principal payment

Unenhanced 30-year interest flow

Rolling interest collateral

Value recapture mechanism

For illustration purposes, we use recent average rates in valuing the bonds 6-month LIBOR--8 50%, and the yield on 30-year Treasury securities--8.00% To be conservative, we calculate the value of 18 months of rolling interest collateral, although, if resources allow, the collateral may extend to 24 months. Values for the bonds' component parts are shown in percent of par

I Valuation of the Principal Payment

The valuation of the principal portion of the cash flow is straightforward The principal, due in one final payment in year 30, is fully collateralized with a 30-year Treasury zero, whose present value (cost) is determined by its current yield

Value of principal:	Par Bond	9.51%
	Discount Bond	6.18% (65% of 9 51%)

II Valuation of the Interest Payment Flow

The interest payment flow is valued by calculating the present value of the 30-year stream of semi-annual coupons--3 125% on the Par Bond and 4 655% on the Discount Bond What rate, however, should be used to discount the flow of interest payments over the life of the bond? This question is not trivial considering that we must take into account

11 03 89 04 25PM *BT CREDIT POLICY P03

not only possible interest payment default, but also the existence of the rolling interest collateral.

To account for these wrinkles, we derive period-specific discount factors which reflect the probability of default (pure Mexican risk), as well as the probability that the interest collateral will be intact in each period. These discount factors are applied to the interest payment flows in each period in order to determine their present values.

An important assumption in this calculation is that the probability of default in each payment period is probabilistically independent. This assumption allows us to generate discount rates which reflect the rolling feature of the interest collateral.

Another important aspect of the present value calculation, is the discount rate used for pure Mexican risk (i.e. the one which takes no account of enhancements). The market discount rate implicit in a 40 cent price for Mexican debt in the secondary market is approximately 22%. The discount rate relevant to bond interest, however, would be less than this for two reasons: 1) the issuance of the bonds implies a successful completion of the debt-reduction exercise, thus reducing overall risk; and 2) the bonds carry implicit seniority to other bank debt.

It is difficult to say how much the current 22% Mexican risk discount rate should be reduced due to these factors. One possibility is to examine the market valuation of the interest flows of the 2008 Morgan-Mexican bond issued last year--a bond similar in nature to the present debt-reduction bonds, but without any interest collateral. Currently, the 2008 bond trades at approximately 78% of face value (which itself was 70% of original par value of the debt) with a coupon of LIBOR+1 5/8% and 18 1/2 years remaining to maturity. When stripped of its principal, the unenhanced interest stream on the bond yields an internal rate of return of 17.59%. We consider 17.59% a lower bound for the Mexican risk discount. We place the appropriate discount rate in the range, 18.5-20.0%.

11 03 89 04 25PM *BT CREDIT POLICY P04

Our model allows us to value the unenhanced interest and the rolling interest collateral separately These values are shown below

Value of 30 years' interest payments--unenhanced.

	Discount Rate for Mexican Risk	
	18 5%	20 0%
Par Bond	33 62	31 15
Discount Bond	32.56	30 17

Value of the interest collateral.

	Discount Rate for Mexican Risk	
	18.5%	20.0%
Par Bond	9 18	9.35
Discount Bond	9 12	9.25

III. Valuation of the Value Recapture Mechanism.

The value recapture mechanism takes effect in 1996. Under value recapture, Mexico will make additional payments to bondholders, represented by detachable certificates, in the event that oil revenues rise above a specified level in real terms This level is calculated using a benchmark price for Mexico's oil export mix of $14 a barrel in 1989 dollars

To value this potential payment flow, judgements must be made on future Mexican oil prices and oil production volumes between the years 1996 and 2019 Considering alternative oil price and production scenarios, as well as the annual limit on these payments of 3% of original eligible debt, the recapture mechanism adds, on average, 2.3 percent to the present values of the bonds when discounted at 18.5%, and 2 0 percent when discounted at 20 0%

11 03 89 04 25PM *BT CREDIT POLICY P05

IV Total Value of the Discount and Par Bonds

Discount Rate for Mexican Risk. 18.5%

	Discount Bond	Par Bond
Value of interest	32.56	33 62
Value of interest collateral	9 12	9 18
Value of principal	6.18	9.51
Value of recapture mechanism (avg)	2 30	2 30
Total Value	**50 16**	**54 61**

Discount Rate for Mexican Risk. 20 0%

	Discount Bond	Par Bond
Value of interest	30 17	31 15
Value of interest collateral	9 25	9 35
Value of principal	6 18	9 51
Value of recapture mechanism (avg)	2 00	2.00
Total Value	**47.60**	**52.01**

Lawrence J Brainard, Senior Vice President

Ann Ginsburg, Assistant Treasurer

11 03 89 04 25PM *BT CREDIT POLICY P06

Office Memorandum

Mexico

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CONFIDENTIAL

TO The Acting Managing Director DATE October 23, 1989

FROM S T Beza

SUBJECT Trip to Frankfurt (October 19-20)

In Frankfurt I participated in the presentation of the Mexican economic program and financing package to commercial banks from Germany, Denmark, and the Netherlands Deutsche Bank hosted the meeting which was chaired by Mr Murtfeld, Senior Vice President Mr Husain represented the World Bank

In my view the meeting went quite well, and most banks seemed quite satisfied with Mexico's performance Most of the questions that arose dealt with specific issues of the package and were handled by Mr Gurría or his lawyer, Mr Walker

Mr Gurría mentioned to me that there were indications were that the debt reduction option might be more popular than was thought earlier (It may be recalled that the conventional guess has been that 20 percent of the exposure would go for new money, 20 percent for debt reduction, and 60 percent for interest reduction) Mr Gurría said that it was possible that new money would account for no more than 15 percent, debt reduction might be in the range of 35-40 percent, leaving some 45-50 percent for interest reduction

Mr Gurría thought that the enhancements of US$7 billion would still be sufficient because the increased cost of enhancement resulting from the reduction of new money would be offset by the shift (relative to the earlier assumption) from debt service reduction to debt reduction It is a little cheaper to enhance debt reduction than debt service reduction, but our calculations show that the new distribution would require enhancements of around US$7 2 billion

In Frankfurt I visited the Bundesbank to meet with Mr Rieke and two of his associates (Mr Schonberg and another officer) to discuss issues relating to Latin American countries In particular, we discussed the question of financing assurances as it applies to cases such as Argentina and Ecuador, which have sizable interest arrears to the banks and which under their programs can be expected to accumulate further arrears for some time to come

Bundesbank officials are uncomfortable about proceeding with such cases, but I pressed them to consider these in terms of the alternatives available I noted that if we did not go ahead with Argentina, for example, it would be very difficult to maintain our presence in the country as if it were under a program Following the meeting on Mexico, I discussed these matters further with Mr Schonberg, who represented the Bundesbank at the meeting He said that they had understood my message and that they would be reviewing the issues we had discussed

cc The Managing Director (o/r)
Mr Frenkel, Mr Whittome, Mr H Simpson

Office Memorandum

① mex co
② Travel-approval memo

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TO The Deputy Managing Director (Cleared with Administration)

DATE October 13, 1989

FROM S T Beza

SUBJECT Staff Visit to Mexico

As I discussed with you yesterday, a staff mission will visit Mexico City in late November to review developments under the extended arrangement with Mexico In addition, we have discussed with the authorities the visit of a small staff team to examine the fiscal policy stance for next year ahead of the presentation to Congress of the budget for 1990 in mid-November For this purpose, I propose that Messrs Loser (Head) and Kalter (both WHD) visit Mexico City for about ten days starting October 30

November 8, 1989

cc ADM
Mr Caiola
Mrs Braña

Mr Bielaski

As per our telephone conversation, the Mexico mission was delayed until November 9, 1989

M Caiola

Mission ID 90034200

Pgm No 412

1989 OCT 13 PM 3:03
OFFICE OF THE DEPUTY MANAGING DIRECTOR

1989

Office Memorandum

TO The Deputy Managing Director
(Cleared with Administration)

DATE November 8, 1989

FROM S T Beza

SUBJECT Mexico--Staff Visit

At the request of the authorities, a staff team will visit Mexico City tomorrow to examine the fiscal policy stance for next year ahead of the presentation to Congress of the budget for 1990 in mid-November For this purpose, I propose that Messrs Loser (Head) and Kalter (both WHD) visit Mexico City for about five days starting November 9

cc ADM
Mr Caiola
Mrs Braña

not sent

Office Memorandum

TO: The Deputy Managing Director
(Cleared with Administration)

DATE: October 12, 1989

FROM: S. T. Beza

SUBJECT: Mexico--Presentation of Financing Package

As I noted to you yesterday, Mr. Gurría informed me that the German banks have requested that the Fund and Bank participate in the presentation of the financing package to the community of banks in Frankfurt on October 20 (see attached communication). The tentative plan is that I will represent the Fund at that presentation and I would travel on the evening of October 18.

Attachment

cc: ADM
Mr. Caiola
Mrs. Braña

Mission ID: 90034100

Pgm No: 413

1989 OCT 13 PM 3:02
OFFICE OF THE
DEPUTY MANAGING DIRECTOR

RECEIVED
OCT 13 1989
DY. DIR. ADM.

FACSIMILE MESSAGE

Mexico

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CLEARY, GOTTLIEB, STEEN & HAMILTON
One State Street Plaza, New York, New York 10004 (212) 344-0600
Telecopy number: (212) 269-4978 (Gps I, II & III)

Fax Number(s): 202-623-7499
Name: Mr Ted Besa
Company: International Monetary Fund
City: Washington, D.C.
State/Country:
Tel. No: 202-623-8631

From: Ana Demel
Date. October 12, 1989
No /Pgs. (incl. cover). 1
Our File Number. 24636-080

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(This space to be used for short or supplemental messages)

Dear Mr. Besa.

At Angel Gurria's request, I am pleased to inform you that Mexico's presentation of the 1989-92 Financing Package in Frankfurt, Germany will be held at 11:00 A.M. on Friday, October 20 at the Frankfurter Hof, AM Kaiserplatz. The presentation will last approximately two hours and will be followed by an informal luncheon.

With best regards,

Ana Demel

Ana Demel

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT
1989 OCT 12 PM 12 08

12 OCT 89 11:40

Mr. Bergo

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Office Memorandum

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INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.
1989 OCT -5 AM 8:29

To: The Managing Director
The Deputy Managing Director

October 4, 1989

From: Gerhard Laske

Subject: Financial Aspects of the Fund's Role <u>in Mexico's Debt Reduction Operation</u>

There are two functions of a financial nature that the Fund might be asked to undertake, as the Collateral Agent, in the debt reduction operation (DROP) for Mexico that was described in yesterday's memorandum of Mr. Liuksila. These are, first, that of a custodian for the securities issued to the name of the Fund to guarantee the capital value as well as part of the interest on bonds issued by Mexico in the context of the DROP and, second, that of an investment agent, buying and redeeming a variety of public and private debt instruments, including commercial paper, in the context of the interest guarantee mechanism.

We do not yet know precisely what kind of role for the Fund the Mexican authorities or the Advisory Bank Committee may have in mind, but we expect an understanding on the kind of request to be made by Mexico will be reached soon between the Mexican negotiators and the commercial banks involved. The first of the two functions mentioned above--that of a custodian for certain securities serving as collateral --would appear comparatively straightforward and could be accommodated by Treasurer's without giving rise to a need for significant additional resources. In contrast, the second one--that of an investment agent-- may raise some difficult issues of policy for at least some Executive Directors. (We understand from the Bank of Mexico that they would have no difficulties in handling these investments themselves but this may not be the procedure favored by the Bank Advisory Committee.)

First, the execution of investments presently foreseen would require the Fund to deal in private capital and money markets, an activity the Executive Board has not authorized for the Fund's own investments (of borrowed resources and for Administered Accounts). Directors--particularly those doubtful of the advisability of the Fund getting involved in escrow and other administered accounts--may have strong views about the Fund taking actions on behalf of debtor members that were thought inappropriate for the Fund's own accounts. Moreover, any dealing in private markets would be likely to heighten the pressure for a waiver of immunities.

Second, any extensive trading activities (for which the Fund presently is not adequately equipped) is likely to increase the cost of the Fund's role as collateral agent. A rough first estimate indicates a need for additional staff resources in Treasurer's of about one man-year for a purely custodial function; in contrast, engaging in trading activities would cause a more significant increase in cost as it would

require several additional man-years and additional EDP support. Though it is difficult to estimate these costs without all relevant information on trading and investments, for the Mexico operation alone these costs are projected to aggregate up to an annual expenditure of about US$1.0-1.5 million, which would translate into an increase for the rate of charge of one to two basis points. These estimates do assume, as indicated by counsel for Mexico, that the Fund would act only on instructions with a minimum of discretion involved. However, we would expect that Mexico (and other members that may request Fund assistance in DROPs) would not wish to push these costs upon members paying charges but would be willing to assume them. Nevertheless, these costs could become an issue in the discussions.

In the light of these considerations we would intend, if you agree, to inform counsel representing Mexico (and counsel representing the Bank Advisory Committee) in the ongoing discussions that limiting the Fund's role to that of a custodian would be likely to facilitate acceptance by the Executive Board of the Fund's involvement in the DROP.

For your approval, please

cc: Mr. Beza
Mr. Gianviti
Mr. H. Simpson

Office Memorandum

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TO: Mr. Beza DATE: October 4, 1989

FROM: Jacob A. Frenkel J.F

SUBJECT: Mexican Financing Package

The attached notes suggest that the rolling interest guarantees (holy rollers) might be an instrument we should stay away from if we can. The alternative suggested in the note to the DMD is not a real winner either but something along these lines is worth thinking about.

Attachment

cc: Mr. Goldstein
Mr. Loser

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.
1989 OCT -4 PM 12: 17

Office Memorandum

TO	The Deputy Managing Director	DATE	October 2, 1989
FROM	M P Dooley *MD*		
SUBJECT	<u>Interest Guarantees</u>		

The rolling interest guarantee utilized in the Mexican financing program has a serious shortcoming Such guarantees are valuable to the creditor only when the debtor fails to make a contractual interest payment It follows that the contractual interest rate must be high enough to make nonpayment probable Creating new instruments with high contractual interest rates may not be in the debtor's interest Moreover, since in the Mexican agreement interest earnings are returned to Mexico, the longer a creditor expects to wait for payment from the guarantee fund, the lower the guarantee's present value to the creditor

In contrast a cash buy-back or a zero coupon guarantee of a principal avoids this problem The value of a buy-back to the creditor is clear The value of a zero coupon collateral is slightly less clear, but in general the creditor could "strip" his rights to the zero and sell his rights for cash immediately Thus, the correspondence to the buy-back is very close

Could an interest guarantee have the same property? It seems straightforward from a technical point of view that it could, although the marketability of this synthetic bond is uncertain The technique would be to use the same terms as a conventional bond but to demand that additional "interest" be paid to a sinking fund in every year so that the value of such payments was equal to the face value of the bond at maturity These interest payments could be fully collateralized by a zero coupon bond of the same maturity and face value This contract would have no final payment, a feature typical of most mortgage loans in the United States

This would be a transparent way around our Board's guidelines for the use of set asides and additional Fund lending A proposal along these lines might also force the Board to revise the guidelines

cc Mr Frenkel
Mr Goldstein

Office Memorandum

TO Mr Frenkel DATE September 20 1989

FROM M P Dooley MD

SUBJECT Evaluation of the Mexican Financing Package

- Given the structure of the debt reduction instruments offered, the Mexican Government has done a very professional job in protecting its interests Our best guess is that contractual debt will be retired at an implicit price very near the secondary market price of 43 cents This implicit price is lower than our preliminary estimate (see attachment) because in the Mexican agreement, interest earnings on interest collateral is returned to the Mexican Government In order to place principal guarantees, interest guarantees and cash buy-backs on an equal footing, we had assumed that interest earned on collateral accounts remains in those accounts and is available to the creditor The fact that this assumption was likely to be incorrect was recognized in the preliminary evaluation done for the Board by the Western Hemisphere Department last month

It was clearly rational for the Mexican Government to demand that interest earned on interest collateral be returned to them given that the other terms of the exchange had been set However, this feature of the agreement has some additional implications that we may want to avoid in future negotiations

- This is probably a good time to recall that the general nature of the debt reduction instruments offered in the package was imposed on Mexico by creditor governments rather than by market forces Although Mexico has managed to minimize the potential economic costs that such instruments might have generated, it is important to take stock of the remaining difficulties in order to better assist other countries

- For various technical and political reasons, creditor governments have supported the inclusion of par and non-par bonds in the Mexican proposal The Research Department staff has argued and maintains the view, that such instruments are not superior to simple cash buy-backs in reducing the contractual value of debt In fact, the main lesson from the long and difficult negotiation between Mexico and its creditors is that the amount of debt that can be bought through collateralized exchange and buy-backs is roughly equivalent

- The supposed economic advantages of the instruments offered appear to have evaporated over time Unfortunately, some economic disadvantages have become more apparent Two disadvantages seem particularly important at this time First, the relative attractiveness of par and non-par bonds to creditors will change as market interest rates change A fall in market interest rates makes

the fixed interest par exchange bond more valuable as compared to the floating rate discount bond Moreover, the collateral guarantee of principal is more valuable to the creditor than an equally costly collateral guarantee of interest in the proposed package This is the case because the creditor will eventually receive the initial contribution plus capital gains on the zero coupon principal collateral In contrast, in the Mexican agreement interest earnings on interest collateral belongs to Mexico Thus, even if the creditor expects to receive the interest collateral in the future, its present value to the creditor is somewhat less than the debtor's initial contribution to the interest guarantee Since the fixed interest par bond has more value in the principal as compared to the discount bond, this will also tend to favor the par exchange bond If U S interest rates fall further in the coming months, there will be a strong incentive for the banks to take all their debt reduction option in the form of fixed interest rate, par exchanges The U S Treasury has claimed that this would cause considerable difficulties in dealing with the Congress

- A more important problem is that the interest guarantee for both the par and non-par bond is an inefficient use of Fund resources We would guess that $100 million placed in the interest collateral account would have a present value to creditors of only about $50 million It follows that Mexico can "buy" only $50 million in debt or debt-service reduction with this guarantee Since interest on the collateral account returns to Mexico, it might be argued that Mexico has gotten something for nothing But if Mexico also expects that payments from the collateral account with a present value of $50 billion will eventually be made, it follows that a fair deal would be for Mexico to get debt or debt-service reduction equivalent to a $50 million buy-back The "extra" $50 does not buy any debt reduction (after all the creditor does not expect to get the money) and does oblige Mexico to borrow--at first from the Fund but eventually from other sources--in order to invest in an escrow account It is unfortunate that a part of the limited official resources that we have won for the Mexican program has been tied up in an escrow account that will benefit no one for the next 30 years

- In summary, the Mexican Government has done very well within the framework imposed But the supposed benefits of the particular instruments employed have proven to be an illusion The costs, in contrast, while modest, are real It would seem wise, in the future, to consider alternative approaches One possibility would be for the debtor to specify the amount of debt or debt-service reduction it expects to receive in exchange for available resources The creditor banks could then decide in what form they would like to restructure debt or whether they would prefer a cash buy-back This would be a truly market-based approach

Office Memorandum

TO Mr Beza DATE July 27, 1989

FROM Jacob A Frenkel JF

SUBJECT <u>Evaluation of the Mexican Agreement</u>

As discussed, I attach a memorandum prepared by Mr Dooley containing a preliminary evaluation of the Mexican Agreement The bottom line is that the terms of the package are broadly consistent with market pricing

Attachment

cc Mr Loser

Remember in valuing the $7 billion put aside for interest and principal support, the creditor may expect to get some part of the present value of this $7 billion rather than the whole amount It seems very unlikely that the bank would expect to get <u>both</u> the full present value of the $7 billion and the $1 7 billion present value of the recapture clause Not to put too fine a point on it, we split the difference and say the package of enhancements and the recapture provision might have a present value of $8 billion With this in hand, the implicit market price at which the new Mexican risk is priced can be found The banks are asked to give up old debt with a market value of

$45 billion * P

where P is the market price

The banks in return receive either par or non-par bonds with a contractual value of 65 percent of the $45 billion they surrender Thus, any combination of a 35 percent discount of face value (at LIBOR + 13/16) or no discount with 6¼ interest will yield a new contractual value of $29 25 billion The banks, therefore, receive

$29 25 P + $8 0 billion

The implicit market price of Mexican risk is about $0 50 which compares closely with the current market price of $0 45

cc Mr Goldstein

Office Memorandum

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.

1989 OCT -4 PM 2: 19

Mr. Beza
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Mexico

TO: The Managing Director
The Deputy Managing Director

DATE: October 3, 1989

FROM: Aarno Liuksila

SUBJECT: Mexico: Role of the Fund as Collateral Agent for 1989-92 Financing Package

This afternoon Mr. David Sabel of Cleary, Gottlieb, Steen & Hamilton (212-344-0600), counsel for Mexico, telephoned me in reference to the matter discussed in my earlier memorandum to you on the subject indicated above. He informed me that together with Mr. Walker (also counsel for Mexico) he had raised the possibility of the Fund serving as Collateral Agent under the 1989-92 Financing Package, with Shearman & Sterling, counsel for the Advisory Committee for Mexico.

The preliminary response of lawyers from Shearman & Sterling was that the creditor banks could go along with the appointment by Mexico of the Fund to serve as Collateral Agent, but only provided that the position of the creditor banks was not thereby compromised. In other words, they should be substantially in the same position vis-a-vis the Fund as they were vis-a-vis Morgan Guaranty performing this function under the 1988 Collateral Pledge Agreement with Mexico. He said that they would expect the Fund to assume liability for a breach of the usual standard of care, i.e., liability for willful misconduct and gross negligence. To my question whether a waiver by the Fund of its immunity from judicial process would constitute a sine qua non for the consent by the Advisory Committee (which Mr. Sabel believed had been consulted on this matter) Mr. Sabel replied that in their view as counsel for Mexico it would be unlikely that the creditor banks would consent to the appointment of the Fund as Collateral Agent unless the Fund waived its immunity at least vis-a-vis the fiscal agent for breach of the standard of care; effectively, the Fund would be liable if it did not perform the "agreed written obligations" that it would have to undertake. When specifically pressed on the point he did not preclude the possibility that the Advisory Committee might be satisfied with some kind of substitute legal technique under which the Fund would not be exposed to domestic laws and jurisdictions.

I said that I had reported to management on our earlier discussions and that no decisions had been taken by management pending a careful consideration of all relevant issues. He said that they will telephone me later this week or early next week. In light of the discussions that have taken place between the two law firms on this matter, we would expect to hear imminently from Shearman & Sterling and would be prepared to answer their questions about the legal position of the Fund.

cc: Mr. Beza
Mr. Whittome
Mr. Wittich/Mr. Laske/Mr. Gupta
Mr. Gianviti
Mr. H. Simpson

Office Memorandum

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.

1989 OCT -4 PM 2:36

Mr. Beza — STB CL JB IO F

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CONFIDENTIAL

TO: The Managing Director
The Deputy Managing Director

DATE: October 2, 1989

FROM: Aarno Liuksila

SUBJECT: Mexico: Role of the Fund as Collateral Agent for 1989-92 Financing Package

Following the presentation of Mexico's 1989-92 Financing Package at the IDB on September 26, 1989, and at the request of Mr. Walker who is Mexico's counsel, I saw Mr. José Angel Gurria, Undersecretary of International Financial Affairs, Secretaría de Hacienda y Crédito Público, who explained to me that the Mexican Government, as a member of the Fund, would be grateful if the Fund would agree to hold the collateral funds that enhance Mexico's 1989-92 Financing Package. He felt that, in addition to the useful financial services the Fund would provide, such "implicit endorsement by the Fund of the Financing Package" would be valuable in helping to convince the commercial banking community to accept Mexico's proposals. Subsequently, later on the same day and on September 27, 1989, Mrs. Ordoobadi (LEG) and I met with Messrs. Enrique Vilatela and José Juan de Olloqui, Director General for External Credit, and Advisor to the Undersecretary, respectively, of Mexico's Finance Ministry, and with Messrs. Mark Walker and David Sabel and Ms. Ana Demel of Cleary, Gottlieb, Steen & Hamilton, Mexico's legal counsel. At the second meeting, which was not attended by Mr. Walker, we were joined by Messrs. Wittich and Gupta of the Treasurer's Department. The purpose of the meetings was to discuss the possibility of the Fund acting as Collateral Agent for Mexico's 1989-92 Financing Package.

As a result of these meetings, it was agreed that Mr. Walker would get in touch with Shearman & Sterling, counsel for the creditor banks, to explore the appointment of, and the attribution of functions between, the fiscal and collateral agents under the Financing Package. Mr. Walker will get in touch with us early this week to report whether the banks would be willing to accept as a collateral agent an institution other than another domestic commercial bank. A full report, together with detailed recommendations on these issues, will follow if the creditor banks respond favorably to Mexico's suggestion that the Fund act as collateral agent.

1. Functions of Collateral Agent

As Collateral Agent, the Fund would be asked to perform three functions relating to the management of the collateral which will be used to secure payment of the principal amount and specified interest payments falling due under the discount and par bonds issued by Mexico pursuant to the above-mentioned Financing Package. The first function of the Fund as Collateral Agent would be to hold the collateral in the name of the Fund as Collateral Agent for Mexico. Second, the Fund would be asked to hold the proceeds of certain collateral pursuant to instructions received from

Mexico or the commercial bank that will be appointed as Fiscal Agent for the Financing Package Third, the Fund would be required, upon the occurrence of certain events, to distribute the proceeds of the collateral to Mexico or to the Fiscal Agent (or to the Paying Agent), as the case may be, in accordance with the instructions of the Fiscal Agent

In performing these functions, it was emphasized that the Fund would not be called on to exercise discretion Rather, the Fund would act on the basis of written instructions which would be delivered to the Fund in each case in a prescribed form of notice

2 Collateral for Principal

In order to secure payment in full of the principal amount of the discount and par bonds, Mexico will purchase zero-coupon debt instruments in up to ten currencies, including U S Treasury obligations or other comparable collateral If the Fund were to serve as Collateral Agent, Mexico would transfer such obligations to the Fund's accounts at the Fund's depositories At the Federal Reserve Bank of New York, the collateral would be held by the Fund in a segregated book-entry Treasury securities account until the maturity of the underlying obligations The account at the Federal Reserve could be denominated either in the name of the Fund as "depository", or in the name of the Fund "as Collateral Agent for Mexico" or as "Collateral Agent for the Bondholders " 1/ The issue of the title of the account has not yet been decided As this will make a legal difference with respect to the privileges and immunities which could be enjoyed by collateral held by the Fund as Collateral Agent, and with respect to the bondholders' ability to perfect a secured interest in the collateral, it is expected that the issue will be carefully negotiated by the creditor banks

It is contemplated that the principal collateral would not be available to bondholders until maturity, even in the event of an intervening default by Mexico In consequence, the Fund would have no duty with respect to such collateral other than custodianship

At maturity, the Fund as Collateral Agent would be notified by the Fiscal Agent by means of a prescribed form of notice how to distribute the collateral Such distribution would consist of the Fund transferring the proceeds of the collateral account to the Fiscal Agent (or the Paying Agent), or simply returning the collateral to Mexico

Notwithstanding the foregoing, it is possible that the Fund might be called upon to release the collateral prior to the maturity of the underlying obligations in the event that all or some of the discount or par bonds are redeemed by Mexico prior to the bonds' maturity date In

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1/ This latter formulation was used in the case of the Collateral Pledge Agreement entered into by Mexico in 1988

such event, the Fiscal Agent would notify the Fund by means of a prescribed form of notice that the Fund should transfer the same amount of collateral to the account maintained by Mexico at the appropriate depository

3 Collateral for Interest

In order to secure payment of interest on the discount and par bonds, Mexico will pledge cash or short-term investments in an amount equal to up to 24 months, but in no event less than 18 months, of the interest payments that will fall due under the bonds It is contemplated that Mexico will retain the right to direct the investment of such collateral as long as its investment decisions comply with the agreed set of permitted investments formulated by Mexico and the creditor banks Mexico would also be required to respect certain agreed limitations concerning the duration of each particular investment to allow for sufficient liquidity to meet interest payments under the bonds

As Collateral Agent, the Fund's role could range from custodianship of the collateral to implementing Mexico's investment decisions If investments were to be implemented by the Fund, it would be on the basis of investment instructions received in a prescribed form from either Mexico or the Fiscal Agent If received from the Fiscal Agent, it is contemplated that the instructions would be accompanied by a certificate by the Fiscal Agent to the effect that the investment is a permitted investment Involvement of the Fund only as a custodian would obviate the need for discretionary investment decisions on the part of the Fund

In the event of a default by Mexico in interest payments, the creditor banks have agreed that there will be no immediate distribution of the interest collateral Rather, a specified percentage of bondholders will have to agree to draw on the interest collateral before it may be paid out 1/

If the Fiscal Agent notifies the Fund that Mexico has defaulted on its interest payments, the Fund as Collateral Agent would be notified by the Fiscal Agent of the default and given specific instructions how to invest the interest collateral in light of Mexico's default Such instructions, for example, might restrict investments thereafter to short-term maturities so the Fund would be able to distribute proceeds of the collateral to the bondholders if the requisite percentage of bondholders agree to draw on the interest collateral

If the bondholders determine that they want access to the collateral, then the Fiscal Agent would so notify the Fund and instruct the Fund by means of a prescribed form of notice to transfer a specified

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1/ Under the terms of the Financing Package, all reinvestment income will be paid to Mexico Mexico has no replenishment obligation with regard to the collateral account

amount of collateral to the account of the Fiscal or Paying Agent The Fiscal Agent (or Paying Agent) would, in turn, make payments to the bondholders If the bondholders do not elect to draw on the interest collateral, the Fiscal Agent would notify the Fund, as Collateral Agent, to terminate the interim investment procedures and resume acting on the basis of normal investment instructions

With regard to the nature of the interest collateral described above, it should be noted that there is, at present, a shortfall of about US$1 2 billion of the amount needed to secure interest payments under the terms of the Financing Package It is anticipated that Mexico, pending disbursements by the Fund, the World Bank, and Japan, will cover this shortfall by a letter of credit to be issued by a group of commercial banks

Thus, in addition to the cash and short-term investments described above, it is expected that the interest collateral will include a letter of credit representing a bridge loan in the approximate amount of US$1 2 billion The letter of credit would be held by the Fund, as Collateral Agent, together with the other forms of interest collateral Under the contemplated arrangements concerning an event of default by Mexico of its interest payments, the Fiscal Agent might instruct the Fund to draw on the letter of credit, or the Fiscal Agent might call on the letter of credit itself and deposit the same in the collateral account In either event, the Fund would have new cash in the collateral account to be invested in the manner described above In no event would the Fund have any liability for the collection of the amounts due under the letter of credit With regard to the letter of credit arrangements, we expressed a preference that the Fund not be asked to call on the letter of credit

In the event that Mexico is able to substitute cash for the letter of credit, the Fund as Collateral Agent would be instructed by the Fiscal Agent to release the letter of credit The cash would then be invested in the manner described above

It should be noted that there would be no pooling or sharing of collateral between the principal and interest collateral accounts, or as between categories of creditors

4 Legal Considerations

It was explained that the reason Mexico would like the Fund to act as Collateral Agent is so that the collateral would be held in such a way that it would be protected from seizure or attachment by creditors of Mexico and, in the view of the counsel for Mexico, so that the collateral would not be held in a way that would give rise to unanticipated tax liability More specifically, it was stated that Mexico would like the Fund to act as Collateral Agent so that the reinvestment income earned by Mexico would be protected by the Fund's immunities and would not, therefore, be subject to attachment by commercial or private creditors

Mexico believes that the arrangement should be satisfactory to the Fund because it entails virtually no exercise of discretion by the Fund Rather, as stated, the Fund's management of the collateral would be carried out pursuant to instructions received from the Fiscal Agent in a prescribed form Moreover, the Fund would be exculpated in the operative legal documentation from all but intentional misconduct or gross negligence

With regard to the Fund's potential liability, it might also be noted that under well-developed domestic legal systems, including, notably, the 1939 U S Trust Indenture Act, the Fund as Collateral Agent would be considered an agent and not a trustee and, therefore, would not be held to the higher fiduciary standard of care that arises in the context of trustee relationships Indeed, as described by counsel for Mexico, the Fund as Collateral Agent would be acting as an agent for Mexico or the Fiscal Agent, and not as a trustee for bondholders

The legal documentation used to establish the Fund as Collateral Agent would consist of a Collateral Pledge Agreement In practice, such agreements have usually been tripartite For example, when Mexico issued collateralized Floating Rate Bonds in 1988, the Collateral Pledge Agreement was entered into among Mexico, the Collateral Agent and the Fiscal Agent In the present case, it was suggested that the Fund might prefer to enter into a bilateral agreement with Mexico This would emphasize that the genesis of the Fund's role as Collateral Agent is the provision of services to a member pursuant to Article V, Section 2(b) of the Articles of Agreement In any event, it was made clear that the Fund would have to receive a formal request from Mexico pursuant to Article V, Section 2(b) before it could agree to provide services as Collateral Agent

The issue of governing law and the Fund's immunity from judicial process and from government action was the most troublesome discussed at the meetings Counsel for Mexico indicated that it was doubtful that the creditor banks would agree to the designation of general principles of international law as the governing law of the Collateral Pledge Agreement One of the principal reasons cited why international law would be unacceptable was the need for the bondholders to have a perfected security interest in the collateral and the absence of any developed international law in this area For this reason, counsel for Mexico indicated that the creditor banks' preference in all likelihood would be for New York law to govern the the pledge of the U S dollar assets under the Collateral Pledge Agreement The issue of governing law, which could potentially involve some ten (10) legal systems, would undoubtedly require careful negotiation among lawyers for Mexico, the Fund, and the creditor banks

Mexico's counsel also advised us that it was unlikely that the creditor banks would be willing for the Fund to serve as Collateral Agent unless the Fund agreed to at least a limited waiver of its immunities Specifically, it was suggested that the Fund would be required to waive its immunity from judicial process with respect to actions brought by the

Fiscal Agent under the Collateral Pledge Agreement concerning the collateral managed by the Fund thereunder. We discussed the possibility of a limited waiver, but indicated that the question of waiver was subject to the decision of the Fund's Executive Board and that there would be great reluctance by the Board to grant any waiver.

When discussing the Fund's immunities, the issue was also raised whether the Fund's own assets could be reached in the event a judgment were rendered against the Fund. In this connection, it was noted that the Fund's own resources are not available to meet obligations or liabilities incurred in the course of the administration of resources contributed to the Fund by the Fund's members or by others under Article V, Section 2(b). We concluded by mentioning that under a limited waiver such as discussed the Fund's gold, SDR, and currency holdings in the General and SDR Departments and other administered accounts would not be exposed to risk. Thus, if the language of the limited waiver is carefully formulated, the Fund's liability would always be limited to what could be satisfied by the assets held in the collateral accounts.

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As a result of these preliminary discussions, it would appear that two types of issues will require careful consideration: (a) financial issues, i.e., the cost to the Fund of managing the Account for Mexico, with possible reimbursement of expenses and payment of management fees by Mexico; (b) legal issues, which would be entirely different if the Fund were to follow its usual approach to the establishment of administered accounts (e.g., ESAF Trust, Bolivia etc.), or, alternatively, followed the commercial banks' practice of subjecting the collateral arrangements to different domestic laws and courts depending on the currency involved; the latter approach would require considerable legal work to structure the operation, and the staff would have to examine the consequences of subjecting the Fund to up to ten different domestic legal systems, that is, to the application of different domestic laws with the involvement of different national courts, assuming that the creditors (contrary to our position) insist on a waiver of the Fund's immunities.

Moreover, it should be noted that this case would constitute a precedent for similar accounts in the future. Therefore, any deficit incurred by the Fund in the management of an account for Mexico would be compounded by the establishment of other similar accounts. Similarly, any waiver of the Fund's immunities, with the possibility of costly ensuing litigation against the Fund, would also have to be contemplated in other cases.

cc: Mr. Beza
Mr. Whittome
Mr. Laske/Mr. Wittich/Mr. Gupta
Mr. H. Simpson

Office Memorandum

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.
1989 OCT -3 AM 10: 52
1989 OCT -2 PM 5: 01
OFFICE OF
THE MANAGING DIRECTOR

TO: The Managing Director

DATE: October 2, 1989

FROM: S. T. Beza

SUBJECT: Mexico: Dinner with President Salinas

The following are points that you might find useful for your dinner with President Salinas:

- Mexico's economic performance under the program supported by the extended arrangement has been highly satisfactory. Inflation has been reduced sharply, and economic activity is rising, based on private investment, after several years of stagnation.

- Major advances have been made in the fiscal area, with a sharp increase in the primary surplus (3 percentage points of GDP higher in 1989 than in 1988 and 1.8 points higher than the 1989 original program).

- Structural adjustments measures continue to be implemented vigorously, particularly in the areas of external trade, public sector divestiture, financial markets and foreign direct investment.

- The external current account deficit has widened, but so far has been financed by increases in private capital flows. However, authorities have to be alert to the possible weakening of the balance of payments (Cordoba point at breakfast).

- Completion of the term sheet for Mexico's package is a major advance in securing foreign financing. This has helped strengthen private sector confidence, with positive effects on capital inflows.

- However, financing available under the package has reduced margins from those of the original program. This makes economic performance dependent on favorable developments in oil prices and interest rates, and does not allow room for slippages in policy. Also, this makes the opening of economy to capital from abroad all the more important.

- Continued strong policy implementation is needed, particularly in the fiscal area. To secure gains obtained to date, efforts to reduce PSBR and operational deficit have to continue.

- Prices in the public sector have to be realistic and exchange rate has to be kept under review (part of Cordoba problem may be competitiveness lost in 1988).

cc: The Deputy Managing Director
Mr. H. Simpson