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Mr. Duran Downs

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THE BANKING ADVISORY GROUP FOR MEXICO

AND THE INTERNATIONAL BANKING COMMUNITY

Mr. Gunter
We need to look at this again.
DJB

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cc: MD
DMD
Mr. PEREZ/
MR. ORTIZ
ETR
LEG
WHD
MR. BROWN

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I WOULD LIKE TO INFORM YOU ABOUT THE ECONOMIC PROGRAM ADOPTED BY MEXICO AND ABOUT THE DECISION TAKEN BY THE EXECUTIVE BOARD OF THE INTERNATIONAL MONETARY FUND IN RESPECT OF MEXICO'S REQUEST FOR FINANCIAL SUPPORT. THE WORLD BANK HAS REVIEWED THE STRUCTURAL REFORMS TO BE CARRIED OUT BY MEXICO UNDER THIS PROGRAM AND I UNDERSTAND THAT THE PRESIDENT OF THE BANK WILL INFORM YOU DIRECTLY ABOUT THE BANK'S ASSESSMENT OF THESE REFORMS.

IN LATE 1982 MEXICO EMBARKED ON A THREE-YEAR ADJUSTMENT PROGRAM THAT WAS SUPPORTED BY AN EXTENDED ARRANGEMENT FROM THE FUND. THE IMPLEMENTATION OF THAT PROGRAM BROUGHT ABOUT A MARKED TURNAROUND IN ECONOMIC CONDITIONS IN 1983 AND 1984; THE OVERALL PUBLIC SECTOR DEFICIT WAS REDUCED BY MORE THAN 10 PERCENTAGE POINTS OF GDP FROM 1982 TO 1984, INFLATIONARY PRESSURES ABATED, AND THE BALANCE OF PAYMENTS IMPROVED MARKEDLY. MOREOVER, PROSPECTS FOR SUSTAINED ECONOMIC GROWTH WERE ENHANCED BY THE IMPROVEMENT IN MEXICO'S COMPETITIVENESS STEMMING FROM

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THE ADJUSTMENT OF THE EXCHANGE RATE AND THE PURSUIT OF A PRUDENT WAGE POLICY. ECONOMIC PERFORMANCE BEGAN TO FALTER IN LATE 1984 AND WORSENED IN 1985, HOWEVER, PARTLY REFLECTING SLIPPAGES IN DOMESTIC POLICY IMPLEMENTATION, BUT ALSO AS A RESULT OF THE WEAKENING OF THE INTERNATIONAL PETROLEUM MARKET AND THE EFFECTS OF THE EARTHQUAKES THAT STRUCK MEXICO CITY IN SEPTEMBER 1985.

THE SHARP AND RAPID DECLINE IN OIL PRICES THAT HAS OCCURRED SINCE THE BEGINNING OF 1986 HAS EXACERBATED MEXICO'S DIFFICULTIES. WHILE THE MEXICAN AUTHORITIES HAD INITIALLY FRAMED A BUDGET FOR THIS YEAR THAT SOUGHT TO CORRECT THE FISCAL IMBALANCE, THE MORE THAN 50 PERCENT DROP OF OIL PRICES DURING THE FIRST HALF OF 1986 WORSENED THE PUBLIC SECTOR FINANCIAL POSITION AND THE BALANCE OF PAYMENTS SHARPLY, AND THUS DEALT A SEVERE BLOW TO AN ALREADY WEAKENED ECONOMY. THE AUTHORITIES HAVE TRIED TO LIMIT THE PRESSURE ON DOMESTIC PRICES AND ON THE BALANCE OF PAYMENTS BY TIGHTENING CREDIT TO THE PRIVATE SECTOR AND

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BY DEPRECIATING THE CURRENCY IN REAL TERMS. IN THE PROCESS, HOWEVER, INTEREST RATES HAVE MOVED UP SHARPLY, AND INTEREST PAYMENTS ON THE PUBLIC DEBT ARE ESTIMATED TO EXCEED 18 PERCENT OF GDP IN 1986, UP FROM SOME 12 PERCENT OF GDP IN 1985.

THE GOVERNMENT OF MEXICO HAS NOW EMBARKED ON AN ECONOMIC AND FINANCIAL PROGRAM DESIGNED TO ADDRESS THE COUNTRY'S EXTERNAL AND INTERNAL IMBALANCES AND PUT THE ECONOMY BACK ON A PATH OF SUSTAINED GROWTH. ON SEPTEMBER 8, 1986 THE EXECUTIVE BOARD OF THE FUND CONSIDERED MEXICO'S REQUEST FOR AN 18-MONTH STAND-BY ARRANGEMENT AMOUNTING TO SDR 1.4 BILLION IN SUPPORT OF THIS PROGRAM; AS EXPLAINED BELOW, THE AMOUNT OF FINANCIAL SUPPORT UNDER THIS ARRANGEMENT CAN BE AUGMENTED BY UP TO SDR 800 MILLION IN THE CONTEXT OF A SPECIAL MECHANISM SET UP TO PROTECT THE LEVEL OF DOMESTIC INVESTMENT EXPENDITURES BY PROVIDING TEMPORARY FINANCING TO MEXICO IN CASE THAT THERE IS A REVENUE SHORTFALL BROUGHT ABOUT BY EXOGENOUS FACTORS.

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THIS MECHANISM WOULD BE ACTIVATED IF OIL PRICES SHOULD DROP BELOW A SPECIFIED LEVEL. THE EXECUTIVE BOARD DECIDED TO APPROVE THE ARRANGEMENT IN PRINCIPLE, PENDING COMPLETION OF THE PACKAGE TO FINANCE THE PROGRAM.

THE MEXICAN PROGRAM COMBINES FINANCIAL AND STRUCTURAL POLICIES WHICH, BY STRENGTHENING THE SAVINGS PERFORMANCE OF THE ECONOMY AND IMPROVING ECONOMIC EFFICIENCY, ARE EXPECTED TO RESTORE BALANCE OF PAYMENTS VIABILITY AND BREAK THE INFLATIONARY TREND. A CENTRAL COMPONENT OF THE PROGRAM IS THE STRENGTHENING OF THE PUBLIC SECTOR FINANCES. FISCAL MEASURES CALCULATED TO YIELD THE EQUIVALENT OF 3 PERCENTAGE POINTS OF GDP ARE TO BE IMPLEMENTED OVER THE PERIOD OF THE PROGRAM. THESE ACTIONS--WHICH INCLUDE TAX INCREASES, PRICE AND TARIFF ADJUSTMENT, AND SPENDING CURBS--ARE IN ADDITION TO THE ADJUSTMENT ALREADY BEGUN UNDER THE 1986 BUDGET. THE FISCAL EFFORT IS TO BE ACCOMPANIED BY MONETARY AND CREDIT

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POLICIES GEARED TO REDUCING INFLATION AND ATTAINING THE BALANCE OF PAYMENTS TARGET, WHILE MAKING PROVISION FOR A VOLUME OF CREDIT TO THE PRIVATE SECTOR CONSISTENT WITH THE GROWTH OBJECTIVE OF THE PROGRAM. IN ADDITION TO THE CONTINUED PURSUIT OF A FLEXIBLE EXCHANGE RATE POLICY, THE AUTHORITIES HAVE ASSIGNED AN IMPORTANT ROLE TO IMPROVING RESOURCE ALLOCATION. STEPS ARE BEING TAKEN TO INCREASE THE SCOPE OF MARKET FORCES IN INTEREST RATE DETERMINATION, TO REALIGN PRICES AND TARIFFS AND RAISE EFFICIENCY IN THE OPERATIONS OF PUBLIC ENTERPRISES, TO LIBERALIZE THE TRADE SYSTEM, AND TO PROMOTE FOREIGN DIRECT INVESTMENT. AS ALREADY NOTED, THE WORLD BANK IS TO PLAY A CENTRAL ROLE IN ASSISTING THE MEXICAN AUTHORITIES IN THEIR EFFORTS TO IMPLEMENT THE STRUCTURAL REFORMS.

THE PROGRAM SEEKS TO STRIKE A REASONABLE BALANCE BETWEEN FINANCING AND ADJUSTMENT. THE CURRENT ACCOUNT OF MEXICO'S BALANCE OF PAYMENTS IS EXPECTED TO SHIFT FROM A SURPLUS OF U.S. DOLLARS 0.5 BILLION IN 1985 TO DEFICITS OF

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U.S. DOLLARS 3.5 BILLION IN 1986 AND OF U.S. DOLLAR 2.9 BILLION IN 1987; THUS, THE DETERIORATION IN THE CURRENT ACCOUNT IS PROJECTED AT ABOUT ONE HALF OF THE LOSS IN EXPORTS RESULTING FROM THE DROP IN OIL EXPORT EARNINGS. IN ORDER TO FINANCE THE CURRENT ACCOUNT DEFICITS IN 1986-87, PERMIT A NEEDED REPLENISHMENT OF INTERNATIONAL RESERVES, AND ALLOW FOR SOME NET PAYMENT OF PUBLIC AND PRIVATE DEBT, THE PROGRAM CALLS FOR NET CAPITAL INFLOWS OF U.S. DOLLAR 12.5 BILLION OVER THE SAME TWO-YEAR PERIOD. OF THIS AMOUNT, OFFICIAL SOURCES (INCLUDING THE FUND) ARE TO PROVIDE U.S. DOLLAR 6.5 BILLION. BESIDES DRAWINGS FROM THE FUND, NET DISBURSEMENTS OF U.S. DOLLAR 2.7 BILLION ARE ENVISAGED FROM THE WORLD BANK AND THE IDB FOR PROJECTS ALREADY UNDERWAY AND NEW ONES STILL TO BE APPROVED, AND NET DISBURSEMENTS OF U.S. DOLLAR 2.5 BILLION ARE PROJECTED FROM OFFICIAL BILATERAL SOURCES; THIS REPRESENTS AN INCREASE IN THE EXPOSURE TO MEXICO BY OFFICIAL CREDITORS DURING 1986-87 OF SOME 45 PERCENT OVER THE STOCK

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OUTSTANDING AT THE END OF 1985. THE REMAINING U.S. DOLLAR 6 BILLION REQUIRED TO FINANCE THIS PROGRAM FOR THE PERIOD 1986-87 WOULD HAVE TO BE COVERED BY COMMERCIAL BANKS.

THE PROGRAM CONTAINS TWO SPECIAL MECHANISMS THAT ARE AIMED AT INSULATING THE IMPLEMENTATION OF THE PROGRAM FROM FURTHER EXTERNAL SHOCKS AND UNCERTAINTIES. IN VIEW OF THE UNSETTLED CONDITIONS IN THE INTERNATIONAL PETROLEUM MARKET AND OF THE VULNERABILITY OF MEXICO'S ECONOMY AND ITS INVESTMENT PROGRAM TO CHANGES IN PETROLEUM EXPORT RECEIPTS, SOME OF THE TARGETS OF THE PROGRAM AND THE STRUCTURE AND SIZE OF THE FINANCING PACKAGE ARE RELATED TO THE EVOLUTION OF OIL PRICES. A COMBINATION OF ADDITIONAL FOREIGN FINANCING AND ADJUSTMENT IS CALLED FOR IF THE PRICE OF OIL SHOULD FALL BELOW U.S. DOLLAR 9 A BARREL, AND A REDUCTION OF FINANCING IS ENVISAGED IF THE OIL PRICE SHOULD RISE ABOVE U.S. DOLLAR 14 A BARREL. THE STAND-BY ARRANGEMENT APPROVED IN PRINCIPLE CONTAINS A COMMITMENT BY THE FUND OF UP TO SDR 800 MILLION TOWARD THE FUNDING OF

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THIS CONTINGENCY MECHANISM; COMMERCIAL BANKS ARE EXPECTED TO CONTRIBUTE TO THIS MECHANISM AN AMOUNT CONSISTENT WITH MAINTAINING THE CONTRIBUTIONS OF THE FUND TO THE FINANCING OF THE MECHANISM WITHIN ONE THIRD OF THE TOTAL. A SECOND MECHANISM PROVIDES FOR ADDITIONAL FOREIGN FINANCING FOR INVESTMENT PROJECTS SCREENED AND REVIEWED BY THE WORLD BANK IF THE ECONOMIC RECOVERY FAILS TO MATERIALIZE DESPITE THE EFFECTIVE IMPLEMENTATION OF POLICIES UNDER THE PROGRAM.

AS I HAVE NOTED, THE EXECUTIVE BOARD OF THE INTERNATIONAL MONETARY FUND HAS CONSIDERED MEXICO'S REQUEST FOR A STAND-BY ARRANGEMENT IN SUPPORT OF THIS PROGRAM. HOWEVER, SINCE NEGOTIATIONS ON THE EXTERNAL FINANCING PACKAGE REQUIRED TO SUPPORT THE PROGRAM HAVE NOT YET BEEN COMPLETED, THE ARRANGEMENT COULD NOT GO INTO EFFECT IMMEDIATELY AND THE EXECUTIVE BOARD THEREFORE DECIDED TO APPROVE IT IN PRINCIPLE. WITHIN THE PERIOD UNTIL SEPTEMBER 29, 1986, THE ARRANGEMENT WILL BECOME

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EFFECTIVE WHEN THE FUND FINDS THAT THE FINANCING OF THE PROGRAM HAS BEEN ASSURED. THE EXECUTIVE BOARD OF THE WORLD BANK HAS RECENTLY APPROVED A MAJOR LOAN PACKAGE FOR MEXICO AND CREDITOR GOVERNMENTS HAVE JUST AGREED TO A RESCHEDULING OF DEBT SERVICE PAYMENTS FALLING DUE OVER THE PERIOD SEPTEMBER 22, 1986-MARCH 31, 1988, FOR DEBT CONTRACTED THROUGH DECEMBER 31, 1985; BOTH OF THESE ARRANGEMENTS FOR ASSISTANCE DEPEND UPON THE FULL COOPERATION OF MEXICO'S COMMERCIAL BANK CREDITORS. HENCE, TO ENSURE THE EARLY AVAILABILITY OF FINANCIAL SUPPORT FROM THE FUND AND OTHER OFFICIAL SOURCES, I WOULD LIKE TO REQUEST WRITTEN ASSURANCES FROM THE INTERNATIONAL BANKING COMMUNITY BY SEPTEMBER 28, 1986 AT THE LATEST, TO CONFIRM ITS PARTICIPATION IN MEETING MEXICO'S FINANCING REQUIREMENTS FOR 1986 AND 1987 AS INDICATED ABOVE.

J. DE LAROSIERE
MANAGING DIRECTOR
INTERFUND

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INTERNATIONAL MONETARY FUND

September 26, 1986

Duncan:

The attached memorandum may be of interest to you.

Attachment

Russell

G. Russell Kincaid

Office Memorandum

To : Mr. Duran-Downing July 14, 1986

From : R. Kronenberg RK

Subject: Mexico: IBRD Trade Policy Loan

The TPL negotiations were obviously protracted and difficult; the Bank staff agreed to certain concessions with great reluctance, taking into account Mexico's parallel negotiations for accession to the GATT. Nevertheless, the final package is disappointing, particularly in view of the Bank staff's contention that many of Mexico's present difficulties were caused by inadequate trade liberalization earlier in the decade.

1. A primary objective of the program is to increase Mexico's exposure to external competition by replacing quantitative restrictions with an appropriate tariff structure. The Government's refusal to establish QR targets pending the outcome of the GATT negotiations provides little assurance that adequate progress will be achieved toward this end. Arguments for excluding agriculture (very broadly defined) because it "could be the subject" of a separate sector loan are unconvincing.

2. The program's present formulation does not present a convincing case for gradualism of the degree proposed. The authorities contend that gradualism is necessary "to reduce the uncertainty caused by sudden changes and to grant industry enough time to make the adjustments needed to adapt to the new condition of openness to international competition" (Annex IV, p.7). Absent a preannounced, product-specific liberalization schedule, it is difficult to see how the gradual approach will achieve the desired results. The authorities' concern that a sudden opening to foreign competition will discourage investment also seems misplaced; if anything, their fear should be that gradualism, without an announced, product-specific liberalization schedule, will result in further wasteful investment, perpetuating political pressures against future liberalization.

3. Given that the thrust of the program has shifted to the tariff side, the progress planned in this area seems unduly slow. The ability to offset tariff reductions with tariff surcharges is worrisome, despite their "temporary" nature. Does the Bank have a clear idea of how extensively these surcharges will be used, and for how long? Why should two and a half years be required to reduce the number of tariff rates by three?

4. In 1985, export controls applied to 44 percent of non-oil exports. The program's failure to address this issue seems inconsistent with its goal of reducing the bias against exports.

5. While one of the loan's stated objectives is to reduce dependence on subsidies (paragraph 92), little is said about export subsidies and their adverse effects on production efficiency.

6. Table VIII.8 indicates that, between July and December 1985, the sectoral dispersion of effective rates of protection increased sharply. What factors were responsible for this development?

7. The project description indicates that the loan would finance part of the additional imports from the removal of NTBs. Since less progress is being achieved in this area than originally intended, is the full amount of the loan still justified?

cc: Mr. Anjaria (o/r)

File Mexico

Office Memorandum

To: The Managing Director
The Deputy Managing Director

September 23, 1986

From: C. David Finch and Francois Gianviti

Subject: Mexico--Linkage of Commercial Bank Disbursements to Official Involvement

The draft financing principles recently proposed by commercial banks for Mexico incorporated provisions for very tight and comprehensive linkage of the banks' disbursements to Fund and Bank actions and to contributions of export credit agencies and the Paris Club. These proposals represent an extreme example of the recent tendency for commercial banks to make new money disbursements so conditional on the performance of other parties in the debt strategy that the timing and extent of their own participation can no longer be securely counted upon. Under these circumstances, the assurance provided by the "critical mass" of bank commitments is seriously weakened, raising questions as to the viability of the members' balance of payments and hence the adequacy of safeguards for the use of the Fund's resources. It is notable that the network of links embodied in the proposed bank financing principles for Mexico would in effect arrogate to commercial banks the role of financial monitoring and coordination of financing flows that customarily has devolved on the Fund as organizer of the financing package.

The types of linkage adopted in recent bank financing agreements have varied widely. In several instances, they have posed risks of serious delays in the disbursement of bank finance through linkage to different sources of financing. Recent cases involving official bilateral financing include conditions relating to export credit disbursements in the Philippines and to Paris Club debt relief in Ecuador. Concerns also have arisen about indirect cross-conditionality between the Fund and the Bank. The issue of indirect cross-conditionality was illustrated in the case of Panama, when two commercial bank disbursements were delayed because of a World Bank related performance condition; this delay in turn contributed to noncompliance with the Fund program, which resulted in still further delay in the commercial bank disbursements. Recent examples of cross-linkage to the Fund and the Bank are summarized in Attachment I.

In addition to these concerns, provisions in commercial bank agreements have, in some cases, appeared to conflict with Fund policies as laid down in decisions or guidelines of the Executive Board. Examples of such conflict have included: the linkage of bank agreements to extended periods of enhanced surveillance or performance under future Fund arrangements; the inclusion of covenants to provide Fund staff papers outside the context of enhanced surveillance; the attempt to inhibit early repurchases in the Fund by making this a trigger for early repayment of banks; and the failure to acknowledge that a purchase may not take place because of the absence of balance of payments need.

We will need to work with the authorities and the banks to facilitate agreements that provide adequate assurance to banks, but in ways that are not rigid to the point of unworkability. The question arises how best to achieve this and to begin to establish, more generally, a degree of control over practices in this area of bank linkage to official involvement. First, it may be appropriate for the Fund to go as far as possible in ensuring that the financing contributions of other participants in the debt strategy are on track. This would not only safeguard the Fund's own resources, but assist in reassuring commercial banks.

A second, parallel step would be to develop some guidelines on commercial bank linkage, identifying key concerns and indicating approaches to be avoided. First, the problems associated with cross-linkage could be mitigated by less frequent intervals (annual or semiannual) for linkage to the Bank; this would also reflect more realistically the different nature of the Bank's relations with member countries. Indeed, it might be preferable for commercial banks to link separate disbursements to the Fund and the Bank, avoiding the policy concerns arising from cross-linkage. As regards the other concerns mentioned above, preconditions relating to the terms and scale of official financing should be resisted, and clauses relating to Fund involvement should respect existing guidelines and decisions of the Executive Board. The second attachment to this memorandum suggests tentative guidelines covering these various areas.

While these are important issues for the Fund, some flexibility will no doubt be required to arrive at practical solutions. Moreover, care will be necessary to ensure that the Fund is not drawn into arbitrating on issues that are primarily for commercial judgment. Nevertheless, there may also be a need to take action to alert member countries and banks in general to these various concerns. In due course, a review of experience in this area might appropriately be presented to the Executive Board in conjunction with the next review of enhanced surveillance.

This memorandum has been discussed with the Western Hemisphere Department.

Attachment

cc: Mr. Wiesner
Mr. Beza
Mr. Brown

Linkage of Commercial Bank Financing to World Bank Conditions

There has been considerable diversity in the types of linkage to World Bank activities that have been incorporated in commercial bank financing packages. In some cases the linkage has been broadly defined, with commercial banks requiring evidence of "progress" in negotiation or implementation of structural reforms. In other cases, the linkage to Bank loans has been based on certification by the Bank that debtor countries have borrowed a specified amount by a particular deadline. In some cases, all commercial bank disbursements under a new money package have been tied to performance under both Fund- and Bank-supported programs, while in other cases linkage to the Bank applied to only one disbursement from a new money package.

In the new money agreement for Chile signed in November 1985, in addition to certification from the Fund, banks required a notification from the World Bank before each disbursement confirming that Chile's Structural Adjustment Loan (or "comparable facility") was in effect, and that Chile had drawn by specified dates the full amount expected to be available to it under the SAL.

In the new money agreement with Colombia of December 1985, all commercial bank disbursements were linked to the Fund, but one was also contingent on confirmation from the World Bank that Colombia would have access to the second tranche of a trade policy loan.

In 1985, commercial banks conditioned their restructuring and new money agreements with Costa Rica on the implementation of a World Bank SAL, as well as on a Fund program. Successive delays with implementation of the SAL and the Fund stand-by arrangement meant that the second disbursement of new bank money--expected originally in mid-1985--was made in November 1985.

For Cote d'Ivoire, some disbursements under a 1985 new money agreement were conditional on a statement by the Bank on the eligibility of the borrower for drawdowns under a SAL and indicative statements about future loans. The restructuring agreements for 1984 and 1985 maturities also contained refinancing conditions involving both the Fund and the World Bank. The World Bank condition was not met, as the 1985 SAL was not signed as expected, and banks waived that condition during 1985 in order to continue the refinancing.

In addition to conditions involving the Fund, the new money agreement with Panama for 1985-86 required certification from the World Bank regarding progress in negotiating and implementing a structural adjustment loan. The double linkage to the Fund and the Bank created difficulties in this case. Although the Fund program was on track, commercial banks did not make the first disbursement when it was scheduled, because adequate progress had not been made with the World Bank. Some months later, progress had been made with the World Bank, but Panama was no longer in compliance with the Fund program, and so the initial disbursement by commercial banks was again delayed.

Tentative Guidelines on the Linkage of Commercial Bank Financing to Official Actions

1. Problems of cross linkage to the Fund and the Bank

a. The nature of the involvement of the Fund and the Bank in member countries' economies differs in important ways, and these differences need to be reflected in the procedures for linkage adopted by commercial banks. 1/ It may be more in keeping with the nature of the Bank's operations to link annual or semiannual commercial bank disbursements to major Bank actions such as approval of a new sector loan or an assessment by the Bank covering progress in implementing development policies. This would tie commercial bank disbursements to events that evidence advancement of the Bank's developing relationship with a country.

b. To avoid any impression of cross-conditionality on individual disbursements, separate commercial bank disbursements should preferably be tied to each institution. Some disbursements would be linked to quarterly evidence of compliance with a Fund arrangement, and certain other disbursements would be linked to World Bank certifications. If any commercial bank disbursements are linked both to Fund arrangements and to

1/ Specifically, a country's ability to make purchases from the Fund provides evidence, generally on a quarterly basis, that macroeconomic policies remain on track. The Bank's normal pattern of disbursements in a country relates to continuing activities under project, sector and structural adjustment loans in different time frames. Moreover, the Bank's monitoring procedures differ from those of the Fund.

the World Bank, less frequent intervals for linkage to the World Bank would reduce the scope for operational problems.

c. It would seem particularly inappropriate for cofinancing arrangements with the World Bank to contain performance clauses predicated on Fund arrangements, since in these cases the closeness of association with the World Bank raises the issue of implied cross-conditionality particularly sharply.

2. Problems of potential conflict with other Fund policies

a. Clauses that seek to precommit future resources or procedures of the Fund, including enhanced surveillance, should be worded in ways that do not appear to prejudice the autonomy of the Fund in deciding on its future relations with members, and also take account of existing Board guidelines (e.g., on the duration of enhanced surveillance). The understanding reached in the case of Uruguay would represent an acceptable compromise where future Fund procedures are at issue. In essence, the Fund management would indicate general willingness to propose to the Board future procedures (such as a financial arrangement or enhanced surveillance) that are requested by the member and are consistent with Board guidelines.

b. Commercial banks would preferably include Fund involvement among the conditions precedent for specific financial decisions, such as a disbursement of new money or activation of an annual tranche of restructuring under a MYRA, but not as a direct event of default on the country's debt, as was also agreed in the case of Uruguay. Such an approach would help to avoid unrealistic conditions relating to Fund involvement over a long period.

c. Agreements with commercial banks should acknowledge that the release of Fund staff reports outside the context of enhanced surveillance is not permitted at present, and should not put t member in the position of having to seek specific approval by the Executive Board.

d. Agreements should not inhibit a member's right or obligation to make early repurchases in the Fund; thus early repurchases in the Fund should not trigger early repayment of a member country's bank debt.

e. While commercial bank disbursements may continue to be conditioned on purchases from the Fund (as is the general practice), provision should be included for an alternative certification by the Fund if a purchase is not made for reasons unrelated to the observance of performance criteria, e.g., because of the absence of balance of payments need.

3. Precommitment of other official financing

a. Member countries should be advised of the difficulties that may arise if they agree to clauses that seek to establish in advance the scale or terms of bilateral official financing, such as debt relief in the Paris Club or export credit commitments and disbursements.

b. Similar considerations arise with regard to the World Bank's future financial involvement in debtor countries; the World Bank has recently objected to the content of such clauses.

4. Other issues concerning flexibility

a. Member countries should be advised of the need for adequate periods for corrective action to be set after dates for economic performance conditions to be met by the member under a Fund arrangement, so that such actions can be taken without a waiver by banks being necessary.

b. Member countries should be advised that, where waivers under agreement with commercial banks may be necessary, a qualified majority of the banks should be able to approve the waiver, which would avoid undue leverage by individual banks.

5. Assistance by Fund staff

In order to give effect to the guidelines, staff would stand ready to provide technical assistance to members in connection with the formulation of linkage in bank financing agreements.

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Office Memorandum

TO: The Managing Director
The Deputy Managing Director

September 22, 1986

FROM: K. Burke Dillon KBD

SUBJECT: Meeting of Export Credit Agencies on Mexico

On Thursday and Friday, September 11 and 12, representatives of the export credit agencies of the G-10 countries plus Denmark and Spain met in Brussels to discuss Mexico's adjustment program and economic prospects. A Mexican delegation, headed by Mr. Alfredo Phillips and including Mr. Ariel Buira, made an initial presentation on Thursday morning and returned for brief further discussion with the agencies on Friday. A representative of the bank steering committee, Mr. Braut of Société Générale, reported on the banks' discussions with Mexico and answered questions from the agency representatives. Staff from the Fund, the Bank, and the IDB also participated in the meetings. The Fund staff was represented by Mr. Joaquin Pujol, Mr. Luis Duran-Downing, and myself.

This was the first time that the export credit agencies had met to discuss a particular debtor country, and the meeting was seen by all concerned as a radical departure from the low profile the agencies have maintained in the past. As you will recall, the impetus for such a meeting originated in a discussion of the Baker initiative at last February's Berne Union meeting. At that time a task force was formed on the role of export credit agencies in the debt strategy. The task force concluded that the main deficiency in present procedures was that there existed no forum for the discussion of export credit policies in which all of the key creditor governments were represented by the appropriate decision makers, and it recommended that procedures be established whereby ad hoc meetings could be convened to discuss particular debtor countries. The task force report was presented to the June Berne Union meeting, where its recommendations were supported by most delegations but strongly opposed by the export credit agencies from France (COFACE) and Germany (Hermes).

The Brussels meeting on Mexico was, therefore, organized outside the formal framework of the Berne Union. It was convened by the Belgian agency (OND) and, with a view to French and German concerns, the invitations provided for the participation of governmental export credit authorities where that was considered appropriate. COFACE and Hermes initially declined to attend the Brussels meeting but, at the last minute, decided to be represented at a low level for "purposes of information." In the end, no delegation included governmental authorities outside the export credit agency, although this would appear to be an important consideration only for France and Germany.

Given this background and the general awareness of precedents that might be set, the delegates focused as much on their own procedures as they did on the situation of Mexico. Much of the time devoted to the Mexican case--perhaps too much--was taken up by presentations from the Mexican delegation and the international organizations, and there was only limited exchange of views among the delegates on Mexico's prospects and on their own credit and cover policies. It was, nevertheless, encouraging that discussion and questions tended to focus on how agencies could select projects or support programs that contributed most effectively to Mexico's adjustment effort. To that end, the agencies made clear that they expected the World Bank to play a major role. Delegates appeared generally to consider that the meeting had been worthwhile, improving their understanding of Mexico's program and economic outlook. Both the Canadian and Spanish delegates indicated that they came away with a more positive assessment of Mexico's adjustment efforts. Although there was no attempt to agree on a concerted approach among agencies, Mexico's four major creditors all announced that they planned to resume or maintain cover, which should have a positive competitive effect on the policies of other agencies. A chairman's summary of the discussion is attached.

A tour de table and direct discussions with delegates permitted the staff to obtain further information on recent cover policies and demand for cover that appeared, in some cases, to be more firmly grounded than indications received through other channels. In particular, information provided to the Fund staff by the U.S. Eximbank on the loan pipeline and typical disbursement patterns would indicate that the level of Eximbank disbursements for Mexico in 1987 that has been suggested by U.S. Treasury officials is unrealistic. Overall the discussions with agencies indicated a low level of approvals over the first nine months of 1986, reflecting the low demand experienced by most agencies and the tighter policies applied by some. This would underscore the appropriateness of projecting only a slow recovery in disbursements, even if most agencies adopt a fairly open stance over the period of the Fund arrangement.

Agencies expressed a desire to have follow-up with the Fund and Bank staffs on the Mexican case. It was noted that such follow-up could be provided in the context of the usual country discussions at the February and June Berne Union meetings, as well as during the annual visit of a small group of Berne Union representatives to Washington, which is scheduled this year for early November. Follow-up could be improved, the staffs indicated, by increasing the number of agencies represented in the Washington visits and, perhaps, by having such visits more than once a year.

It was unclear what the next move will be regarding the broader question of ad hoc meetings on particular countries. On the one hand, it was reported that France and Germany intended to raise the issue in the EEC in an attempt to get a concerted EEC position that such country discussions should take place only in the OECD export credit group. Other agencies were, however, already talking about possible candidates and hosts for future similar ad hoc meetings. Nigeria and Egypt were mentioned as possible candidates, and the Canadians might be prepared to host the next meeting.

Attachment

cc: AFR, ASD, ETR, EUR, MED, RES, WHD
Mr. Brown
Office in Europe

bcc: Mr. Finch
Mr. Beveridge
Mr. Guitian
Mr. Kanesa-Thasan
Mr. Brau
Mr. Boorman
Mr. Anjaria
Mr. Pujol
Mr. Duran-Downing
Mr. Watson
Mr. Allen

file

Office Memorandum

To: Mr. Finch

September 22, 1986

From: C. M. Watson

Subject: Mexico: Commercial Bank Linkage

I attach a revised draft on the issue of commercial bank linkage, with particular reference to the banks' financing proposals for Mexico. This draft reflects discussions with the Legal Department and the Western Hemisphere Department, but is subject to their final clearance.

Attachments

cc: Mr. Gianviti
Mr. Wiesner
Mr. Beza
Mr. Guitian
Mr. Silard

mm6cmwcacZ

To: The Managing Director
The Deputy Managing Director

September 22, 1986

From: C. David Finch

Subject: Mexico--Linkage of Commercial Bank Disbursements to Official Involvement

The draft financing principles recently proposed by commercial banks for Mexico incorporated provisions for very tight and comprehensive linkage of the banks' disbursements to Fund and Bank actions and to contributions of export credit agencies and the Paris Club. These proposals represent an extreme example of the recent tendency for commercial banks to make new money disbursements so conditional on the performance of other parties in the debt strategy that the timing and extent of their own participation can no longer be securely counted upon. Under these circumstances, the assurance provided by the "critical mass" of bank commitments is seriously weakened, raising questions as to the viability of the members' balance of payments and hence the adequacy of safeguards for the use of the Fund's resources. It is notable that the network of links embodied in the proposed bank financing principles for Mexico would in effect arrogate to commercial banks the role of financial monitoring and coordination of financing flows that customarily has devolved the Fund as organizer of the financing package.

The types of linkage adopted in recent bank financing agreements have varied widely. In several instances, they have posed risks of serious delays in the disbursement of bank finance through linkage to different sources of financing. Concerns have also arisen about indirect cross-conditionality between the Fund and the Bank. The issue of indirect cross-conditionality was illustrated in the case of Panama, when two commercial bank disbursements were delayed because of a World Bank related performance condition; this delay in turn contributed to noncompliance with the Fund program, which resulted in still further delay in the commercial bank disbursements. Recent examples of cross-linkage to the Fund and the Bank are summarized in Attachment I.

In addition to these concerns, provisions in commercial bank agreements have, in some cases, appeared to conflict with Fund policies as laid down in decisions or guidelines of the Executive Board. Examples of such conflict have included: the linkage of bank agreements to extended periods of enhanced surveillance or performance under future Fund arrangements; the inclusion of covenants to provide Fund staff papers outside the context of enhanced surveillance; the attempt to inhibit early repurchases in the Fund by making this a trigger for early repayment of banks; and the failure to acknowledge that a purchase may not take place because of the absence of balance of payments need.

We will need to work with the authorities and the banks to facilitate agreements that provide adequate assurance to banks, but in ways that are not rigid to the point of unworkability. The question arises how best to achieve this and to begin to establish, more generally, a degree of control over practices in this area of bank linkage to official involvement. First, it may be appropriate for the Fund to strengthen its own monitoring to ensure that the financing contributions of other participants in the debt strategy are on track. This would not only safeguard the Fund's own resources, but assist in reassuring commercial banks.

A second, parallel step would be to develop some guidelines on commercial bank linkage, identifying key concerns and indicating approaches to be avoided. First, the problems associated with cross-linkage could be mitigated by less frequent intervals (annual or semiannual) for linkage to the Bank; this would also reflect more realistically the different nature of the Bank's relations with member countries. It would also be preferable for commercial banks to link separate disbursements to the Fund and the Bank, avoiding the policy concerns arising from cross-linkage. As regards the other concerns mentioned above, preconditions relating to the terms and scale of official financing should be resisted, and clauses relating to Fund involvement should respect existing guidelines and decisions of the Executive Board. The second attachment to this memorandum suggests tentative guidelines covering these various areas.

While these are important issues for the Fund, some flexibility will no doubt be required to arrive at practical solutions. Moreover, care will be necessary to ensure that the Fund is not drawn into arbitrating on issues that are primarily for commercial judgment. Nevertheless, there may also be a need to take action to alert member countries and banks in general to these various concerns. In due course, a review of experience in this area might appropriately be presented to the Executive Board [in conjunction with the next review of enhanced surveillance, which it is planned to offer as a Board Paper in the first half of next year].

This memorandum has been discused with the Legal Department and the Western Hemisphere Department.

Attachment

cc: Mr. Gianviti

Mr. Wiesner

Mr. Beza

Mr. Brown

Linkage of Commercial Bank Financing to World Bank Conditions

There has been considerable diversity in the types of linkage to World Bank activities that have been incorporated in commercial bank financing packages. In some cases the linkage has been broadly defined, with commercial banks requiring evidence of "progress" in negotiation or implementation of structural reforms. In other cases, the linkage to Bank loans has been based on certification by the Bank that debtor countries have borrowed a specified amount by a particular deadline. In some cases, all commercial bank disbursements under a new money package have been tied to performance under both Fund- and Bank-supported programs, while in other cases linkage to the Bank applied to only one disbursement from a new money package.

In the new money agreement for Chile signed in November 1985, in addition to certification from the Fund, banks required a notification from the World Bank before each disbursement confirming that Chile's Structural Adjustment Loan (or "comparable facility") was in effect, and that Chile had drawn by specified dates the full amount expected to be available to it under the SAL.

In the new money agreement with Colombia of December 1985, all commercial bank disbursements were linked to the Fund, but one was also contingent on confirmation from the World Bank that Colombia would have access to the second tranche of a trade policy loan.

In 1985, commercial banks conditioned their restructuring and new money agreements with Costa Rica on the implementation of a World Bank SAL, as well as on a Fund program. Successive delays with implementation of the SAL and the Fund stand-by arrangement meant that the second disbursement of new bank money--expected originally in mid-1985--was made in November 1985.

For Cote d'Ivoire, some disbursements under a 1985 new money agreement were conditional on a statement by the Bank on the eligibility of the borrower for drawdowns under a SAL and indicative statements about future loans. The restructuring agreements for 1984 and 1985 maturities also contained refinancing conditions involving both the Fund and the World Bank. The World Bank condition was not met, as the 1985 SAL was not signed as expected, and banks waived that condition during 1985 in order to continue the refinancing.

In addition to conditions involving the Fund, the new money agreement with Panama for 1985-86 required certification from the World Bank regarding progress in negotiating and implementing a structural adjustment loan. The double linkage to the Fund and the Bank created difficulties in this case. Although the Fund program was on track, commercial banks did not make the first disbursement when it was scheduled, because adequate progress had not been made with the World Bank. Some months later, progress had been made with the World Bank, but Panama was no longer in compliance with the Fund program, and so the initial disbursement by commercial banks was again delayed.

Tentative Guidelines on the Linkage of

Commercial Bank Financing to Official Actions

1. Problems of cross linkage to the Fund and the Bank

a. The nature of the involvment of the Fund and the Bank in member countries' economies differs in important ways, and these differences need to be reflected in the procedures for linkage adopted by commercial banks. 1/ It may be more in keeping with the nature of the Bank's operations to link annual or semiannual commercial bank disbursements to major Bank actions such as approval of a new sector loan or an assessment by the Bank covering progress in implementing development policies. This would tie commercial bank disbursements to events that evidence advancement of the Bank's developing relationship with a country.

b. To avoid any impression of cross-conditionality on individual disbursements, separate commercial bank disbursements should preferably be tied to each institution. Some disbursements would be linked to quarterly evidence of compliance with a Fund arrangement, and certain other disbursements would be linked to World Bank certifications. If any commercial bank disbursements are linked both to Fund arrangements and to the World Bank, less frequent intervals for linkage to the World Bank would reduce the scope for operational problems.

1/ Specifically, a country's ability to make purchases from the Fund provides evidence, generally on a quarterly basis, that macroeconomic policies remain on track. The Bank's normal pattern of disbursements in a country relates to continuing activities under project, sector and structural adjustment loans in different time frames. Moreover, the Bank's monitoring procedures differ from those of the Fund.

c. It would seem particularly inappropriate for cofinancing arrangements with the World Bank to contain performance clauses predicated on Fund arrangements, since in these cases the closeness of association with the World Bank raises the issue of implied cross-conditionality particularly sharply.

2. Problems of potential conflict with other Fund policies

a. Clauses that seek to precommit future resources or procedures of the Fund, including enhanced surveillance, should be worded in ways that do not appear to prejudice the autonomy of the Fund in deciding on its future relations with members, and also take account of existing Board guidelines (e.g., on the duration of enhanced surveillance). The understanding reached in the case of Uruguay would represent an acceptable compromise where future Fund procedures are at issue. In essence, the Fund management would indicate general willingness to propose to the Board future procedures (such as a financial arrangement or enhanced surveillance) that are requested by the member and are consistent with Board guidelines.

b. Commercial banks would preferably include Fund involvement among the conditions precedent for specific financial decisions, such as a disbursement of new money or activation of an annual tranche of restructuring under a MYRA, but not as a direct event of default on the country's debt, as was also agreed in the case of Uruguay. Incorporating member countries' relations with the Fund under financial arrangements or enhanced surveillance in this form, rather than as direct events of default on the country's outstanding debt, would help to avoid unrealistic conditions relating to Fund involvement over a long period.

c. Agreements with commercial banks should acknowledge that the release of Fund staff reports outside the context of enhanced surveillance is not permitted at present, and should not put the member in the position of having to seek specific approval by the Executive Board.

d. Agreements should not inhibit a member's right or obligation to make early repurchases in the Fund; thus early repurchases in the Fund should not trigger early repayment of a member country's bank debt.

e. While commercial bank disbursements may continue to be conditioned on purchases from the Fund (as is the general practice), provision should be included for an alternative certification by the Fund of economic performance if a purchase is not made, e.g., because of the absence of balance of payments need.

3. Precommitment of other official financing

a. Member countries should be warned of the difficulties that may arise if they agree to clauses that seek to establish in advance the scale or terms of bilateral official financing, such as debt relief in the Paris Club or export credit commitments and disbursements.

b. Similar considerations arise with regard to the World Bank's future financial involvement in debtor countries; the World Bank has recently objected to the content of such clauses.

4. Other issues concerning flexibility

a. Member countries should be warned of the need for adequate periods for corrective action to be set after dates for economic performance conditions to be met by the member, so that such actions can be taken without a waiver by banks being necessary.

b. Member countries should be warned that, where waivers are required, only a qualified majority of the banks should be necessary to approve the waiver, which would avoid undue leverage by individual banks.

file

INTERNATIONAL MONETARY FUND

Sept. 19, 1986

Mr. Beza:

We have obtained, on an informal basis, from the IFC a summary of their proposals for a Mexican Fund. While their thinking is at a fairly early stage, you may be interested to glance at these proposals.

Attachment

cc: Mr. Guitian
Mr. Pujol
Mr. Duran-Downing (o/r)
Mr. Brown

C. Maxwell Watson

Mexico (M$632.9 = US$1)

IFC-Mexico Debt Conversion Fund. In line with official initiatives aimed at LDC debt reduction and, specifically, the recent Mexican Debt agreement of July 23, 1986, IFC proposes to form a closed-end investment company whose principal objective would be long-term capital appreciation through investment in securities, primarily equity securities, of Mexican companies. The Fund as currently conceived would initially be capitalized at US$25 million with IFC as principal shareholder, and would be expected to grow to approximately US$250 million. These funds would primarily be generated through the issuance of foreign currency denominated certificates of participation to commercial banks in exchange for a portion of their existing foreign currency loans to Mexican private (or in some cases public) sector corporations. It is intended that the Fund shares or certificates be ultimately widely sold through a public secondary offering and be registered and listed on a major developed country stock exchange. The Fund would contribute to reducing Mexico's foreign debt and foreign exchange outflows, facilitate the restructuring of the Mexican private sector, improve the liquidity of commercial bank creditors, and stimulate the local securities market. IFC is currently awaiting specific operational assurances from the Mexican Ministry of Finance and the mandate to implement this concept. (New Item).

9700H

For information M. Phair. IFC ph.5-6190

MEXICO:
SUMMARY OF A PROPOSAL FOR
AN IFC MEXICO FUND

July 1986

Capital Markets Department

MEXICO

IFC MEXICO FUND

PROPOSAL

Project Summary:

1. IFC proposes to form a closed-end investment company (tentatively called IFC Mexico Fund, Inc. (The Fund) whose principal investment objective would be long-term capital appreciation through investment in securities, primarily equity securities, of Mexican companies. The Fund would eventually be capitalized with shares to be initially wholly-owned by IFC at approximately US$250 million (including up to US$25 million from IFC) through issuance of foreign currency (dollar) denominated certificates of participation to participating commercial banks in exchange for a portion of their existing foreign currency loans to Mexican private (or in some cases, public) sector corporations. It is intended that the Fund shares or certificates be ultimately widely sold through a public secondary offering and be registered with appropriate authorities and listed on a major developed country stock exchange.

Operational Considerations:

2. There are essentially three phases to the Fund's operations, namely:
a) Phase I (Start-up): The Fund is established as an IFC Fund; that is, IFC would originally own all the shares of the Fund and issue "certificates of participation" in the Fund to participating international commercial banks (the Banks) in amounts which reflect the real value of the financial assets transferred by the Banks to the Fund. The proposed debt for equity exchange by the Banks would be a non-cash transaction involving a discount to face value of the loan(s) that would reflect the current "interbank" market valuation of Mexican foreign debt. The price would be established through negotiation between the Fund managers and the Banks on a case by case (company by company) basis with some outside assessment provided by independent consultants, as needed. Cash, blocked funds or other commercial bank Mexican assets may also be priced for exchange,

b) Phase II (Initial Operations): Management would initially concentrate on the matter of "collection" or conversion, that is, turning the Fund's assets into marketable securities or cash available for investment purposes. In this operational phase Management will require maximum flexibility to negotiate a wide range of financial options including restructurings and recapitalizations, while operating more as a venture capital investor with a "hands on" approach, and finally,

c) Phase III (Maturity), the Fund would enter into more traditional practices of trading and investing in a diversified pool of marketable securities with selection, after analysis, based on yield, risk and projected returns. It would be at this time that the Fund would attempt the public sale of the certificates of participation or shares, depending on circumstances at that time, through a market offering.

Policy/Regulatory Considerations:

The Fund would have to be large enough to be of interest to an independent foreign investment manager and to cover start-up and operational expenses; yet it could not be too large relative to the overall size of the Mexican domestic securities market for reasons of preventing the perception or actual possibility of foreign domination or control. Mexican authorities would be expected to provide prior approval of foreign management and pass through to the Fund existing benefits relating to the assets to be acquired by the Fund, such as collaterals, FICORCA coverage, withholding tax exemption, foreign exchange coverage, etc. Adequate protections are required to permit foreign portfolio investment such as is contemplated by the Fund and the right of the Fund to purchase and sell securities without restriction other than that which would normally apply to such investment funds (asset, industry, foreign investment limits, etc.). Taxation policies would be reexamined in order to ensure that equitable tax treatment for dividends, interest and capital gains is still in place (as with the current "Mexico Fund".). Adequate arrangements for repatriation of income and capital gains and access to foreign exchange must be negotiated. Finally, full coordination with regulatory authorities in the lending countries is required. This will assist the Fund shares to qualify as appropriate investments for meeting applicable regulations and investment diversification criteria and to facilitate the registration, listing and eventual public offering.

Management:

4. Subsequent to receipt of initial approvals from Mexican authorities and more in-depth discussions with potential participating banks on the matter of design, IFC would commence the process of selection of an independent international Fund Manager. This is the most important operational considerations for ensuring the participation of commercial banks, and the (market perception of) ultimate financial success of the Fund. A Mexican advisor would be selected as a logical and necessary complement to the Fund Manager. The indicated candidate or candidates would combine market knowledge with venture capital investment skills, and a proven investment management track record.

Rationale/Benefits:

5. The current Mexican economic situation has severely reduced the ability of the country to service its external debt obligations. The

Baker/Bradley initiatives' shift from incremental loans to debt relief puts a debt to equity swap proposal such as the IFC Mexico Fund in a more appealing position from both the viewpoints of the country and of the commercial banks. The Fund would (1) provide an infusion of cash for investment purposes of up to US$25 million; (2) eventually reduce the Mexican foreign debt in an amount equal to the total face value of the exchanged loans; (3) reduce debt service payments and foreign exchange outflows in the early years; (4) facilitate the restructuring and financial recovery of a number of Mexican private sector corporations (5) reduce risk, enhance collectability and improve potential liquidity of commercial banking assets; (6) partially centralize the debt renegotiation process with Mexican obligors and improve Mexico's foreign banking relationships; and (7) provide a potentially attractive vehicle to encourage institutional investor consideration of Mexican portfolio investment risk.

Summary of Issues and Sequence:

6. The following are the principal issues:

1) Before proceeding further with details of the Fund design, it will be necessary to receive certain clear assurances from the Mexican authorities. The most important of these is with regard to the matter of independent foreign management.

2) Most other issues have been satisfactorily resolved in practice in connection with the existing Mexico Fund, Inc. and with outstanding market instruments such as bonds and FRNs. However, IFC would wish assurances that suitable treatment would be instituted for this Fund with regard to custodian arrangements, ownership and voting rights, taxation treatment of dividend income and capital gains, repatriation rights and access to foreign exchange. Decisions for purchase and sale of securities must be made by the Fund Manager.

3) IFC would require assurances that the conversion from debt to equity in a corporation would not result in that corporation losing its FICORCA benefits.

4) An important question is one of size of the Fund; at this writing US$250 million is considered a target minimum.

7. The general sequence of events are:

1) Receive necessary assurances from Mexican authorities.

2) Once the above is in place, contact potential bank participants for detailed work on project design.

3) Discussions with developed country banking regulators in order to ensure cooperation for the debt conversion and equity fund approach.

4) Initial contacts with potential management and/or possible consultant organizations.

International Finance Corporation

1818 H Street, N.W.
Washington, D.C. 20433
U.S.A.

(202) 477-1234
Cable Address. CORINTFIN

Sir WILLIAM RYRIE
Executive Vice President

→ Mr Erb
Mr. Wiesner
Mr. Beza
Mr. Finch

cc: Mr. Guitián
Mr. Watson

September 18, 1986

Dear Jacques,

Thank you very much for your letter about the idea for an equity fund for Mexico. I am so pleased to have your support. It will not be a panacea, but I believe it could have a significant psychological influence.

We are just revising a paper describing the idea and, in view of your interest, I shall send that to you when it is ready.

We are not yet sure that the Mexican Government will accept the conditions we believe are necesssary for this project to succeed. One key condition is that the fund should be managed by a non-Mexican -- otherwise the banks will simply not participate. However, Petricioli is showing considerable interest. If in your contacts with him you felt able to encourage him, we should greatly appreciate that.

Yours sincerely,

Bill

Mr. J. de Larosiere
Managing Director
International Monetary Fund
Washington, D.C. 20431

Mr Watson
Any comments?

INTERNATIONAL MONETARY FUND

9-18-86

Mr. Guitián:

Manual - for your comments.

Ted

S. T. Beza

cc: Mr Watson
Mr Duran-Downing

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

September 18, 1986

Messrs. Sterie T. Beza, Associate Director
Joaquin P. Pujol, Division Chief
(Western Hemisphere Department, IMF)

The attached (revised) draft telex for Mr. Conable's signature to commercial banks re Mexico has now been cleared by Mr. Stern. Please let us know if you have any comments. It is my understanding that a similar telex would be sent by Mr. de Larosiere at the appropriate time.

P.B

Pieter Bottelier
Division Chief
LC1MX/WB

Attachment

cc: Mr. Steckhan, LC1DR

PBottelier/slc

P-1852

FORM NC 27 OCR
(Modified -- 1/85)

WORLD BANK OUTGOING MESSAGE FORM Cable, Telex
IMPORTANT—PLEASE READ INSTRUCTIONS BELOW BEFORE TYPING FORM

TEXTNAME: Tel-ExtFncg

START HERE

WDIAL

LC1MX

OINFO

-SUBJECT: MEXICO - COORDINATION EXTERNAL FINANCING PACKAGE

-DRAFTED BY: PBOTTELIER:JVARALLYAY/SLC EXT: 72543

-AUTHORIZED BY: BARBER B. CONABLE, PRESIDENT

-TO BE CLEARED BY & CC: STERN, SVPOP; KNOX, LCNVP; STECKHAN,

- LC1DR

-COMMERCIAL BANKS' ADVISORY GROUP

- AND OTHER MEMBERS OF COMMERCIAL BANK SYNDICATION FOR MEXICO

-

-

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BT

WASHINGTON DC - 18-SEP-86

MEXICO ANNOUNCED A FAR-REACHING PROGRAM OF ECONOMIC AND FINANCIAL ADJUSTMENTS IN MEXICO CITY AND IN WASHINGTON, D.C. ON JULY 21. AT A MEETING WITH THE BANKING COMMUNITY IN NEW YORK

END OF TEXT

SIGNATURES:

DRAFTED BY: ____________

AUTHORIZED BY: ____________

READY FOR TRANSMISSION: ____________
(Inputter's Initials)

TRANSMITTED BY: ____________

DATE: ____________

DELIVERY NOTICES RECEIVED? ____________

(Modified -- 1/85)

WORLD BANK OUTGOING MESSAGE FORM Cable, Telex

IMPORTANT—PLEASE READ INSTRUCTIONS BELOW BEFORE TYPING FORM

TEXTNAME: Tel-ExtFncg

START HERE

CITY, THE MEXICAN SECRETARY OF FINANCE AND HIS COLLEAGUES PROVIDED THE DETAILS OF THE PROGRAM. AS WE INDICATED AT THE NEW YORK MEETING, THE WORLD BANK HAS WORKED WITH THE GOVERNMENT ON THE PROGRAM OF ADJUSTMENT, AND IS OF THE VIEW THAT, IF IMPLEMENTED EFFECTIVELY WITHIN THE NEXT 18 MONTHS, IT CONSTITUTES A BASIS FOR MEXICO TO RESUME GROWTH ON A SUSTAINABLE BASIS, WHILE GRADUALLY REDUCING ITS DEPENDENCE ON EXTERNAL CAPITAL AND RESTORING ITS CREDITWORTHINESS. ON JULY 29, THE EXECUTIVE DIRECTORS OF THE WORLD BANK APPROVED THE FIRST OF OUR LOANS IN SUPPORT OF ONE OF THE MAJOR REFORMS, TRADE LIBERALIZATION. ON SEPTEMBER 8, THE IMF APPROVED A STAND-BY, IN PRINCIPLE, IN SUPPORT OF MEXICO'S PROGRAM. THE FUND'S RESOURCES AND OUR LOANS IN SUPPORT OF THE ADJUSTMENT PROGRAM ARE CONTINGENT UPON THE AVAILABILITY OF ADEQUATE SUPPLEMENTARY FINANCIAL RESOURCES FROM PRIVATE BANKS. THE PURPOSE OF THIS TELEX IS TO EXPLAIN, IN BROAD TERMS, THE NATURE OF MEXICO'S ADJUSTMENT PROGRAM AND TO RECOMMEND IT FOR YOUR SUPPORT.MEXICO'S PROGRAM IS DESIGNED TO IMPROVE THE EFFICIENCY AND COMPETITIVENESS OF THE ECONOMY, WHICH WILL ENABLE MEXICO TO RESUME BADLY NEEDED GROWTH OF PRODUCTION AND EMPLOYMENT AND TO SUSTAIN RAPID ECONOMIC GROWTH IN THE FUTURE. THE ADJUSTMENT

END OF TEXT

SIGNATURES:

DRAFTED BY: ______

AUTHORIZED BY: ______

READY FOR TRANSMISSION: ______ (Inputter's Initials)

TRANSMITTED BY: ______

DATE: ______

DELIVERY NOTICES RECEIVED? ______

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PROGRAM IS FAR-REACHING AND WILL REQUIRE IMPROVED DOMESTIC SAVINGS AND ADEQUATE EXTERNAL FINANCING.

THE GOVERNMENT HAS ALREADY EMBARKED UPON A SIGNIFICANT TRADE LIBERALIZATION PROGRAM, INCLUDING ACCESSION TO THE GATT, AND HAS UNDERTAKEN MAJOR CUTS IN THE PUBLIC INVESTMENT PROGRAM. THE GOVERNMENT HAS ALSO UNDERTAKEN INITIATIVES IN A NUMBER OF OTHER CRITICAL AREAS WHICH INCLUDE: (AAA) MAJOR REDUCTIONS IN SUBSIDIES ON KEY COMMODITIES AND SERVICES, (BBB) PRIVATIZATION OF NON-STRATEGIC PARASTATAL ENTERPRISES, (CCC) CLOSING INEFFICIENT INDUSTRIAL PLANTS DRAINING FISCAL RESOURCES, AND (DDD) IMPROVED PUBLIC ENTERPRISE MANAGEMENT, THROUGH INTRODUCTION OF A NEW LAW IN MAY 1986 DESIGNED TO INCREASE ENTERPRISE AUTONOMY AND ACCOUNTABILITY. IN ALL OF THESE AREAS, IMPORTANT INITIAL ACTIONS HAVE BEEN TAKEN, INCLUDING SHARP REDUCTIONS IN SUBSIDIES, THE SALE OF HOTELS AND OTHER ENTERPRISES, AND THE CLOSING OF A MAJOR STEEL PLANT. THE PROCESS OF REFORM IN THESE AND OTHER AREAS WILL CONTINUE.

IN ADDITION, UNDER A GENERAL INTEREST RATE AGREEMENT WITH THE WORLD BANK, THE GOVERNMENT HAS RAISED INTEREST RATES FOR

END OF TEXT

SIGNATURES:

DRAFTED BY: ____________

AUTHORIZED BY: ____________

READY FOR TRANSMISSION: ____________
(Inputter's Initials)

TRANSMITTED BY: ____________

DATE: ____________

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(Modified -- 1/85)

WORLD BANK OUTGOING MESSAGE FORM Cable, Telex

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PREFERENTIAL CREDIT SCHEMES. UNDER THIS AGREEMENT, BY THE END OF THE YEAR INTEREST RATES IN THE MAJOR SECTORS WILL BE AT OR ABOVE THE AVERAGE COST OF FUNDS. BETWEEN 1983 AND 1985, PUBLIC INTEREST RATE SUBSIDIES CHANNELLED THROUGH DOMESTIC DEVELOPMENT BANKS AND TRUST FUNDS DECLINED BY MORE THAN HALF.

A CENTRAL FEATURE OF THE MEDIUM-TERM ADJUSTMENT PROGRAM IS THE PUBLIC SECTOR INVESTMENT PROGRAM. THE WORLD BANK AND THE MEXICAN GOVERNMENT COMPLETED A JOINT REVIEW OF MAJOR COMPONENTS OF THE COUNTRY'S MEDIUM-TERM PUBLIC SECTOR INVESTMENT PROGRAM IN LATE 1985. SUBSEQUENT TO APPROVAL OF THE 1986 BUDGET BY THE MEXICAN CONGRESS LATE LAST YEAR, THE GOVERNMENT INTRODUCED MAJOR CUTS AND DEFERRALS IN INVESTMENTS IN RESPONSE TO THE SHARP DECLINE IN INTERNATIONAL OIL PRICES. THESE CUTS ARE BROADLY COMPATIBLE WITH THE CONCLUSIONS OF THE JOINT PUBLIC INVESTMENT REVIEW BUT, AS A RESULT, PUBLIC INVESTMENTS IN 1986 ARE EXPECTED TO FALL TO A PRECARIOUSLY LOW LEVEL OF 5 PERCENT OF GDP, LESS THAN HALF THE AVERAGE FOR THE PERIOD 1977-82. THE WORLD BANK BELIEVES THAT THE QUALITY OF MEXICO'S CURRENT PUBLIC SECTOR INVESTMENT PROGRAM IS GENERALLY SATISFACTORY AND WE PLAN TO CONTINUE OUR COLLABORATION WITH THE GOVERNMENT TO MONITOR

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AUTHORIZED BY: ____________

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(Inputter's Initials)

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IMPLEMENTATION, IN LINE WITH SECTORAL PRIORITIES. INVESTMENT REVIEWS WITH THE GOVERNMENT ARE EXPECTED TO BE PARTICULARLY DETAILED IN SECTORS WHICH ARE RECEIVING SUBSTANTIAL SUPPORT FROM THE WORLD BANK OR ARE BEING CONSIDERED FOR MAJOR RESTRUCTURING AND NEW BANK LENDING, SUCH AS THE TRANSPORT, FERTILIZER, STEEL, AND AGRICULTURAL SECTORS. WE WILL ALSO BE PLEASED TO WORK WITH THE GOVERNMENT TO DEFINE THE INCREMENTAL INVESTMENTS WHICH MIGHT BE ADDED TO THE CAPITAL BUDGET IN CASE OF RECESSION.

MEXICO'S GROWTH STRATEGY WILL HINGE ON SUBSTANTIAL INCREASES IN NON-OIL EXPORTS AND DOMESTIC SAVINGS. THE WORLD BANK IS PLACING PARTICULAR EMPHASIS ON HELPING THE GOVERNMENT TO STRENGTHEN THE NON-OIL EXPORTS AND INDUSTRIAL SECTORS. THE BANK'S ASSISTANCE STRATEGY FOCUSSES ON THE REQUIRED POLICY REFORMS AND ON ASSOCIATED SPECIFIC INVESTMENT PROGRAMS DESIGNED TO PROMOTE EFFICIENCY AND INTENSIFY THE ECONOMY'S SUPPLY RESPONSE. A US$698 MILLION LOAN PACKAGE TO SUPPORT TRADE POLICY REFORM, INDUSTRIAL EXPANSION, AND TECHNOLOGY DEVELOPMENT, RECENTLY APPROVED BY THE BANK'S BOARD, IS A KEY COMPONENT IN THIS STRATEGY. THESE LOANS, TOGETHER WITH US$574 MILLION FOR FOUR OTHER LOANS ALREADY APPROVED EARLIER THIS YEAR (FOR EARTHQUAKE

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RECONSTRUCTION, TROPICAL AGRICULTURE, AND URBAN DEVELOPMENT) AND TWO FURTHER LOANS IN SUPPORT OF AGRICULTURAL CREDIT AND EXPORT DEVELOPMENT YET TO FOLLOW, ARE EXPECTED TO BRING THE WORLD BANK'S NEW COMMITMENTS FOR CALENDAR YEAR 1986 TO AN UNPRECEDENTED LEVEL OF US$2 BILLION. DEPENDING ON THE PROGRESS MADE BY MEXICO TOWARDS AGREED OBJECTIVES, WHICH WILL BE CLOSELY MONITORED BY THE WORLD BANK, AND ON THE AGREEMENT BY THE OTHER CREDITORS--BOTH THE EXPORT CREDIT AGENCIES AND THE COMMERCIAL BANKS--TO PARTICIPATE ADEQUATELY IN THE PROGRAM, THE LEVEL OF NEW COMMITMENTS IN 1987 AND 1988 COULD BE OF A SIMILAR MAGNITUDE AND WOULD SUPPORT STRUCTURAL ADJUSTMENT AND INVESTMENT PROGRAMS FOR THE INDUSTRY, AGRICULTURE, FERTILIZER, HOUSING, STEEL, AND TRANSPORT SECTORS.

SUCCESS OF THE STRUCTURAL REFORMS AND POLICY ADJUSTMENTS ANNOUNCED BY MEXICO WILL HINGE ON EFFICIENT AND ENERGETIC IMPLEMENTATION, AS WELL AS CLOSE MONITORING OF PROGRESS DURING THE REMAINDER OF THE PROGRAM PERIOD THROUGH 1988.

I WISH TO CONCLUDE BY STRESSING THAT EFFECTIVE IMPLEMENTATION OF MEXICO'S COURAGEOUS EFFORTS TO DEAL WITH ITS PROBLEMS

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CONSTRUCTIVELY ON A SUSTAINED BASIS, WITHIN SEVERE ECONOMIC, FINANCIAL, AND SOCIAL CONSTRAINTS, WILL REQUIRE THE FULL COOPERATION OF THE COUNTRY'S CREDITOR BANKS AND OTHER CREDITORS. WE LOOK FORWARD TO WORKING WITH YOU AND THE IMF IN SUPPORTING MEXICO'S EFFORTS. BEST REGARDS, BARBER B. CONABLE, PRESIDENT, THE WORLD BANK (INTBAFRAD).

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Mexico Files

INTERNATIONAL MONETARY FUND

September 17, 1986

Mr. Beza
Mr. Guitian

I attach a draft concerning commercial bank linkage in the case of Mexico, along the lines discussed yesterday.

Attachment

cc: Mr. Silard

C. Maxwell Watson

mm6cmwcacZ

To: The Managing Director
The Deputy Managing Director

September 17, 1986

From: S.T. Beza and Manuel Guitian

Subject: Mexico--Linkage of Commercial Bank Disbursements to Official Involvement

The draft financing principles recently proposed by commercial banks for Mexico incorporate provisions for very tight and comprehensive linkage of the banks' disbursements to Fund and Bank actions and to contributions of export credit agencies and the Paris Club. These proposals represent an extreme example of the recent tendency for commercial banks to make new money disbursements so conditional upon the performance of other parties in the debt strategy that the timing and extent of their own participation can no longer be securely counted upon. Under these circumstances the assurance provided by the "critical mass" of bank commitments is seriously weakened. It is notable that the network of links embodied in the proposed bank financing principles for Mexico in effect seeks to arrogate to commercial banks a role of financial monitoring, and coordination of financing flows, which properly devolves on the Fund.

The types of linkage adopted in recent cases have varied widely. In several instances they have posed risks of inappropriate delays in the disbursement of bank finance through linkage to different sources of financing; concerns have also arisen about indirect cross-conditionality between the Fund and the Bank, and about conflict with the letter or spirit of existing Fund procedures as laid down in guidelines or decisions of the Executive Board. The issue of indirect cross-conditionality was illustrated in the case of Panama, when two commercial bank disbursements were delayed because of a World Bank related performance condition; this delay in turn contributed to noncompliance with the Fund program, which caused still further delay in the commercial bank disbursements. The main examples of conflict with Fund policies have included: the linkage of financing agreements to extended periods of enhanced surveillance or performance under future arrangements; the inclusion of covenants to provide Fund staff papers outside the context of enhanced surveillance; the attempt to inhibit early repurchases in the Fund by making this a trigger for early repayment of banks; and the failure to acknowledge that a purchase may not take place because of the absence of balance of payments need.

We will need to work with the Mexican authorities and the banks to try to facilitate agreement on arrangements which provide adequate assurance to banks that lending will be suspended at times when policies are seriously off track, but which are not rigid to the point of unworkability. The question arises how best to satisfy these two objectives and to begin to establish, more generally, a degree of control over practices in this area. First, it would be appropriate to clarify and emphasize the action that the Fund will take, for example at the time of reviews in the course of the program, to ensure that the financing contributions of participants in the debt strategy are on track. This element could assist in reassuring banks as to the execution of financing commitments, as well as in safeguarding the Fund's own resources.

A second, parallel step would be to develop some guidelines on commercial bank linkage, identifying key concerns and indicating approaches to be avoided. In essence, it would appear preferable for commercial banks to link separate disbursements to the Fund and the Bank, avoiding the policy and practical concerns arising from cross-linkage. Preconditions relating to the terms and scale of official financing should be resisted, and clauses relating to Fund involvement should respect existing guidelines and decisions of the Executive Board. [The attachment to this memorandum suggests tentative guidelines covering these areas.]

While these are important issues for the Fund, and vigilance in this area is needed, some flexibility will no doubt be required to arrive at a practical solution. Moreover, care will be necessary to ensure that the Fund is not drawn into arbitrating on issues that are primarily for commercial judgment. There may also be a need to take action to alert member countries and banks, more widely, to these various concerns. In due course, a review of experience in this area might appropriately be combined with the next review of enhanced surveillance, which it is planned to offer as a Board Paper in the first half of next year.

If this approach meets with your approval, it could serve as a basis for seeking to facilitate an acceptable agreement in the case of Mexico.

Attachment

cc: Mr. Brown

1. Problems of cross linkage to the Fund and the Bank

a. To avoid any impression of cross-conditionality on individual disbursements, separate commercial bank disbursements should be tied to each institution. Some disbursements would be linked to quarterly evidence of compliance with a Fund arrangement, and certain other disbursements would be linked to World Bank certification of actions relating to structural reforms.

b. It would seem particularly inappropriate for cofinancing arrangements with the World Bank to contain performance clauses predicated on arrangements with the Fund, since in these cases the closeness of association with the World Bank raises the issue of implied cross-conditionality particularly sharply.

c. The nature of the involvment of the Fund and the Bank in member countries' economies differs in important ways, and these differences need to be reflected in the procedures for linkage adopted by commercial banks. 1/ It may be more in keeping with the nature of the Bank's operations to link annual or semiannual commercial bank disbursements to major Bank actions such as approval of a new sector loan or satisfactory completion of a review covering a particular set of development policies. This would tie commercial bank disbursements to events

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1/ Specifically, a country's ability to make purchases from the Fund provides evidence, generally on a quarterly basis, that macroeconomic that evidence advancement of the Bank's developing relationship with a country. 1/

2. Problems of potential conflict with other Fund policies

a. Clauses that seek to precommit future resources or procedures of the institution, including enhanced surveillance, should be worded in forms that do not appear to prejudice the autonomy of the Fund in deciding on its future relations with members, and also take account of existing Board guidelines (e.g., on the duration of enhanced surveillance). The understanding reached in the case of Uruguay would represent an acceptable compromise where future Fund procedures are at issue. In essence, the Fund management would indicate general willingness to propose to the Board future procedures (such as a financial arrangement or enhanced surveillance) that are requested by the member and are consistent with Board guidelines. In turn, the commercial banks could include the existence of Fund involvement among the conditions precedent for specific financial decisions such as activation of an annual tranche of restructuring, but not as a direct event of default on the country's debt. 2/ In addition, as in the case

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1/ If any commercial bank disbursements are linked both to Fund arrangements and to the World Bank, less frequent intervals for linkage to the World Bank would also reduce the scope for operational problems.

2/ Incorporating member countries' relations with the Fund under financial arrangements or enhanced surveillance in the form of conditions precedent to commercial bank disbursements, or to annual tranches of rescheduling under a serial MYRA, rather than as direct events of default on the country's outstanding debt would help to avoid unrealistic conditions relating to Fund involvement over a long period since such conditions would not extend after new money disbursements have been completed or after the consolidation period of a rescheduling.

of Cote d'Ivoire, a telex chould be obtained from the banks indicating that the agreement does not prejudice the Executive Board's future freedom of action.

b. Agreements with commercial banks should acknowledge that the release of Fund staff reports outside the context of enhanced surveillance is not permitted at present, and should indicate that the member is not compelled to seek specific approval by the Executive Board.

c. Agreements should not inhibit a member's right or obligation to make early repurchases in the Fund; thus early repurchases should not trigger early repayment of a member country's bank debt.

d. While commercial bank disbursements may continue to be conditioned on purchases from the Fund (as is the general practice), provision should be included for an alternative certification by the Fund of economic performance if a purchase is not made because of the absence of balance of payments need.

3. Precommitment of other official financing

a. Member countries should be warned of the difficulties that may arise if they agree to clauses that seek to establish in advance the scale or terms of bilateral official financing, such as debt relief in the Paris Club or export credit commitments and disbursements.

b. Similar considerations arise with regard to the World Bank's future financial involvement in debtor countries; the World Bank has recently objected to the content of such clauses.

4. <u>Other issues concerning flexibility</u>

a. Member countries should be warned of the need for adequate grace periods to be set after dates for economic performance conditions to be met by the member, so that corrective actions can be taken without a waiver by banks being necessary.

b. Member countries should be warned that, where waivers are required, a qualified majority (for example, 66 2/3 percent) of the banks should apply, to avoid providing undue leverage to individual institutions.

Linkage of Commercial Bank Financing to World Bank Conditions

There has been considerable diversity in the types of linkage to World Bank activities that have been incorporated in commercial bank financing packages. In some cases the linkage has been broadly defined, with commercial banks requiring evidence of "progress" in negotiation or implementation of structural reforms. In other cases, the linkage to World Bank loans has been based on certification by the World Bank that debtor countries have borrowed a specified amount by a particular deadline. In some cases, all commercial bank disbursements under a new money package have been tied to performance under both Fund- and Bank-supported programs, while in other cases linkage to the World Bank applied to only one disbursement from a new money package.

In the new money agreement for Chile signed in November 1985, in addition to certification from the Fund, banks required a notification from the World Bank before each disbursement confirming that Chile's Structural Adjustment Loan (or "comparable facility") was in effect, and that Chile had drawn by specified dates the full amount expected to be available to it under the SAL.

In the new money agreement with Colombia of December 1985, all commercial bank disbursements were linked to the Fund, but one was also contingent on confirmation from the World Bank that Colombia would have access to the second tranche of a trade policy loan.

In 1985, commercial banks conditioned their restructuring and new money agreements with Costa Rica on the implementation of a World Bank SAL, as well as on a Fund program. Successive delays with implementation of the SAL and the Fund stand-by arrangement meant that the second disbursement of new bank money--expected originally in mid-1985--was made in November 1985.

For Cote d'Ivoire, some disbursements under a 1985 new money agreement were conditional on a statement by the Bank on the eligibility of the borrower for drawdowns under a SAL and indicative statements about future loans. The restructuring agreements for 1984 and 1985 maturities also contained refinancing conditions involving both the Fund and the World Bank. The World Bank condition was not met, as the 1985 SAL was not signed as expected, and banks waived that condition during 1985 in order to continue the refinancing.

In addition to conditions involving the Fund, the new money agreement with Panama for 1985-86 required certification from the World Bank regarding progress in negotiating and implementing a structural adjustment loan. The double linkage to the Fund and the Bank created difficulties in this case. Although the Fund program was on track, commercial banks did not make the first disbursement when it was scheduled, because adequate progress had not been made with the World Bank. Some months later, progress had been made with the World Bank, but Panama was no longer in compliance with the Fund program, and so the initial disbursement by commercial banks was again delayed.

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9/18/86
mmmex34

TO: The Bank Advisory Group for Mexico and the International Banking Community — September 15, 1986

FROM: J. de Larosière, Managing Director of the International Monetary Fund

I wish to inform you about the Mexican economic program and about actions taken by the Executive Board of the International Monetary Fund as regards financial support to Mexico. Action by the Executive Board of the International Monetary Fund on the program of Mexico has been accompanied by a similar decision on the part of the Executive Board of the World Bank as regards Mexico's program of structural reforms, about which the president of the Bank will inform you in greater detail.

The economic program adopted by the Mexican authorities late in 1982 and supported by an extended arrangement with the Fund brought about a marked turnaround in economic conditions in 1983 and 1984. Under this program, the overall public sector deficit was reduced by more than 10 percentage points of GDP from 1982 and 1984, inflationary pressures abated, and the balance of payments improved markedly; in addition, prospects for sustained economic growth were enhanced by the improvement in Mexico's competitiveness stemming from the adjustment of the exchange rate and a prudent wage policy. Economic performance began to falter in late 1984 and worsened in 1985, however, partly reflecting the weakening of the international petroleum market and the effects of the earthquakes that struck Mexico City a year ago, and partly reflecting slippages in domestic policy implementation.

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The sharp and rapid decline in oil prices that has occurred since the beginning of 1986 has exacerbated Mexico's difficulties. While the Mexican authorities had initially framed a budget for this year that aimed at correcting prevailing imbalances, the more than 50 percent drop of oil prices during the first half of 1986 had massive negative repercussions on the public sector financial position and the balance of payments, and thus dealt a severe blow to an already weakened economy. The authorities have tried to limit the pressure on prices and on the balance of payments by tightening credit to the private sector and by depreciating the currency in real terms. In the process, however, interest rates have moved up sharply, and interest payments on the public debt are now estimated to exceed 18 percent of GDP in 1986, up from some 12 percent of GDP in 1985.

In response to this difficult situation, the Government of Mexico has embarked on an economic and financial program designed to address the country's external and internal imbalances and put the economy back on a path of sustained growth. On September 8, 1986 the Executive Board of the Fund considered, on the basis of this program, Mexico's request for an 18-month stand-by arrangement amounting to SDR 1.4 billion. The arrangement was approved in principle, pending completion of the package to finance the program.

The Mexican program combines financial and structural policies designed to restore balance of payments viability, to help break the inflationary trend, to strengthen the savings performance of the economy, and to improve economic efficiency. A central component of the program is the strengthening of the public sector finances. Fiscal measures to be implemented over the period of the program are to yield the equivalent of 3 percentage points of GDP. These actions--which include tax increases, price and tariff adjustment, and spending curbs--are to be implemented in addition to the adjustment already in progress under the 1986 budget. The fiscal effort is to be accompanied by monetary and credit policies geared to the objective of reducing inflation and attaining the balance of payments targets, while making provision for a volume of credit to the private sector consistent with the growth objective of the program. In addition to the continued pursuit of a flexible exchange rate policy, the authorities have assigned an important role to policies aimed at improving resource allocation. Steps are being taken to increase the scope of market forces in interest rate determination, to realign prices and tariffs and raise efficiency in the operations of public enterprises, to liberalize the trade system, and to promote foreign direct investment. The World Bank is to play a central role in assisting the Mexican authorities in their efforts to implement the structural reforms.

The program seeks to strike a reasonable balance between financing and adjustment. Mexico's current account is projected to register a deficit of US$6.4 billion during the period 1986-87. In order to finance this current account deficit while permitting the replenishment of international reserves and certain net payments of public and private debt, the program calls for net official capital inflows of US$12.5 billion over the same two-year period. Of this

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amount, official sources (including the Fund) are to provide US$6.5 billion. Besides net drawings from the Fund amounting to US$1.3 billion, net disbursements of US$2.7 billion are envisaged from the World Bank and the IDB. Net borrowing from official bilateral sources amounting to US$2.5 billion includes balance of payments relief related to the rescheduling of debt service payments falling due during the program period as well as a continued flow of new credits for the financing of imports. This leaves a financing gap of US$6 billion for the period 1986-87 that would have to be covered by commercial banks.

12.5
net 1.3
MDBs 2.7
2.5
$6.5

I should add that the program contains two special mechanisms that are aimed at insulating performance under the program from further external shocks and allowing for some flexibility. In view of the unsettled conditions in the international petroleum market and of the vulnerability of Mexico's economy to changes in petroleum export receipts, some of the targets of the program and the structure and size of the financing package are related to the evolution of oil prices. A combination of additional foreign financing and adjustment is called for if the price of oil should fall below US$9 a barrel, and a reduction of financing is envisaged if the oil price should rise above US$14 a barrel. A second mechanism provides for additional foreign financing for certain investment projects--screened and reviewed by the World Bank--if the economic recovery fails to materialize despite the effective implementation of policies under the program.

As I have noted, the Executive Board of the International Monetary Fund has considered Mexico's request for a stand-by arrangement

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in support of this program. However, since the external financing package required to support the program has not been completed, the Executive Board decided to approve the arrangement in principle. Within the period until September 29, 1986, the arrangement will become effective when it is established that the program is fully financed. While the Executive Board of the World Bank has recently approved a major loan package for Mexico and creditor governments have just agreed to a rescheduling of part of debt service payments falling due over the period September 22, 1986-March 31, 1988, this assistance also depends upon the full cooperation of Mexico's commercial bank creditors. Hence, to ensure the early availability of financial support from the Fund and other sources, I would request written assurances from the international banking community by September 29, 1986, to confirm its participation in meeting Mexico's financing requirements for 1986 and 1987 as indicated above.

INTERNATIONAL MONETARY FUND

September 12, 1986

Mr. Finch:

I attach a summary of linkages in the draft financing principles for Mexico, prepared by Mr. Hansen.

Attachment

cc: Mr. Beza
Mr. Beveridge
Mr. Guitian

C. Maxwell Watson

Office Memorandum

Memorandum for Files

September 12, 1986

Subject: Mexico--Linkages in Proposed Bank Agreement

Only incomplete information on the proposed financial agreement between Mexico and commercial banks is available at the present time, but from the documentation which has been provided it seems that disbursements of new money and restructurings will be closely tied to financing provided from other sources including IMF, IBRD, IDB, Paris Club restructuring, and aggregate levels of new usage of bilateral credits. Covenants and events of default are not specified in detail, but seem to imply the same type of linkages as for conditions precedent.

New money will be provided under seven different categories, with the amounts in the different categories yet to be decided: (i) in parallel financing with the World Bank; (ii) in cofinancing with the World Bank; (iii) with a "put" option to the World Bank; 1/ (iv) loans convertible into equity; (v) in the form of an on-lending facility; (iv) in the form of petroleum indexed debt; and (vii) in other forms.

The type of linkage varies slightly from category to category. For the parallel financing the total amount will be divided into tranches for parallel disbursement with World Bank sectoral loans (five specified and one category "other"). Conditions for drawdown of such loans will include parallel disbursement by the World Bank under specific sectoral loans but also IMF purchases, multiyear Paris Club restructuring, actual aggregate levels of new usage of bilateral credits, implementation of program financed by World Bank structural adjustment loans, and several other references to World Bank loans.

For the cofinancing loans, the conditions for the drawdown of these B-loans will include, in addition to those mentioned for parallel financing, prior or simultaneous disbursement of World Bank A loans which are being cofinanced. Drawdown of A-loans is conditioned on there being no payment default or acceleration under any B-loan to Mexico. There is also mandatory sharing of principal and interest payments by the World Bank, and a mandatory World Bank cross default on the commercial bank B-loans.

As far as amendments to the restructuring agreements on existing debt are concerned, there seem to be similar linkages in the covenants and events of default as for new money. In addition, there is an amendment relating to linkages in the US$23.6 billion (1982-84 maturities) agreement. The conditions for the second tranche extension

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1/ In return for payments of the World Bank fee, the commercial banks will have the option to put any unpaid principal to the World Bank at the time of the scheduled final maturity under the facility.

date (now to be tested at end 1988 rather than at end 1987) have been amended to include IMF drawdowns (presumably under the new stand-by arrangement), World Bank drawdowns, Paris Club restructurings for the years 1986 - 19__, and levels of actual usage of bilateral credits.

It should be noted that in the remaining existing restructuring agreements (and perhaps also in the one referred to above although this is not specifically stated) the covenants have been revised to make purchases from the IMF refer to the new stand-by arrangement and the disbursement schedule under this arrangement. Also, the monitoring procedures (which no doubt refer to the enhanced surveillance by the Fund) have been revised to begin in 1988 and to end with the payment in full of 1983 and 1984 new money agreements and, in addition, new money extended in 1986-87. This would probably imply a later final date for the enhanced surveillance procedure.

Leif Hansen /LH
Senior Economist

INTERNATIONAL MONETARY FUND

September 5, 1986

To: Mr. Finch
Mr. Beveridge
Mr. Guitian (o/r)
Mr. Watson ✓

Attached please find a copy of the proposal on the terms of servicing outstanding loans and new financing that the Mexican authorities have submitted to commercial banks.

Luis Duran-Downing

LDD

August 28, 1986

UNITED MEXICAN STATES

CONCEPTUAL FRAMEWORK FOR A FOREIGN FINANCING STRATEGY: SERVICING OF OUTSTANDING LOANS FROM COMMERCIAL BANKS AND NEW COMMERCIAL BANK FINANCING

I. Introduction

In June of 1986, President Miguel de la Madrid launched an economic strategy the basic objective of which is to achieve sustained growth in a context of financial stability. This objective is reflected in the pathbreaking program agreed to by Mexico and the IMF in July, which encompasses appropriate aggregate demand management and structural reforms. The new program requires a new strategy for the external sector of the economy. The fundamental aspects of external trade, foreign investment and exchange rate policy were announced to the international banking community in the communication of July 24, 1986 from the Ministry of Finance.

The new external financing strategy is now being defined. As regards official creditors, substantial progress has been achieved as evidenced by the direct participation of the World Bank and the IMF in Mexico's 1986-1987 financing program and the forthcoming negotiations with the Paris Club. Mexico is now addressing the most important aspect of its foreign financing: the participation of commercial banks. Set forth below is a conceptual framework offered as a working proposal, together with illustrations of how the ideas embodied in the outline might be applied.

II. Basic Objectives

The underlying premise of the working proposal is that a successful external strategy must satisfy both the external financing requirements of the Mexican economy and the concerns of Mexico's bank creditors in light of the constraints to which they are subject. The basic objectives of the strategy are:

1. To meet Mexico's anticipated financial requirements for 1986 and 1987 within the framework of its IMF-supported economic program.

2. To achieve a more realistic matching of debt service requirements and Mexico's capacity to pay and, at the same time, to minimize the amounts of additional new money to be procured through separate negotiation over the medium term.

3. To protect the Mexican economy from oil price and interest rate shocks.

4. To achieve a longer-term solution to Mexico's debt problem that will foster the reestablishment of normal access to the financial markets.

III. Working Proposal

The framework for the working proposal consists of three parts that address, respectively, the cost of Mexico's previously rescheduled commercial bank debt and its 1983 and 1984 new money loans, the repayment profile of this debt and the means of financing Mexico's 1986 and 1987 new money requirements.

1. The elimination of spreads on previously rescheduled commercial bank debt and on the 1983 and 1984 new money loans, together with the substitution of cost-of-funds rates for the prime rate, would provide savings of more than U.S. $600 million per annum. These savings would in turn reduce future external financing requirements.

2. To meet the basic objectives outlined above, repayment of the principal of and interest on this existing debt would be based on constant present value payments adjusted to reflect changes in the relationship between oil prices and international interest rates. Table 1 illustrates a constant present value payments amortization scheme with an assumed repayment period of 25 years and varying interest rates. Under such a scheme, actual payments are constant if measured at present value, but grow in nominal terms over time. Table 2 illustrates the same scheme with the same assumptions, but the payments are adjusted to reflect variations in the relationship between oil prices and interest rates. The prices of oil and

interest rates shown in Table 2 for the years 1987-1991 are consistent with the assumptions contained in Mexico's medium-term economic program. For illustrative purposes, the table reflects an unfavorable relationship between oil prices and interest rates through the year 1997 and a more favorable relationship thereafter. The effect of the adjustments in Table 2 is to reduce payments in early years and to increase payments in later years in comparison to the payments stream shown in Table 1. This example reflects the symmetrical nature of the adjustment mechanism contemplated.

3. As regards new money for 1986 and 1987, the quality of the banks' asset would be enhanced if a portion of this new money were used to purchase a zero coupon bond issued by the World Bank and pledged to secure repayment of the principal of the new money. The zero coupon bond would have a value at maturity equal to the total amount of new money borrowed. From the banks' point of view, the risk of principal repayment would not be a Mexican portfolio risk, but a World Bank risk. From the Mexican point of view, defeasance of the additional debt from the outset would improve expectations as to Mexico's economic future.

IV. Conclusion

This working proposal is meant to constitute an integral and flexible approach to the questions of debt management and new money. It is intended to provide a basis for constructive discussion, and its essential features have been presented to the Bank Advisory Group for Mexico. Mexico's agreed letter of intent addressed to the International Monetary Fund on July 22, 1986 (and distributed to Mexico's commercial bank creditors) references two contingent financing schemes related to the behavior of oil prices through the end of 1987 and the recovery of Mexico's economy in 1987. The precise mechanism by which these schemes are to be implemented and their relationship to the other elements of Mexico's 1986-1987 commercial bank financing program are in the process of definition.

TABLE 1

25-YEAR AMORTIZATION SCHEME WITH CONSTANT PRESENT VALUE PAYMENTS

YEAR	INTEREST RATE	PRINCIPAL BALANCE[1]	REFERENCE PAYMENT[2]	ACTUAL PAYMENT[3]	PRINCIPAL ADJUSTMENT[4]
1987	7.00	52460.00	3672.20	2245.29	1426.91
1988	7.00	53886.91	3772.08	2402.46	1369.63
1989	7.00	55256.54	3867.96	2570.63	1297.33
1990	7.00	56553.87	3958.77	2750.57	1208.20
1991	7.00	57762.06	4043.34	2943.11	1100.23
1992	8.00	58862.29	4708.98	3178.56	1530.42
1993	8.00	60392.71	4831.42	3432.85	1398.57
1994	9.00	61791.28	5561.22	3741.81	1819.41
1995	9.00	63610.69	5724.96	4078.57	1646.39
1996	10.00	65257.08	6525.71	4486.42	2039.28
1997	10.00	67296.37	6729.64	4935.07	1794.57
1998	9.00	69090.94	6218.18	5379.22	838.96
1999	9.00	69929.90	6293.69	5863.35	430.34
2000	8.00	70360.24	5628.82	6332.42	-703.60
2001	8.00	69656.63	5572.53	6839.01	-1266.48
2002	7.00	68390.15	4787.31	7317.75	-2530.44
2003	7.00	65859.71	4610.18	7829.99	-3219.81
2004	7.00	62639.91	4384.79	8378.09	-3993.29
2005	7.00	58646.61	4105.26	8964.55	-4859.29
2006	7.00	53787.32	3765.11	9592.07	-5826.96
2007	7.00	47960.36	3357.23	10263.52	-6906.29
2008	7.00	41054.07	2873.78	10981.96	-8108.18
2009	7.00	32945.89	2306.21	11750.70	-9444.49
2010	7.00	23501.40	1645.10	12573.25	-10928.15
2011	7.00	12573.25	880.13	13453.38	-12573.25
	7.72		109824.61	162284.61	-52460.00

1. Principal Balance from preceding period plus Principal Adjustment from preceding period

2. Inter[illegible] on Principal Balance

3. Constant present value payment: Principal Balance at beginning of each year divided by remaining number of years and multiplied by 1 plus interest rate for such year

[illegible]. Reference Payment minus Actual Paymen

TABLE 2

25-YEAR AMORTIZATION SCHEME WITH ADJUSTED CONSTANT PRESENT VALUE PAYMENTS

YEAR	OIL PRICE US $	INTEREST RATE	PRINCIPAL BALANCE [1]	REFERENCE PAYMENT [2]	ACTUAL PAYMENT [3]	PRINCIPAL ADJUSTMENT [4]
1987	11.00	7.00	52460.00	3672.20	1411.32	2260.88
1988	11.40	7.00	54720.88	3830.46	1565.03	2265.43
1989	11.90	7.00	56986.31	3989.04	1748.03	2241.01
1990	12.40	7.00	59227.32	4145.91	1948.98	2196.93
1991	12.90	7.00	61424.25	4299.70	2169.50	2130.20
1992	14.00	8.00	63554.46	5084.36	2224.99	2859.36
1993	16.00	8.00	66413.82	5313.11	2746.28	2566.83
1994	18.00	9.00	68980.64	6208.26	2993.44	3214.81
1995	20.00	9.00	72195.46	6497.59	3625.39	2872.20
1996	22.00	10.00	75067.66	7506.77	3948.05	3558.71
1997	24.00	10.00	78626.37	7862.64	4737.66	3124.97
1998	26.00	9.00	81751.34	7357.62	6215.99	1141.63
1999	30.00	9.00	82892.97	7460.37	7817.80	-357.44
2000	30.00	8.00	82535.53	6602.84	9498.63	-2895.79
2001	30.00	8.00	79639.75	6371.18	10258.52	-3887.34
2002	30.00	7.00	75752.40	5302.67	12544.71	-7242.04
2003	30.00	7.00	68510.36	4795.73	13422.84	-8627.11
2004	30.00	7.00	59883.25	4191.83	14362.44	-10170.61
2005	30.00	7.00	49712.64	3479.89	15367.81	-11887.92
2006	30.00	7.00	37824.72	2647.73	16443.55	-13795.82
2007	30.00	7.00	24028.90	1682.02	17594.60	-15912.58
2008	30.00	7.00	8116.32	568.14	8684.47	-8116.32
2009	30.00	7.00	0.00	0.00	0.00	0.00
2010	30.00	7.00	0.00	0.00	0.00	0.00
2011	30.00	7.00	0.00	0.00	0.00	0.00
	23.58	7.72		108870.04	161330.04	-52460.00

1. Principal Balance from preceding period plus Principal Adjustment for preceding period

2. Interest on Principal Balance

3. Constant present value payment as shown in Table 1 adjusted to reflect relationship between oil prices and interest rates

4. Reference Payment minus Actual Payment

Files + C—

BANK FOR INTERNATIONAL SETTLEMENTS

Press Review

(Internal Document)

No. 169

Basle, 28th August 1986

BIS announces contingency support for Mexico BIS PRESS COMMUNIQUE, 27/8/86.

The BIS announces that, with the support of the central banks of the following Group of 10 countries - Belgium, Canada, Federal Republic of Germany, France, Italy, Japan, Netherlands, Sweden, Switzerland and the United Kingdom - and of Spain, it has agreed to grant the Banco de Mexico a credit facility of US$ 400 million. This is part of the near-term contingency support for Mexico's international reserves, of which US$ 1,100 million is being made available to the Banco de Mexico by the US monetary authorities, the central banks of Argentina, Brazil, Colombia and Uruguay and the BIS. The whole facility is granted in the light of the agreement between the United Mexican States and the managements of the IMF and World Bank on a growth-oriented economic programme, and is intended to bridge disbursements from both institutions.

Reserve Bank of Australia reviews domestic and international supervision of banks RESERVE BANK OF AUSTRALIA, REPORT AND FINANCIAL STATEMENTS, 30/6/86.

Background

Prudential supervision in Australia is based broadly on institutional rather than functional lines. The Reserve Bank is responsible for the supervision of banks authorised under the Banking Act and also has the co-operation of the State banks on prudential matters. Formal responsibility for the supervision of non-banks rests with other Commonwealth or State authorities. This demarcation in supervisory responsibilities is mainly a historical development reflecting the different characteristics of banks and non-banks; despite some blurring of these characteristics in recent years, banks continue to have a special status and position in the community.

Work of the Bank's Supervision Unit in 1985/86 included: the lead-up to the authorisation of new banks; further development of the supervisory framework in relation to bank liquidity, large commitments and off-balance sheet activities; the establishment of links with external auditors of banks; and regular consultations with individual banks on their domestic and overseas operations.

Approach to supervision

The broad principles of the Bank's approach to supervision were set out in a paper published in February 1985 entitled "Prudential Supervision of Banks". Deregulation of the financial system and international precedents have led to rapid expansion and innovation by banks; with more banks now operating, banking business has become more complex and competitive and potentially riskier. In this environment, the Bank has encouraged the banks — with whom prime responsibility for their stability lies — to maintain high prudential standards, and has itself moved towards somewhat greater formality in supervision. One step was the inclusion by the Government of conditions in all new banking authorities requiring new banks to consult with the Reserve Bank on prudential matters and to operate within prudential standards determined by the Bank.

Continuing supervision

Supervision of individual banks continues to be based on assessment of the adequacy of management systems for controlling exposures and limiting risk, on the observance of standards relating to levels of capital and holdings of prime assets, and on analyses of statistical returns and other information covering aspects of banks' global banking operations. There is a formal consultation with each bank at least once a year about its operations. Matters covered include corporate strategy, capital adequacy, earnings, the quality of assets, risk exposures both on and off-balance sheet, and management and control systems. The Bank may initiate discussions with a bank at other times as matters of interest arise. Banks are also encouraged to consult the Reserve Bank in advance in respect of new activities.

The international operations of Australian banks continued to grow faster than their domestic operations during the year. However, the rate of

IMF OFFICIAL MESSAGE

WASHINGTON, D. C. 20431

cc: Mr Aurora, Cummings
Mr Watson

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MR. A. LAMFALUSSY
BANK FOR INTERNATIONAL SETTLEMENTS
BASLE, SWITZERLAND

DISPATCHED IMF
1986 AUG 20 AM 12: 17

1) Mr Beveridge
2) Mr Ugarthan o/r

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MR. PEREZ
MR. ORTIZ
ETR
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MR. BROWN

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I WOULD LIKE TO TAKE THIS OPPORTUNITY TO THANK YOU FOR YOUR VALUABLE EFFORTS IN ASSEMBLING THE FINANCING PACKAGE FOR MEXICO, AND WISH TO BRING YOU UP TO DATE ON DEVELOPMENTS.

YOU ARE FAMILIAR WITH THE ARRANGEMENTS THAT HAVE BEEN MADE ON THE OFFICIAL PORTION OF THE FACILITY FOR NEAR-TERM CONTINGENCY SUPPORT FOR MEXICO'S INTERNATIONAL RESERVES. WITH REGARD TO THE COMMERCIAL BANKS, A TELEX WAS SENT ON AUGUST 18, 1986 TO THOSE BANKS THAT HAVE BEEN REQUESTED TO PARTICIPATE IN THAT FACILITY. THAT TELEX CONTAINED COMMUNICATIONS FROM THE MINISTER OF FINANCE AND PUBLIC CREDIT, THE MANAGING DIRECTOR OF THE FUND, AND THE BANK ADVISORY GROUP FOR MEXICO ASKING CONFIRMATION OF THE BANKS' PARTICIPATION. IN HIS TELEX TO THE BANKS, THE MANAGING DIRECTOR STATED THAT IT IS IMPORTANT THAT THE BANK PORTION OF THE CONTINGENCY SUPPORT FACILITY IN THE AMOUNT OF US DOLLARS 500 MILLION BE PUT IN PLACE WITHOUT DELAY.

IF REQUIRED INITIAL BELOW

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TELEX NO.:

DRAFTED BY NAME (TYPE): S. T. BEZA — EXT.: 8631 — DEPT.: WHD — DATE: 08-19-86

AUTHORIZED BY NAME (TYPE): ACTING MANAGING DIRECTOR

AUTHORIZED BY NAME (TYPE):

TYPE ** ON LAST OR ONLY PAGE OF MESSAGE

Log B7852

SEC. 48 REV 1 11-18-82

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WASHINGTON, D. C. 20431

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I WOULD ALSO LIKE TO INFORM YOU THAT THE BANK ADVISORY COMMITTEE AND REPRESENTATIVES OF MEXICO HAVE COMMENCED DISCUSSIONS ON THE LONGER-TERM COMMERCIAL BANK FINANCING PACKAGE FOR 1986-87.

WITH REGARD TO THE FUND'S WORK ON MEXICO, WE HAVE SCHEDULED A MEETING OF EXECUTIVE DIRECTORS FOR SEPTEMBER 8, 1986 AT WHICH TIME MY PROPOSAL TO APPROVE MEXICO'S REQUEST FOR A STAND-BY ARRANGEMENT WILL BE CONSIDERED. THE STAFF REPORT RELATING TO MEXICO'S REQUEST WAS CIRCULATED TO EXECUTIVE DIRECTORS LAST WEEK.

SINCERELY YOURS,

RICHARD D. ERB

ACTING MANAGING DIRECTOR

INTERFUND

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WASHINGTON, D. C. 20431

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Mr. Walton

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MR. A. MUDGE
SHEARMAN & STERLING
CITICORP CENTER
153 EAST 53RD STREET
NEW YORK, NEW YORK

DISPATCHED IMF
1986 AUG 18 PM 4:47

1) Mr. Beveridge
2) Mr. Gaitan o/r

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QUOTE

TO: THE BANKS REQUESTED TO PARTICIPATE IN THE FACILITY TO PROVIDE NEAR-TERM CONTINGENCY SUPPORT FOR MEXICO'S INTERNATIONAL RESERVES

FROM: J. DE LAROSIERE, MANAGING DIRECTOR, INTERNATIONAL MONETARY FUND

DATE: AUGUST 18, 1986

I AM PLEASED TO CONFIRM THAT THE MANAGEMENT OF THE FUND HAS REACHED AGREEMENT WITH THE MEXICAN AUTHORITIES ON AN ECONOMIC PROGRAM IN SUPPORT OF WHICH MEXICO HAS REQUESTED A STAND-BY ARRANGEMENT FROM THE FUND IN THE AMOUNT OF SDR 1,400 MILLION. THE LETTER OF INTENT FROM THE MEXICAN AUTHORITIES REQUESTING THE STAND-BY ARRANGEMENT DESCRIBES THE FINANCIAL AND STRUCTURAL POLICIES THAT ARE BEING PURSUED IN ORDER TO CREATE THE CONDITIONS FOR SUSTAINED GROWTH OF THE MEXICAN ECONOMY IN THE CONTEXT OF FINANCIAL STABILITY. MEXICO AND THE WORLD

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DRAFTED BY NAME (TYPE): ~~S. T.~~ BEZA EXT.: 8631 DEPT.: WHD DATE: 8|18|86

AUTHORIZED BY NAME (TYPE): THE ACTING MANAGING DIRECTOR

AUTHORIZED BY NAME (TYPE):

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BANK ALSO HAVE BEEN DEVELOPING THE FRAMEWORK FOR WORLD BANK SUPPORT OF MEXICO'S STRUCTURAL REFORMS.

WORK IS NOW PROCEEDING IN BOTH OFFICIAL AND PRIVATE CIRCLES ON THE FINANCING PACKAGE THAT IS NECESSARY TO BACK MEXICO'S ADJUSTMENT EFFORT. WHILE THE FINANCING PACKAGE IS BEING DEVELOPED, ARRANGEMENTS NEED TO BE MADE TO ENABLE MEXICO TO COVER ITS LIQUIDITY REQUIREMENTS IN THE INTERIM PERIOD. OUR EXAMINATION OF THE COUNTRY'S EXTERNAL FINANCING PROSPECTS IN THE NEXT SEVERAL MONTHS INDICATES THAT A FACILITY OF U.S. DOLLAR 1.6 BILLION IS NEEDED TO PROVIDE NEAR-TERM CONTINGENCY SUPPORT FOR MEXICO'S INTERNATIONAL RESERVES.

IN VIEW OF THE IMPORTANCE OF MEXICO'S IMPLEMENTING ITS ADJUSTMENT EFFORT IN A CLIMATE OF CONFIDENCE AND WITH ORDERLY PAYMENT PROCEDURES, IT IS APPROPRIATE THAT BOTH THE OFFICIAL COMMUNITY AND THE COMMERCIAL BANKS PARTICIPATE IN THIS FACILITY. THE OFFICIAL PORTION OF U.S. DOLLAR 1.1 BILLION IS IN PLACE, AND IT IS IMPORTANT

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NEW YORK, NEW YORK

THAT THE COMMERCIAL BANK PORTION OF THE FACILITY FOR
CONTINGENCY SUPPORT IN THE AMOUNT OF U.S. DOLLAR 500
MILLION ALSO BE PUT IN PLACE WITHOUT DELAY.

REGARDS,

J. DE LAROSIERE

MANAGING DIRECTOR

INTERNATIONAL MONETARY FUND

UNQUOTE

RICHARD D. ERB

ACTING MANAGING DIRECTOR

INTERFUND

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WASHINGTON, D. C. 20431

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cc: Mr. Duran Downing
Mr. Wanner

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MR. A. LAMFALUSSY
BANK FOR INTERNATIONAL SETTLEMENTS
BASLE, SWITZERLAND

DISPATCHED IMF
1986 AUG 14 PM 9 00

1. Mr. Beaudry
2. Mr. Guitian o/r

MEXICO

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MR. PEREZ/
MR. ORTIZ
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MR. BROWN

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THIS IN REFERENCE TO YOUR TELEX OF AUGUST 12, 1986.

WITH REGARD TO THE ACTIVITIES OF THE COMMERCIAL BANKS, THE ADVISORY COMMITTEE IS WELL ADVANCED IN ITS WORK ON THE FACILITY FOR CONTINGENCY SUPPORT. ALSO, ON THE BASIS OF MEETINGS WITH MEXICAN OFFICIALS AND WITH THE STAFF OF THE FUND AND THE WORLD BANK, THE ECONOMIC SUBCOMMITTEE OF THE ADVISORY COMMITTEE OF BANKS IS IN THE PROCESS OF PREPARING ITS REPORT TO THE ADVISORY COMMITTEE ON BOTH THE ECONOMIC PROGRAM AND THE FINANCING PACKAGE. THIS PREPARATORY WORK SHOULD BE COMPLETED SHORTLY, AND THE ADVISORY COMMITTEE AND REPRESENTATIVES OF MEXICO ARE EXPECTED TO MEET IN THE NEXT FEW DAYS TO BEGIN WORK ON THE TERMS OF THE NEW MONEY FINANCING FROM COMMERCIAL BANKS.

WITH REGARD TO THE FUND'S WORK ON MEXICO, WE ARE CONTINUING TO PLAN ON THE BASIS OF A MEETING OF EXECUTIVE DIRECTORS ON SEPTEMBER 5, 1986 TO CONSIDER MEXICO'S REQUEST FOR A STAND-BY ARRANGEMENT. I MIGHT NOTE THAT THE STAFF REPORT RELATING TO THAT REQUEST IS TO BE CIRCULATED

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C TELEX NO.:

D DRAFTED BY NAME (TYPE): S. T. BEZA EXT.: 3631 DEPT.: WHD DATE: 08-14-86

AUTHORIZED BY NAME (TYPE): The Acting Managing Director AUTHORIZED BY NAME (TYPE): (**)

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TO EXECUTIVE DIRECTORS TODAY.

SINCERELY YOURS,

RICHARD D. ERB

ACTING MANAGING DIRECTOR

INTERFUND

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C TELEX NO.:

D DRAFTED BY NAME (TYPE): S. T. BEZA EXT.: 8631 DEPT.: WHD DATE: 08-14-86

AUTHORIZED BY NAME (TYPE): The Acting Managing Director AUTHORIZED BY NAME (TYPE): (**)

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INTERNATIONAL MONETARY FUND

August 13, 1986

Mr. Finch:

The attached memorandum, prepared during my absence by Mr. Kronenberg, makes some worthwhile points about the IBRD's trade policy loan to Mexico.

Att.

Shailendra J. Anjaria

Office Memorandum

mr

To : Mr. Duran-Downing July 14, 1986

From : R. Kronenberg RK

Subject: Mexico: IBRD Trade Policy Loan

The TPL negotiations were obviously protracted and difficult; the Bank staff agreed to certain concessions with great reluctance, taking into account Mexico's parallel negotiations for accession to the GATT. Nevertheless, the final package is disappointing, particularly in view of the Bank staff's contention that many of Mexico's present difficulties were caused by inadequate trade liberalization earlier in the decade.

1. A primary objective of the program is to increase Mexico's exposure to external competition by replacing quantitative restrictions with an appropriate tariff structure. The Government's refusal to establish QR targets pending the outcome of the GATT negotiations provides little assurance that adequate progress will be achieved toward this end. Arguments for excluding agriculture (very broadly defined) because it "could be the subject" of a separate sector loan are unconvincing.

2. The program's present formulation does not present a convincing case for gradualism of the degree proposed. The authorities contend that gradualism is necessary "to reduce the uncertainty caused by sudden changes and to grant industry enough time to make the adjustments needed to adapt to the new condition of openness to international competition" (Annex IV, p.7). Absent a preannounced, product-specific liberalization schedule, it is difficult to see how the gradual approach will achieve the desired results. The authorities' concern that a sudden opening to foreign competition will discourage investment also seems misplaced; if anything, their fear should be that gradualism, without an announced, product-specific liberalization schedule, will result in further wasteful investment, perpetuating political pressures against future liberalization.

3. Given that the thrust of the program has shifted to the tariff side, the progress planned in this area seems unduly slow. The ability to offset tariff reductions with tariff surcharges is worrisome, despite their "temporary" nature. Does the Bank have a clear idea of how extensively these surcharges will be used, and for how long? Why should two and a half years be required to reduce the number of tariff rates by three?

4. In 1985, export controls applied to 44 percent of non-oil exports. The program's failure to address this issue seems inconsistent with its goal of reducing the bias against exports.

5. While one of the loan's stated objectives is to reduce dependence on subsidies (paragraph 92), little is said about export subsidies and their adverse effects on production efficiency.

6. Table VIII.8 indicates that, between July and December 1985, the sectoral dispersion of effective rates of protection increased sharply. What factors were responsible for this development?

7. The project description indicates that the loan would finance part of the additional imports from the removal of NTBs. Since less progress is being achieved in this area than originally intended, is the full amount of the loan still justified?

cc: Mr. Anjaria (o/r)

cc Mr. [illegible] Mr. Watson

MEXICO

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CC: MD
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MR. DALLARA
MR. P. PEREZ
ETR
LEG
MR. R. BROWN

cc Mr. Guitian

P O S S I B L E   D U P L I C A T E

DATE : 13.08.1986

TO : INTERNATIONAL MONETARY FUND
WASHINGTON D.C.
FROM : BANK FOR INTERNATIONAL SETTLEMENTS - BASEL

0272
OUR REFERENCE : BIZ 03556

MR. RICHARD D. ERB, DEPUTY MANAGING DIRECTOR

PLEASE FIND BELOW THE TEXT OF A MESSAGE WHICH A HAVE TODAY SENT TO MR. PAUL VOLCKER AT THE FEDERAL RESERVE BOARD IN WASHINGTON:

Q U O T E
IT IS MORE THAN THREE WEEKS SINCE THE MANAGING DIRECTOR OF THE IMF SENT HIS MESSAGE TO MINISTERS AND GOVERNORS OF THE G-10 AND SPAIN ASKING WHETHER THEY WOULD CONSIDER PARTICIPATING IN A BRIDGING CREDIT FOR MEXICO TO HELP MAINTAIN THAT COUNTRY'S RESERVES AT A SUFFICIENT LEVEL AND GENERALLY TO SUPPORT ITS ECONOMIC PROGRAMME, WHILE BOTH THE FUND AND THE WORLD BANK WERE WORKING OUT THE NECESSARY FINANCING PACKAGE. DURING THIS TIME WE HAVE, FOLLOWING POSITIVE IF SOMETIMES CAUTIOUS RESPONSES FROM ALL ELEVEN CENTRAL BANKS, BEEN WORKING CLOSELY WITH THE FEDERAL RESERVE ON THE DETAILS OF POSSIBLE ARRANGEMENTS. LAST WEEK WE WERE ABLE TO SEND PRELIMINARY DRAFTS OF THESE VERY COMPLEX PROPOSALS TO THE CENTRAL BANKS FOR THEIR INFORMATION AND CONSIDERATION. WE HAVE NOT, HOWEVER, HAD ANY DIRECT CONTACT WITH THE BANK OF MEXICO.

THIS MORNING WE READ NEWS AGENCY REPORTS OF A STATEMENT BY MEXICO'S FINANCE MINISTER TO THE EFFECT THAT WHAT HE IS SEEKING IS NOT SO MUCH A SHORT-TERM FACILITY, BRIDGING THE TIME GAP BEFORE DISBURSEMENTS BY THE IMF AND THE WORLD BANK ARE LIKELY TO OCCUR, BUT A STANDBY FACILITY FOR 18 MONTHS WITH THE REPAYMENT OF DRAWINGS NOT SPECIFICALLY LINKED TO ANY IDENTIFIABLE NEW RESOURCES.

IF WHAT WE READ IS TRUE, AND IT IS NOT INCONSISTENT WITH SOME OF THE MOST RECENT INDICATIONS WE HAVE HAD IN EXCHANGES WITH YOUR STAFF, IT SEEMS TO ME THAT THE WHOLE FOUNDATION ON WHICH LE??T?? EEN TRYING TO BUILD

INCOMING CABLE/TELEX

OUR AGREEMENT IS NO LONGER IN PLACE. I DO NOT FEEL THAT THE BIS HAS ANY MANDATE FROM THE GOVERNORS TO NEGOTIATE ANX?G?G OTHER THAN A SHORT-TERM BRIDGING FACILITY DESIGNED TO PRE-FINANCE PROBABLE MEXICAN DRAWINGS ON THE FUND AND SOME WORLD BANK LOAN DISBURSEMENTS AND I DO NOT THINK THAT WE SHOULD GO BEYOND THESE TERMS OF REFERENCE WITHOUT A NEW MANDATE FROM THE CENTRAL BANKS, WHO IN TURN MIGHT WELL EXPECT SOME EXPLANATION AS TO WHY AND IN WHAT WAY THE NATURE OF THE FINANCING MENTIONED IN THE MANAGING DIRECTOR'S TELEX OF 20TH JULY HAS CHANGED.

I AM SENDING A COPY OF THIS MESSAGE TO ALL ELEVEN GOVERNORS AS WELL AS TO THE MANAGING DIRECTOR OF THE IMF. I AWAIT YOUR COMMENTS WITH INTEREST.
U N Q U O T E

REGARDS
A. LAMFALUSSY
GENERAL MANAGER

INTERBANK

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Connect Time : 654 seconds

INCOMING CABLE/TELEX

cc. Mr. Duran-Downing
Mr. Watson

SPECIAL DELIVERY CABLE

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CC: MD
DMD
MR. DALLARA
MR. P. PEREZ
MR. R. BROWN

962487 BIZ CH

INCOMING CABLE/TELEX

DATE : 12.08.1986

TO : INTERNATIONAL MONETARY FUND
WASHINGTON D.C.
FROM : BANK FOR INTERNATIONAL SETTLEMENTS - BASEL

OUR REFERENCE : BIZ 07173

MR. RICHARD D. ERB
DEPUTY MANAGING DIRECTOR

REFERENCE YOUR MANAGING DIRECTOR'S TELEX OF 20TH JULY AND MINE OF 22ND JULY PROMISING TO KEEP HIM INFORMED ABOUT PROGRESS ON OUR SIDE CONCERNING A POSSIBLE BRIDGING FACILITY FOR MEXICO.

WE UNDERSTAND FROM THE CONTACTS WE HAVE HAD WITH THE CENTRAL BANKS OF THE G-10 COUNTRIES AND SPAIN THAT YOU HAVE RECEIVED A FAVOURABLE RESPONSE TO YOUR REQUEST CONCERNING A BRIDGING FACILITY IN FAVOUR OF THE BANCO DE MEXICO. ALL THE CENTRAL BANKS IN QUESTION, WITH THE EXCEPTION OF THE FEDERAL RESERVE, HAVE EXPRESSED THE WISH TO ACT THROUGH THE BIS.

WE HAVE ALREADY MADE CONSIDERABLE PROGRESS WITH THE PAPERWORK BUT HAVE NOT YET ASKED FOR ANY FORMAL COMMITMENT FROM THE CENTRAL BANKS. I WOULD NOT BE ABLE TO ASK FOR ANY SUCH COMMITMENT UNLESS I CAN AT THE SAME TIME ENLIGHTEN THEM ON TWO MATTERS TO WHICH THEY ATTACH GREAT IMPORTANCE.

THE FIRST OF THESE MATTERS CONCERNS THE STATE OF PROGRESS OF NEGOTIATIONS WITH THE CREDITOR BANKS REGARDING SUPPORT BY THE COMMERCIAL BANKS FOR THE TOTAL FINANCING PACKAGE AS WELL AS FOR THE BRIDGING OPERATION. THE SECOND, WHICH IS LINKED TO THE FIRST, IS THE DEGREE OF PROBABILITY OF THE IMF BOARD APPROVING THE STANDBY FACILITY FOR MEXICO IN EARLY SEPTEMBER. COULD I HAVE YOUR VIEWS ON THESE TWO MATTERS?

REGARDS.
A. LAMFALUSSY

INTERBANK

cc. Mr. Watson cc. Mr Duran Downing

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FROM: SWISS BANK CORPORATION
GENERAL MANAGEMENT
BASEL

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INTERNATIONAL MONETARY FUND
WASHINGTON, D.C.

ATTENTION: MR. JACQUES DE LAROSIERE, CHAIRMAN OF THE EXECUTIVE BOARD AND MANAGING DIRECTOR

I HAVE SENT TODAY THE FOLLOWING TELEX TO:

CITIBANK N.Y.
NEW YORK

ATTENTION: MR. WILLIAM RHODES, CHAIRMAN ADVISORY GROUP MEXICO

BASLE, AUGUST 11, 1986 FL/DR EA

MEXICO - STAND-BY CREDIT 1986

SWISS BANK CORPORATION HAD DECIDED TO WITHDRAW ITS PROPOSAL TO OFFER THE BANKS PARTICIPATING IN THE STAND-BY CREDIT THE OPTION TO MAKE THEIR CONTRIBUTION OF THE FORM OF A TEMPORARY INTEREST DEFERRAL RATHER THAN THROUGH CASH. WE RECOGNIZE TWO COMPELLING CONSTRAINTS: THE LIMITED TIME AVAILABLE FOR THE IMPLEMENTATION OF THE SCHEME AND LEGAL OBSTACLES RELATED TO CERTAIN CLAUSES IN THE IMF ARTICLES OF AGREEMENT.

OUR CONCLUSION IS BASED ON THE UNDERSTANDING, CONFIRMED BY YOU AND PRACTICALLY

INCOMING CABLE/TELEX

ALL MEMBERS OF THE ADVISORY GROUP, THAT THE PROPOSED SCHEME WILL BE DISCUSSED IN CONNECTION WITH THE PREPARATION OF THE 1986/87 REFINANCING PACKAGE FOR MEXICO.

I DO NOT HIDE FROM YOU THAT THE DEVELOPMENT OF THE MEXICAN RESTRUCTURING NEGOTIATIONS IS A SOURCE OF GREAT CONCERN TO US. ONCE AGAIN THE BANKS ARE EXPECTED TO CONTRIBUTE LARGE AMOUNTS OF NEW MONEY INVOLUNTARILY, BASED ON PARTLY UNRELIABLE MEXICAN DATA, AND WIHTOUT ENOUGH TIME TO DISCUSS PRESSING AND FUNDAMENTAL PROBLEMS RELATED TO THE NEW SERIES OF DEBT RESTRUCTURING NEGOTIATIONS IN LATIN AMERICA AND ELSEWHERE. WE PERCEIVE A GROWING UNEASINESS ON THE PART OF BANK DEPOSITORS AND SHAREHOLDERS EVERYWHERE OVER THE CONTINUING FORCED ADDITION TO BANK ASSETS WHICH ARE PERFORMING ONLY IN THEORY. THESE PROBLEMS PRESENT A GROWING THREAT TO THE INTERNATIONAL BANKING SYSTEM AND SHOULD BE ADDRESSED ON A GLOBAL SCALE AND WITHOUT DELAY.

WITH BEST REGARDS,

FRANZ LUTOLF
SWISS BANK CORPORATION

CC: TO BANK OF AMERICA NT AND SA, SAN FRANCISCO
BANK OF MONTREAL, MONTREAL
THE BANK OF TOKYO, LTD., TOKYO
BANKERS TRUST COMPANY, NEW YORK
THE CHASE MANHATTAN BANK, N.Y., NEW YORK
CHEMICAL BANK, NEW YORK
CITIBANK N.A., NEW YORK
DEUTSCHE BANK AG, FRANKFURT
LLOYDS BANK PLC, LONDON
MANUFACTURERS HANOVER TRUST COMPANY, NEW YORK
MORGAN GUARANTY TRUST COMPANY OF NEW YORK, NEW YORK
SOCIETE GENERALE, PARIS

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WITHDRAWAL NOTICE

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Department/Division/ Collection:	Exchange and Trade Relations Department Records/fonds/1946-1995
Series/Subseries:	ETRIC Country Debt Files/series/ 1978-1992
Box number:	A65753-005
File number:	1
ADLIB ref. number:	66014
File title & dates:	Mexico Debt File, January - September, 1986
Doc. title & dates:	Memorandum from Shearman & Sterling to Mr. Beza on the term sheet for the bridge financing, August 11, 1986
Doc. Classification:	Confidential

File

Office Memorandum

To: Mr. Finch

August 6, 1986

From: C.M. Watson CMW

Subject: Mexico--Securing Support from Commercial Banks

The Management asked that thought be given to modalities for securing participation in the Mexican financing package of banks with medium and small exposures. The attached draft seeks to bring out some of the difficult issues that arise in designing an instrument for this purpose. Perhaps it would be useful to have a meeting within the Department at which the issues raised here could be discussed, with a view to preparing a memorandum to Management.

Attachment

cc: Mr. Beveridge
Mr. Guitian
Mr. Boorman
Mr. Brau
Ms. Dillon

Mexico--Securing Support From Commercial Banks

1. Introduction

The 1983 and 1984 new money packages for Mexico were arranged by means of an equiproportional increase in exposure by virtually all of Mexico's creditor banks. Banks' contributions were based on their total exposure to Mexico in August 1982, including loans to the Mexican private sector, interbank exposure, and trade financing. Since the 1982 base date, many commercial banks have made substantial provisions against their exposure to Mexico, and some banks have disposed of their medium term loan claims. Some private sector debt has been repaid through FICORCA, and the pattern of holding of trade claims against Mexico has no doubt evolved considerably. 1/

Because of these changes in bank exposure, the 1982 base date has become somewhat artificial. In light of these developments, a new money package endorsed by the Advisory Committee and acceptable to other major creditor banks may fail to command sufficient support from banks with medium and small exposures. This memorandum raises for discussion issues concerning alternative instruments for banks with medium and small exposures.

1/ Interbank exposure has been largely maintained through the formal interbank facility. Exposure to Pemex may also have been maintained through the acceptance facility, although the shrinkage in oil earnings has resulted periodically in regulatory difficulties relating to this facility.

2. Design of an instrument for banks
unwilling to provide new money

In the circumstances envisaged above, the creditor group can be divided into four categories:

-- Banks assenting to the new money package
-- Banks prepared to provide relief through some modality such as interest capitalization, but unwilling to participate in the form of new money
-- Banks currently receiving interest but not prepared to participate in burden sharing of any kind
-- Banks who no longer hold claims on Mexico.

In the event of difficulties in securing support, the question arises whether a form of claim could be designed to facilitate their participation in burden sharing of banks in the second category above. (Such an instrument could possibly also be used to compel participation by banks in the third category.) Alternative options have been requested by some banks in the past. Usually, their preference has been for an option to reschedule ("capitalize") interest during the new money period. Another possibility sometimes discussed has been to issue to such banks in lieu of their existing claims--marketable instruments bearing a submarket interest rate ("exit bonds").

In considering what instrument might appeal to reluctant banks, these still appear to be the two main possibilities. If "exit bonds" were issued that would pay interest at a lower rate than existing claims, it would be very difficult to establish an interest rate for such bonds. If banks were compelled to exchange existing claims for "exit bonds," it would be hard to argue that they had been treated equitably. Thus, in the case of banks that wish to dispose of claims at a discount, there may be attractions in arrangements such as the debt-equity/discounted loans claim scheme in Chile, which allow claimholders to extinguish their claims voluntarily at a discount determined by the market, diminishing the interest flow from the debtor country while also eliminating the call for new money on the claimholder. 1/ More generally, the secondary market in debt allows banks to dispose of debt at a discount, but sales on this market do not reduce debt service payments or necessarily affect banks' base date exposure.

Under the alternative--some form of interest capitalization--the debtor country would pay interest on existing claims of banks with small exposures partly in cash and partly in additional claims, during the new money period. Claims in lieu of full interest payment could be provided in book form or in the form of bonds which could be sold. The advantage of this route is that the proportion of interest paid in cash could be varied each year in line with future new money packages (and could in principle revert in due course to 100 percent).

The interest capitalization route would potentially be more equitable than "exit bonds," since banks--whether they participated in new money or not--could receive the same net cash transfer and experience the same increase in claims on the debtor with respect to

1/ However, one of the two variants of the Chile scheme apparently does not result in a full extinction of the claims in the new money base.

their medium-term debt. Of course, equitable treatment is not the only possibility. In principle, such claims in lieu of interest payments could be designed to offer a claim superior to that of "new money" banks, a claim with the same financial terms, or a claim that would penalize banks that did not participate in new money.

Banks have examined in a working group on new money packages the possibility of preferential claims for banks with small exposures, and have discarded this route. The reasons for this were the difficulty of establishing a cut-off point for banks receiving such preference, and--to some degree--the unwillingness of multilateral organizations to offer protection for selected claims. The possibility of a penal claim has so far been considered unviable by banks. It would probably not appeal to banks on a "voluntary" basis, while if it were issued on a forced basis the penal nature of the terms might involve the agent bank in legal disputes with other creditor banks. Moreover, penal terms might preclude the debtor government, creditor governments, or the Fund from arguing in court that a fair multilateral agreement had been devised.

These considerations suggest that there are advantages in issuing a claim with similar financial terms to the new money package as partial payment of interest to reluctant banks.

3. Problems inherent in interest capitalization

Even if new claims were offered to reluctant banks on similar terms to the new money package, there are two particular operational concerns in distributing interest payments in this form. First, interest payments may have to be made in an identical form to all banks under the loan/restructuring agreement--including banks willing to use the new money modality. This issue could probably be avoided if claims in lieu of interest were issued only to banks who selected such an option willingly, in order to avoid advancing new money while still participating in burden sharing. However, if an element of forcing were introduced, the fact of paying full interest to some banks only (albeit as a quid pro quo for participation in new money) could jeopardize the legal position of agent banks. If forcing appears a real possibility in the long run, the form of payment might therefore need to be identical for all creditors under any loan agreement from the outset. Issuance of claims in lieu of interest to banks that wish to record full income in their published accounts (principally U.S. money center banks) would pose some accounting and regulation difficulties, although these may not be insuperable.

Second, this technique could open up difficult problems of inter-creditor equity relating to different kinds of debt. The technique of issuing claims in lieu of interest would appear to be applicable mainly to medium term public sector debt. Where banks are receiving interest payments on short term trade related debt--whether through the Pemex facility or through general trade finance--it would seem highly undesirable in a longer term perspective to pay them only partly in cash. It could be argued that trade loans also should be converted into a facility, and interest partly paid in new claims. Such an approach could produce a strong disincentive to open external trade lines to Mexico. Analogous concerns arise in the case of interbank exposure--although this might be viewed as already having been partially transformed to medium term debt. Interest payments under FICORCA mechanism could also perhaps be handled by part payment in claims.

If short-term claimholders were paid in cash in full, this would substantially change the pattern of burden sharing. Among other results, the burden of financing would tend to shift to some degree away from U.S. regional banks toward U.S. money center banks. More broadly, it might shift the burden from U.S. banks to other nationality groups of banks. Even if it were desired to pay all existing claimholders in part in new claims, banks no longer holding trade related claims (or private sector claims that have been repaid) would no longer be receiving interest payments on such debt against which to offset a new money contribution. Thus, some shift in ex ante burden sharing would be unavoidable.

Some difficult issues could also arise with regard to interest capitalization even for medium term debt. In particular, banks that have exercised a currency conversion option into low interest rate currencies might receive very little interest in cash in order to absorb new claims equivalent to the same percentage of existing exposure as banks that have lent in U.S. dollars. Changing to an identical proportion of interest payments in cash and claim would alter the new relative exposure positions.

These same difficulties, relating to the possible need for identical claims and the change in burden sharing, could also apply in a slightly modified form to the issuance of exit bonds in lieu of banks' stock of existing loans.

4. Broader implications for the restructuring process

A general concern exists that an optional modality for reluctant banks might eventually spread to the entire new money package or to other countries. First, some banks could prefer the "passive" route of contribution, to avoid shareholder suits relating to active participation in new money (although a limit could be set on banks' option amounts). Second, if it were necessary to force banks, an identical financing modality might become necessary for reasons of equity; this could result in a more widespread shift to rescheduling interest on medium term debt and letting short term debt float free. Third, some debtor countries could take the forcing of banks outside a multilateral context and move directly to unilateral rescheduling of interest payments.

Mexico

Office Memorandum

August 4, 1986

MEMORANDUM FOR FILES

Subject: Enhanced Surveillance--Commercial Banks
Receipt of Fund Reports

The MYRA for Venezuela, includes a covenant committing Venezuela to maintain the monitoring procedures for enhanced surveillance during the life of the restructuring. A violation of this covenant (as all others) would be an event of default. The monitoring procedures attached to the document state that "the government will provide the creditor banks with copies of the reports received by the government from the international agencies as such reports become available."

In the case of Mexico, failure to implement the monitoring procedures set forth by the banks and Mexico could also constitute an event of default under the MYRA. An amended set of financing principles to the loan agreements states that a qualified majority of banks may call an event of default if banks believe that the reporting procedures that are set out in another clause of the document (where a timetable is given for the transmission of Fund documents to the banks) are not being implemented as had been contemplated by monitoring procedures, described in a document dated September 8, 1984 (the monitoring procedures themselves do not specifically provide for the transmission of documents to the banks).

In the case of Yugoslavia, there is an explicit reference to the possibility of a stand-by arrangement in place of enhanced surveillance in the clause dealing with "trigger" mechanisms. This states that "notwithstanding any provision to the contrary, the 'triggers,' and the covenants and conditions precedent relating thereto, will be suspended and not apply during any period when a stand-by arrangement with the Fund is in effect." However, the financing agreement treats Yugoslavia's request for enhanced Article IV monitoring separately from the terms and conditions providing for "triggers." Thus, it could be interpreted that enhanced surveillance should continue, even with a stand-by arrangement. In any event, the Venezuelan authorities agreed with banks to continue to provide Fund documents throughout the period to 1991. The enhanced monitoring arrangements with the Paris Club provide for Yugoslavia to have "an appropriate relationship with the Fund" defined as either enhanced monitoring under Article IV, or (under exceptional circumstances) a stand-by arrangement. Thus, official creditors clearly view these as alternative forms of Fund involvement.

In <u>Ecuador</u>, the bank MYRA includes as a condition precedent for each annual tranche of the rescheduling from 1987 that "the consultation and reporting procedures outlined in the Monitoring Procedures Memorandum have been implemented and maintained in effect as contemplated thereby." The events of default under the MYRA also include the failure to carry out these procedures. A qualified majority of lenders is needed to call an event of default under this clause. The loan documents include a timetable for the transmission of reports to the banks.

Caroline Atkinson

Caroline Atkinson
Economist
International Capital Markets Division
Exchange and Trade Relations Department

Attachments

Office Memorandum

cc: Mr. Guitian
Mr. Duncan-Downing

TO: The Managing Director
The Deputy Managing Director

June 11, 1986

FROM: A. F. Mohammed

SUBJECT: Senate Hearing on Mexican Economy

Attached for information is a report by Mr. Russell on the hearing held yesterday in the Senate Foreign Relations Committee.

Attachment

cc: Mr. Finch
Mr. Habermeier
Mr. Hood
Mr. Whittome
Mr. Wiesner/Mr. Beza
Mr. Brown

Office Memorandum

TO: Mr. Mohammed June 11, 1986

FROM: R. W. Russell RWR

SUBJECT: Senate Hearing on Mexico's Financial Situation

The Senate Foreign Relations Committee held a hearing yesterday on Mexico's financial situation. The hearing was held jointly by Senator Helms' Subcommittee on Western Hemisphere Affairs and Senator Mathias' Subcommittee on International Economic Policy.

Senator Helms defended his decision to hold a hearing last month on the Mexican drug traffic and corruption issue--a hearing that attracted unfavorable comment in the press of both countries. Senator Helms displayed charts tracing the declining exchange rate for the peso (which he said chronicled the "spiral down" of the Mexican economy), and the rise in Mexico's total foreign debt. Senator Helms said U.S. taxpayers were called upon in August 1982 to bailout Mexico with $9 billion; he would not support another bailout.

Senator Mathias observed that Mexico's problems are to a large degree not of its own making, citing high interest rates in the early 1980s, and declining oil prices more recently. Both he and Senator Evans (Republican from Washington) deplored the fact that so little attention is paid to Mexico by the United States, compared to the attention given to smaller Central American nations. Senator Evans remarked that he thought that some of the Administration's testimony at the earlier hearing held by Senator Helms had been "imprudent and inappropriate," and noted that it is "easy to bluster about U.S. taxpayers and what we will and will not do," but Senators have a responsibility to proceed carefully and study the situation before pronouncing.

The first witness, Senator Phil Gramm of Texas, contended that many of Mexico's problems are "self-produced," and he emphasized the importance of a change in Mexico's policies toward its private sector and toward foreign direct investment. He referred to a survey of Fortune 500 companies which found that 52 percent of companies would expand existing investments in Mexico or make new investments there if Mexico were to treat foreign investment as favorably as East Asian economies do. Senator Gramm said that in the absence of changes by Mexico in its economic policies, U.S. taxpayers would not have enough resources to bail out Mexico, but if Mexico's policies change, they "won't need our help."

Assistant Treasury Secretary Mulford testifying for the Administration, emphasized the difficult steps the Mexican government has already taken, saying that he felt Mexico has not received the credit that is due it and suggesting that criticism of Mexico comes too quickly. Secretary Mulford urged Senators to view current problems in the context of a period of years which has included a major adjustment effort by Mexico. Mexico was "adjusting quite well" until it ran into problems in 1985. Secretary Mulford said Mexican officials have consistently "demonstrated a constructive attitude toward their problems." He noted that Mexico, in contrast to some other indebted countries, had never let interest arrears grow.

Secretary Mulford was asked several questions about current negotiations. He said discussions are continuing with the Fund on a standby of "about $1 billion." Mexico's projected fiscal deficit still is "an area of disagreement." Mexico is negotiating a large trade liberalization loan with the World Bank, which together with other Bank loans, would bring Bank disbursements to Mexico to $1 billion this year. If Mexico is able to complete negotiations with the Fund and Bank, "I have no doubt the commercial banks will agree to put new money in." He said commercial banks would be counted on for $2.5 to $2.7 billion in new money. The remainder of the $5 billion to $6 billion of external financing needed by Mexico this year would probably come primarily from Paris Club rescheduling (savings of $600 to $900 million) and an export credit package under discussion with Japan (no amount mentioned). Senator Murkowski (Republican from Alaska) asked whether the Administration had considered additional oil purchases from Mexico for the strategic reserve. The Secretary said only that oil is one of many areas that have been discussed with the Mexican government.

Secretary Mulford said the estimated $6 billion loss in oil revenue for 1986 will be offset in part by: savings from lower interest rates ($1.3 billion to $1.4 billion), savings on the "pricing" of loans from commercial banks (about $700 million), a reduction of past spreads on commercial bank loans (about $400 million), and increased export opportunities due to stronger economic growth in oil consuming countries ($300 million). Thus, declining world oil prices will result in a net loss to Mexico of $2.5 to $3.5 billion, not $6 billion.

Secretary Mulford discussed debt-for-equity swaps at length in response to questions from Senators. He pointed out the potential for Mexican companies and individuals holding liquid assets abroad to buy foreign bank loans at a discount and swap them for equity positions in Mexican state-owned companies to be privatized. He noted that the Mexican government plans to sell 200 state-owned companies, some of which might present good opportunities for debt/equity swaps. The Secretary also mentioned that some foreign companies have used debt/equity swaps recently to expand investments in Mexico

The Secretary was asked about a <u>Wall Street Journal</u> article of June 10 which stated that Mexico would owe its creditors $1.8 billion on July 1. Secretary Mulford said the number was "not right," repeating a statement he made earlier in the hearing that Mexico's debt service on commercial borrowings is fairly even throughout the year and averages about $750 million per month. Mexico, he emphasized, has been meeting its debt service obligations and can continue to do so.

A panel of nongovernment witnesses completed the hearing. Professor Paul Craig Roberts said recent developments confirm his view that piling debt upon debt only worsens the problem; U.S. banks should write off the worst loans; Mexico should open its economy to foreign investment and reach agreements with banks to convert debt into equity quickly. An analyst for Coopers and Lybrand described his company's recent report which rates Mexico's economic prospects poorly in relation to those of other developing countries, primarily because of its dependence upon commodity earnings. Coopers and Lybrand expect commodity earnings to remain depressed for another ten years; they suggest Mexico shift its economy quickly to "a high value-added manufacturing base." Dr. Richard Feinberg of the Overseas Development Council said Mexico's good behavior has not been rewarded by commercial banks; instead, banks have tried to reduce their exposure in Mexico. An economist from the Bank of America who said his bank is looking for: 1) actions by the Mexican government demonstrating a willingness to undertake adjustment; 2) the adoption of an IMF program, which he termed "very important"; and 3) progress in medium-term structural adjustment in Mexico.

INTERNATIONAL MONETARY FUND

June 2, 1986

cc: Mr. Gurtian
Mr. Watson

TO : The Managing Director

FROM: Richard D. Erb

You may find of interest the comments that Gurria made in the session on debt that I participated in at the ICC meeting in Barcelona (in particular see pp. 18 through 23).

Also attached is the statement made by Guth.

Mexico

Attachments

cc: Mr. Wiesner
Mr. Beza
Mr. Finch
Mr. Tanzi

RK, CA, Mwaje

Office Memorandum

To: Mr. Finch

From: C.M. Watson

June 2, 1986

Subject: Visit of Mr. Lutolf

I attach a letter sent by Mr. Lutolf to the Managing Director on April 30 reviewing the meeting of European banks on Mexico. This provides his agenda for the meeting with the Managing Director on Wednesday. A general concern is that the letter and attachment indicate a "wait and see" attitude on the side of commercial banks. The Managing Director will no doubt wish to emphasize that the banks need to show greater responsibility than this. He may also wish to enquire what general progress has been made as regards ways to handle the small bank problem. The Managing Director may also wish to update Mr. Lutolf on developments in various debtor countries, and in particular on progress in negotiations with Mexico. This would provide a context in which to comment on the "oil facility" proposal.

Of the issues raised in Mr. Lutolf's letter and attachment, four are of particular importance in operational terms:

1. The banks lay great stress on direct linkage of their contribution to the debt strategy to actions by creditor governments, for example in providing export credits. If unduly rigid linkages were introduced, progress in the debt strategy could be seriously impeded. Recent efforts in this direction have included attempting to specify in debt restructuring agreements the percentage of relief to be provided by the Paris Club (in Ecuador) or the drawdown of export credits (in the Philippines). Where overly rigid preconditions are introduced for implementation of commercial bank restructurings or disbursements, lengthy delays could result and waivers be required. (This problem of linkages has also arisen in excessively complex legal clauses to key bank disbursements to simultaneous progress under both Fund and World Bank policy reforms.)

2. The attachment to Mr. Lutolf's letter emphasizes that World Bank guarantees will be necessary. It is crucial at this stage to discourage banks from conditioning their disbursements on the availability of such guarantees.

3. It is also suggested that no new money will be made available by commercial banks, outside the framework of World Bank cofinancing, unless this is strictly transaction-related. In this connection it will be important to emphasize that, while rebuilding trade and project lending is important, a certain volume of medium-term general purpose balance of payments financing will remain indispensible for some key debtor countries in the period ahead.

4. There is also a statement at the end of the submission that trade-related debt should be given priority for interest servicing, as well as exempted from rescheduling. This sentence may be an indication that such financing should be removed from the new money base where concerted packages are being arranged. The capital markets mission discussions with Swiss banks indicated remaining pressure for such exemption. This was cited as one reason to advance the modality of interest capitalization--which would normally be applied to medium-term debt only. While all advisory committee banks acknowledge the degree of erosion that has taken place in the 1982 base for new money packages, the dangers of seeking to find a new basis for burden-sharing among commercial banks at this point (in cases where concerted packages are still necessary) are manifest.

GURRIA

GURRIA

Mr. Chairman:

Ladies and Gentlemen:

The ~~international~~ efforts to avoid major damages to the international financial system arising from the Third World debt problem have been largely successful. The system is today stronger and sounder, and better prepared to deal with uncertainty. Banks have higher loan-loss reserves and have enjoyed several good years of profits since 1982, when the debt problem arose.

The debtors, who continued to pay interest in full throughout the period, cannot claim the same. They are generally poorer, weaker and more constrained in their economic policy options. For them the price of the debt crisis habeen ~~...~~ slow growth, unemployment and yes, strange as it may seem, higher inflation (at least until December of 1985), notwithstanding the fact that it was precisely inflation which we were all attempting to fight.

The title of this panel "International Cooperation to Ease the third World Debt Problem" is indicative of how the world has now decided to live with the problem, albeit in "manageable" dimensions, rather than tackle it decisively and challenge the conventional wisdom that says that this can't be done. The Great concern this causes is that one never attains 100% of one's goals. Therefore, while in trying to solve it we may succeed in easing it, if we only try to ease it we might only succeed in perpetuating it.

what can be done?

1) Growth of OECD countries is critical. Now that the U.S. is no longer growing as fast as in 1984, let Japan, Germany, the U.K. and others pick part of the slack of the world's economy. Trade and production must grow in OECD "locomotive" countries to provide the world growth, including that of debtor countries;

2) ~~[illegible]~~ We need open, non protected markets. We are told to adjust and liberalize our trade policies,

4) Nominal interest rates have fallen that is good. But real interest rates continue very high. Interest rates should ~~b~~ fall to their historical real average of one to two percent. This should place them today ~~between~~ three to four percent in total for U.S. ~~d~~ollars, rather than seven to eight percent, which we pay

5) Credit flows to debtor countries have virtually stopped. At least in 1983 they were negligible in the case of Latin America. The area suffered a negative net transfer of more than 30 billion dollars only last year. This is because all owe 360 billion dollars, paid interest at a rate of about 9

percent, and got back almost nothing in new loans from banks except trade lines.
The pact was broken: the unspoken understanding was: I lend you; you pay me. Only debtor countries kept their part of the bargain.

Flows have to be resumed, particularly from banks. They hold 80% of the debt of Latin America and they have clear responsibility in the problem. They cannot suddenly run away from it and claim that their Board of Directors doesn't want any more exposure in highly instable Latin America.

6) Of course, multilateral development banks have to take a more active role than in the past. But then, they always have been rather active, and they have never denied a loan for lack of money. But they cannot suddenly change and become new entities overnight. They are heavy beaurocracies, with a strong resistance to change and deeply ingrained vested interests, both of their staff as well as of their most important shareholders. They can help, but they are not the key.

6) Of course, multilateral development banks have to take a more active role than in the past. But then, they always have been rather active, and they have never denied a loan for lack of money. But they cannot suddenly change and become new entities overnight. They are heavy beaurocracies, with a strong resistance to change and deeply ingrained vested interests, both of their staff as well as of their most important shareholders. They can help, but they are not the key.

7) Governmental participation is critical. The one ingredient obviously missing in the so-called "program for sustained growth" launched in Seoul last October is official money first and official regulatory flexibility second. The usefulness of official money is obvious. Paris Club reschedulings of both principal and interest without withdrawing export-credit cover from debtor countries is essential. It is not happening. While countries preach to banks about international solidarity, they do not practice it.

8) But regulatory flexibility for banks is perhaps even more important. Today, if a commercial bank in the U.S. writes off ~~part of its~~ or writes down part of

its LDC portfolio they have to reflect it fully in this quarter's balance sheet. Banks cannot offer to their debtors any flexibility lest they show important losses. They therefore "get tough" with debtors because regulators "get tough" with them.

Recently, U.S. regulations have been modified to allow the gradual write-down of certain energy loans and farm loans over 7 years. This should be done, in fact must be done and — may I dare say — inevitably will be done with LDC debt. But in the meantime, there is a

lot of pain involved and, unfortunately
banks tend to find solutions
centered around minimum common
denominators. When we talk about
regulations, the U.S. is certainly the
most limiting factor to a more
rationale solution to the problem,
given its regulatory framework.

In an active secondary market,
Banks today are selling
Latin American debt at deep
discounts which oscillate around
40% for the biggest debtors.
Why then insist that they should
continue to get 100% interest
on something which they all
acknowledge is not worth 100

In ~~full~~ recognition of the above, some European banks already have made loan-loss reserves for almost half of their LDC portfolios. This means that, through flexible fiscal and accounting practices, the burden ~~t~~ of potential losses is being shared by taxpayers. But this has meant relief for bank ~~[illegible]~~ shareholders, not for debtor countries. And this relief has not yet become generalized. It is sorely lacking in the U.S., where commercial banks do not enjoy the privileged social and political status they have elsewhere.

Do I sound bitter? Yes!

Do I sound frustrated? Of course!

Do I sound desesperate? Not yet,
but give me time

Let me ~~[illegible]~~ ~~[illegible]~~ illustrate why by ~~[illegible]~~ telling you a few facts about Mexico which are typical of a highly indebted, middle income country.

From 1982 to 1985, Mexico h[as]:

- Reduced inflation by half, from 120% ~~to~~ ~~[illegible]~~ 63%;

- Reduced its fiscal deficit by half, from more than 18% to 9.5%;

— Reduced its borrowing requirements from 8 billion in 1982, to 5 billion in 198
to 3.8 billion in 1984
and 0 in 1985.

— Eliminated its current account deficit from 13 billion in 1981 to a surplus of 4 billion in 1984 and balance in 1985;

~~— Reduced the size of the total public sector budget from 39% of GDP in 198 to~~

- Reduced public expenditures in goods and non-financial services from almost 31% of GSP in 1981 to 23% in 1985 and barely 20% in 1986;

- Reduced public sector investment from almost 10% in 1981 to less than 5% in 1985 and even less in 1986.

- Reduced public sector wages and salaries from almost 8% of GSP in 1981 to barely 6% in 1986;

a chronical

— Transformed ~~a the chronically~~ ~~[illegible]~~ "primary ~~[illegible]~~ deficit", that is, the result of deducting interest payments from the total public sector borrowing requirements, into a "primary surplus" of around 4% of GDP on average during 1982 to 1986.

— Achieved a zero "operational deficit", that is, the one that results from deducting from the nominal fiscal deficit the nominal inflationary component of the domestic interest payments of the public sector.

— Absorbed a fall of real wages of between 30 and 40% in the last four years as part of the "adjustment process:";

— Barely grew at all between 1982 and 1985 in nominal terms and had a cumulative per capita drop of almost 10. of GDP in the period;

16 - bis

- is reducing subsidies by lifting price controls in even the most basic items as bread and tortillas;
- is selling, closing down or restructuring ~~[illegible]~~ public sector companies which are non strategic to the running of government.
- is actively promoting foreign investment in priority areas, with special emphasis in export oriented ventures.
- has dramatically liberalized its trade policy from a highly protective, license system, to a tariff based one with an agreed calendar for the gradual reduction of protection.

That is adjustment; we know what it means; we have suffered it.

But we went even further in a efforts; ~~[illegible]~~ for 1986 we already had an approved budget; we were going to have a deficit of only 5% of GDP, (half of the one for 1985) inflation of around 45% and foreign borrowings of around 4 billion. Oil was supposed to sell at 22.50 per barrel and we were going to export 1.5 mill barrels per day.

Suddenly, oil drops to half that price and volume drops sharply by about 300 000 barrels per day. We suddenly find we have lost 7.5 billion dolla[rs] in income for 1986; half of our oil exports; one third of our total exports; 6% of Gross Domestic Product.

Suddenly, our fiscal deficit soars to double digit figures. Our inflation rebounds sharply and our needs for more debt increase. All for reasons beyond our control

Do we get immediate assis-
tance and relief? No!

We are told to adjust mor-
and are expected to contin-
to pay interest.

Well, we have done so for
five full months of 198
without getting a cent in
fresh money from the bank.

They are waiting for us to
agree on a new IMF agreemen
but the IMF does not easily
accept double digit deficit.

20

They are asking for further adjustment measures which we may not be able to deliver, because our adjustment already lasts 4 years and is already too painful.

We have to say, however, that the only reason why we have continued to be able to service our debt punktually ~~with~~ while at the same time financing all necessary imports and not losing reserves, ~~[illegible]~~

21

~~[illegible]~~

is because there has been a reflow of capital into Mexico ~~[illegible]~~ since the beginning of 1986 which has compensated the current account deficit caused by the fall in oil revenues. This reflow, which reverses ~~past~~ damaging trends of ~~the~~ capital flight (although much more modest than those being bandied around by supposedly serious banking institutions) is due to very tight credit policy in Mexico. One should not take it for granted.

Mexico will therefore soon have to decide whether it negotiates with banks in the context of an IMF Agreement or without it. In both cases, negotiations will happen. Only Banks would obviously prefer the first case. So would we, if we can arrive at a satisfactory deal which recognizes the harsh reality we are going through.

we will need further support from the banks; we hope to get it and hope that banks will recognize our very difficult condition and the ~~our~~ great responsibility ~~as we~~ we have shown so far in our financial relations with the rest of the world

We must not forget that ~~if we cannot show that~~ unless such responsible ~~the~~ attitude is reciprocated by our creditors through timely support and understanding, tensions in the international financial system can easily rise and all we have won so far could be lost.

Let's work to avoid this scenario.

Let's be bold, creative and flexible.

Thank you!

file

Office Memorandum

MEMORANDUM FOR FILES March 25, 1986

Subject: Meeting with U.S. Members of Mexico Advisory Committee

The Deputy Managing Director met on March 19, 1986 with U.S. members of the bank advisory committee for Mexico. Mr. Rhodes opened the discussion by stating that the chairmen of the advisory committee banks had agreed that committee members should approach their respective national authorities to discuss a number of issues of mutual concern. The U.S. banks had held discussions earlier in the day with the Treasury, the Federal Reserve and also with the World Bank. The purpose of this meeting was to pursue these issues with the Fund. The banks raised three main issues: progress in securing policy reform in Mexico, the rollover on Friday, March 21 of the $950 million principal payment, and the structure and terms of the next financial package for Mexico.

With regard to policy reform, Mr. Rhodes emphasized that the banks wished to see a letter of intent to the Fund and a comprehensive and convincing program of structural reform with the Bank agreed before commitment of a new financial package. Both he and Mr. Coleman emphasized the need for linkage of bank financing to policy reforms endorsed by both the Fund and the Bank. Mr. Rhodes said that Mr. Gurria was optimistic on progress with the Bank. However, the discussions earlier in the day had indicated that Bank officials were somewhat disappointed with the speed of progress on trade reform and the degree of movement on other structural issues. The banks were concerned that Mexico had done nothing to implement the debt/equity clauses in its multiyear rescheduling agreement (MYRA), and feared this indicated a continuing unwillingness to open the economy to foreign investment.

On macroeconomic policies, the bankers were hopeful that rapid progress might be in prospect; the Deputy Managing Director warned that it might take time to secure a satisfactory agreement on fiscal policy in particular. Mr. Rhodes pressed the need for the exchange rate and interest rates to be kept realistic, to induce corporations to repatriate dollars held outside Mexico. The bankers expressed strong concern about Mexico's willingness to take measures that would prevent capital flight, and indicated that they would resist building a reserve increase into the macroeconomic program, in part because it would increase the scope to finance capital flight. Pressed by the Deputy Managing Director, they did, however, acknowledge the general case for including reserve increases in the Fund programs. They also believed that the Mexicans were still overestimating the financing needs, including an overly pessimistic interest rate projection.

Turning to the rollover of the $950 million payment, Mr.Rhodes stated that the Mexicans were pressing extremely strongly that the rollover on March 21 should be for six months instead of the customary three months. Such an extension would be difficult to secure from the generality of creditor banks, in part because of a concern that this request reflected a tactic of deferring bank pressure and leverage, because of a likely emergence of arrears during the next three months. The banks had suggested 90 days renewal with a goodwill clause. This had been refused and the situation was at a deadlock. Mr. Volcker had not given specific advice on this issue. With regard to the negotiations in general, he had counselled adopting a low profile, seeking to work out an agreement with the Mexicans over time, and avoiding confrontation. The Deputy Managing Director made clear that the decision on the rollover was one for the banks to take in light of their assessment how important and sensitive this question was for the Mexican authorities.

With regard to the prospective financing package the banks emphasized very strongly that the next package should not be a traditional "plain vanilla" medium term balance of payments loan. The maximum use should be made of equity conversion, trade facilities, parallel financing and cofinancing with development banks, and oil related transactions. There was concern among the banks whether the Fund and the World Bank appreciated the degree of resistance to a traditional new money package. The Deputy Managing Director warned them that the financing need of the Central Government, even though restrained under an agreement with the Fund, was likely to imply some medium term general purpose balance of payments financing. Mr. Rhodes said that Mr. Volcker had warned of strong pressure from the Mexicans for some concession on the interest rate. He had advised the banks to think about repackaging the financing in ways that could give a signal of movement and allow the Mexicans to claim progress in obtaining concessions from the banks. Mr. Mulford had ruled out interest capping, interest capitalization, or a submarket interest rate; he pointed to the case for a concession on the interest spread.

The banks pressed the need for a Paris Club, but were concerned about the possibility that German and Japanese export credit agencies would come off cover. They emphasized that this was a crucial problem that governments must be pressed by the Fund and the Bank to resolve.

The banks enquired about the modalities of Fund financing, following their earlier discussion with Messrs. Mulford and Dallara. Mr. Rhodes quoted Mr. Mulford as hinting that exceptional access might be available, but said Mr. Dallara had challenged that view. The Deputy Managing Director said that Mr. Dallara's caution no doubt reflected a concern--which was real--about the wider implications of increasing access for Mexico. He confirmed that the Special Disbursement Account could not be widened to cover Mexico, and that creditor governments had not indicated readiness to make a CFF available. The question was raised whether the EFF could be revived so that an event of default under the MYRA (involving the need for a waiver by creditor banks) could be avoided. The Deputy Managing Director said that this was not realistic. The banks admitted that there would be more worries about the MYRA than a waiver on this particular event of default.

On linkage to the Fund and the Bank, the Deputy Managing Director assured the banks that neither the Fund nor the Bank could proceed without satisfactory progress on their respective sides, but he added that they could not proceed either without the commercial banks. The Deputy Managing Director indicated to banks that the Fund would wish to have discussions at a future date about technical problems that were arising from very rigid clauses in bank agreements relating to cross linkage, and from the requirement that 100 percent approval be secured from creditor banks for any waiver of economic performance covenants or events of default. Mr. Rhodes and Ms. Bauer appeared to indicate that a qualified majority could be introduced in future agreements to avoid making approval of such waivers dependent on 100 percent approval by banks.

C.M. Watson
Chief
International Capital Markets Division
Exchange and Trade Relations Department

cc: The Managing Director
The Deputy Managing Director
Mr. Finch
Mr. Wiesner
Mr. Beza
Mr. Brown

3/13/86

INTERNATIONAL MONETARY FUND

TO : Max

FROM: Klaus

File

Mexico -- ES

Luis just called.

The Mexicans did not give the 85 consultation report to the banks. They may do so at the end of May 1986 to fulfill the reporting requirement at that time.

(Luis received this information on a confidential basis and would not like to see it printed.)

May

Mexico

INTERNATIONAL MONETARY FUND

March 13, 1986

Mr. Boorman
Mr. Belanger

You may be interested in the attached memorandum prepared by Klaus Regling.

Attachment

cc: Mr. Guitian
Ms. Dillon

C. Maxwell Watson

Office Memorandum

To: Mr. Watson

March 13, 1986

From: Klaus Regling KR

Subject: Mexico--Enhanced Surveillance

Please find attached the relevant paragraphs which cover Mexico's reporting obligations to banks in the context of ES. Legally, Mexico is supposed to provide banks with the annual IMF consultation report for 1986 no later than May 31, 1986 and with the mid-year report for 1986 no later than November 30, 1986 (paragraphs VIII and IX of the attachment). There are no provisions in the agreement that would allow the replacement of the reporting requirements under ES by a stand-by. (Incidentally, banks probably received the 1985 Article IV consultation report, as required under paragraph X of the attachment.)

However, as Mr. Duran-Downing has told you, the next consultation with Mexico will probably not be concluded before end-June/mid-July, possibly together with a stand-by arrangement. Two questions could arise:

--Will banks insist on receiving staff reports, even with a stand-by in place? (They did so in the case of Colombia.)
--If they do, should they receive a staff report that covers the consultation and the program?

Attachments

cc: Mr. Duran-Downing

impact of all debt rescheduling), (C) new external financing (including details for both official and commercial sources) and (D) year-end levels for international reserves (gross and net) and external debt (long-term, short-term and debt owed to foreign banks);

(v) upon request of the Majority Banks and within 30 days after they become available, each general financial, statistical or economic report with respect to the Borrower which is furnished after the date hereof to the commercial holders of any External Indebtedness of the Borrower;

✓ (vi) as soon as available for each fiscal year of the Borrower but not later than 90 days after the beginning of such fiscal year, a copy of the Annual Operative Financial Program (together with an English translation) for such fiscal year;

✓ (vii) as soon as available for each fiscal year of the Borrower but not later than 30 days after the beginning of such fiscal year, a copy of the Federal Budget (together with an English translation) for such fiscal year;

(viii) within five days after the delivery thereof to the Borrower (which, on the basis of conversations between the Borrower and the IMF, is anticipated to occur at the end of April) but not later than May 31 of each calendar year beginning with the calendar year 1986, a copy of the annual ✓ IMF Consultation Report for such year, to be prepared by the IMF and delivered to the Borrower pursuant to the Monitoring Procedures;

✓ (ix) within five days after the delivery thereof to the Borrower (which, on the basis of conversations between the Borrower and the IMF, is anticipated to occur at the end of October) but not later than November 30 of each calendar year beginning with the calendar year 1986, a copy of the mid-year IMF Consultation Report for such year, to be prepared by the IMF and delivered to the Borrower pursuant to the Monitoring Procedures; provided that the mid-year IMF Consultation Report for the calendar year 1987 shall be furnished to the Agent not later than September 30, 1987;

Source: Amendment to the $5 billion Credit Agreement (3/3/1983) between Mexico and commercial banks, final draft, dated 3/5/.

(x) as soon as finalized between the Borrower and the IMF, a copy of the Letter of Intent for the calendar year 1985 under the IMF Extended Fund Arrangement and, within five days after the delivery thereof to the Borrower but not later than December 31, 1985, a copy of the IMF report for the year 1985 on the consultations with Mexico under Article IV of the Articles of Agreement of the IMF (it being understood that such IMF report is for the last year under the IMF Extended Fund Arrangement and will not be prepared pursuant to the Monitoring Procedures);

(xi) such other financial, statistical and general information (including reasonably detailed reports on any rescheduling or restructuring of External Indebtedness) about the Borrower, Banco de Mexico and any other Governmental Agency as the Majority Banks may from time to time reasonably request through the Agent; and

(xii) as soon as possible and in any event within five days after the occurrence of any Event of Default or event which, with the giving of notice or lapse of time, or both, would constitute an Event of Default, a notice setting forth the details thereof and the action which the Borrower proposes to take with respect thereto.

End Quote

PART A-11. Amendment to Section 8.01(e) -- IMF. Section 8.01(e) of the Credit Agreement is amended to read as follows:

Quote

(e) IMF. Maintain its membership and eligibility to use the general resources of the IMF and make each purchase scheduled to become available in 1984 and 1985 to the Borrower under the IMF Extended Fund Arrangement not later than 105 days after the scheduled availability date for such purchase indicated in Schedule 2; provided that if the purchase scheduled to become available in the first calendar quarter of 1985 is conditioned upon compliance with performance criteria for such quarter, such purchase shall be made not later than 135 days after the scheduled availability date for such purchase indicated in Schedule 2.

End Quote

Mr. Watson

Office Memorandum

TO: Mr. Beveridge

March 7, 1986

FROM: Luis Duran-Downing

SUBJECT: Mexico--Visit of Mexican Officials

We met briefly with Mexican officials yesterday. They explained that the shortfall in petroleum exports with respect to the 1986 budget approved by congress is estimated at US$6 billion--assuming a volume of 1.28 mbd and an average price of US$14.30 per barrel. About one-third of this shortfall is expected to be covered through additional domestic adjustment so that the deterioration in the external current account with respect to earlier projections would be below US$4 billion. Another one-third of the shortfall is expected to be covered with a combination of new money and refinancing, and the remainder with cuts in interest payments. The cut in interest payments is US$2 billion and represents a reduction of about 3.7 percentage points in interest rates, given a stock of public sector debt with commercial banks estimated at around US$54 billion at the end of 1985.

With these adjustments net official external financing in 1986 is now close to US$8 billion up from the US$4 billion that was contemplated in the original budget. The increase in net international reserves has been kept at US$1.1 billion.

In the discussions held with Mexican officials in late 1985 and early 1986, the staff has argued that the current account surplus for 1986 would be substantially larger than in the official projections if the public sector deficit was reduced as envisaged in the budget. In these circumstances, the original estimate of US$4 billion in net external financing seemed too high and the programmed increase in foreign reserves too low. With the new assumptions about price and volume of oil exports, the need for internal adjustment is more pressing and staff projections of external financing requirements may differ substantially from the projections of the Mexican authorities. Indeed, very preliminary calculations show that after adjusting for the increase in net international reserves, the staff projections of net borrowing requirements are about US$4.6 billion compared to about US$7.0 billion on the Mexican side.

cc: Mr. Guitián (o/r)
Mr. Watson

Need
4
+ 6 bn
2½ bNM
- 2
1½ official
4
2 NM ? official
2

8 Net

MEXICO
Updated: 02/28/86

COUNTRY: Mexico

POLITICAL:

PROGRAM: EFF 1/1/83-12/31/85 (expired)

ARTICLE IV: June 6, 1985

PROGRAM STATUS

Board approved emergency purchase equivalent to SDR 291 million--25% of quota--on 1/10/86. Negotiations on program for 1986 in progress, but complications have arisen because drop in oil prices.

MISSIONS

Frequent contacts staff, Mex. officials in Wash. Oct.-Dec. '85 on program '86. Contacts suspended til this week. Mexicans reportedly working on alternative 86 budget. Visit MinFin U.S. officials this week; information mtg. with MD to explain situation.

PARIS CLUB

Agreed Minute: 6/22/83 Consolidation: 6 months
Forum: Creditor Group Meeting.

Included private debt only. Estimate of rescheduling have dropped from $2 bil. to $1 bil.; $817 mil. signed as of late Aug. Balance owed primarily to Italy, Japan. Bilaterals with Italy, Austria, Denmark, Netherlands, & Switzerland still not signed (LDD would like to know whether these creditors are being paid as claimed by Mexicans). Bilateral with Japan was reportedly signed in 12/85.
Banks pressing Mexico to request an official MYRA starting in 1986; Mexico initially not interested because possibility of going off cover. If CCC included, principal due in 1986 about US$1 billion on a stock at end-1985 of US$4.6 billion.

BANKS

MYRA signed August 1985; ~~8/29~~. ~~Payments due~~ 1985-1990 restructured. Non-PRD ~~Previously unrestructured debt~~ has 1-yr. grace & 14 maturity. Spread rises from 7/8 to 1 1/4 over time. An event of default could be declared if Mexico is not in compliance under EFF. So far, banks have given no signs of invoking this clause, issue will hinge on new agreement with the Fund. On Oct. 10, 1985, ~~10/1/85,~~ banks rolled over $950 mil. for 6 months (the prepayment of the jumbo loan of 1984.) ~~Mexico was requesting $2.5 billion net (or $3.7 billion gross) to commercial banks as part of the financial package for 1986. Seeking $1.5 billion net from multilateral & bilateral.~~

MISCELLANEOUS

Negotiating ~~development~~ program loan (trade liberalization) with Bank (US$500 million) & second export development loan (US$250 million). ¶ In July 1985 Mexico abolished the "free market" & legalized the parallel market, & on 8/5 a "managed float" was introduced in the controlled market. Devaluation of about 20% ~~effected on 7/24/85,~~ & the Gov't. announced a major liberalization of trade. ~~The original budget for 1986 contemplates a substantial reduction of the fiscal deficit. Some quarters in the private sector & in the government have been pressing for "unconventional" solutions to the debt problem (including moratorium).~~ ¶ Authorities say impact of oil prices US$6 billion w/r original budget (overestimation). However, no additional financing needed if no accumulation of reserves, additional petroleum sales to US, debt relief from PC (US$1 billion) and some adjustment measures.

Division/
mission chief: Pujol 8480 Desk officer: Valdivieso 8481 ETR: Duran-Downing 8315

Questions on Mexico

1. #'s on export credits. Principal due? Expected disbursements? Interest due?

Pub vs. Priv. Breakdown?

US, Japan, & France

	1986	87	88
Public sector: bilaterals	\$50 million (780)	788 (1,183)	695 (1,095)
CCC	507 (507)	139 (219)	247 (347)

2. What actually went wrong on fiscal/credit policy in 85?

↑ expenditures ↑ elections - gubernatorial (transfers) to priv sector

wages ↑ also > program.

Oil = 1% of GDP deviation; Total deviation = 5%

3. Significance of July 85 exchange rate action. Previous status? What is in each market?

controlled - 1 month tablita
in both official & free

4. Impact of oil price fall on export receipts?

Average price now \$11.5. Lost another \$3 billion.
4 domestic + 4 more financing in 86

5. What else happened at Feb. 4 meeting with banks?

end 85 stocks

bilaterals	3.381 million
CCC	1.341 million

BIS/OECD: Export credits ↑ 11% in 84, ↓ 1% in 85 I.
($700 million)
Total 86 BU debt service = $1.3 billion; 87 = $1 billion

brmexclq2

Mexico--Briefing Note for Berne Union

I. Relations with the Fund

The 1982 extended arrangement with the Fund went off track by end June 1985 and expired by end December 1985. Following the earthquakes of September 1985, the Mexican authorities requested an emergency purchase equivalent to SDR 291 million--25 percent of quota--which was approved by the Board on January 10, 1986. Negotiations on an adjustment program for 1986 that could be supported by a new one year stand-by arrangement are in progress. Fund financing for Mexico under the emergency drawing and for the new arrangement would total SDR 909 million, equivalent to the amount not drawn under the extended arrangement--78 percent of quota. The emergency drawing absorbed SDR 291 million, leaving SDR 617 million--53 percent of quota--to be phased in four similar purchases. Mexico might also qualify for compensatory financing of an export shortfall during 1986 for as much as 86 percent of quota (SDR 967.4 million) but this will partly depend on the future outlook of the petroleum market and the timing of the approval of the new arrangement in order to fulfill the requirement of cooperation with the Fund. In that event the total entitlement under any CFF drawing might have to be adjusted to avoid double compensation with the emergency drawing. The last Article IV consultation discussion on Mexico was held on June 6, 1985.

II. Background

Mexico's performance during 1985 was much weaker than programmed. The public sector deficit reached 8 1/2 percent of GDP, double the proportion envisaged in the program. Net domestic assets of the Bank of Mexico increased sharply and net international reserves declined by US$3.4 billion . The strong surplus in the external current account virtually disappeared. As the official capital was in virtual balance, the strong reserve decline reflected a net private capital outflow close to US$4 billion.

The authorities introduced a managed float of the controlled official exchange rate at the end of July 1985--following a devaluation of 17 percent--and authorized commercial banks to operate in the parallel market through exchange houses. At this time, a widespread liberalization of import permits was also enacted. For the year as a whole, the effective real depreciation of the Mexican peso reached almost 17 percent. The differential between the exchange rates in the controlled and the free markets reached almost 50 percent by October but declined to about 23 percent by the end of the year.

Economic activity expanded at 4 percent (a faster pace than contemplated in the program) and inflation accelerated and reached 64 percent by December compared with about 59 percent in 1985 and with around 40 percent contemplated in the program.

III. Macroeconomic policy

The Mexican authorities have prepared a budget for 1986 aiming at a halving of the overall borrowing requirements of the public sector to about 5 percent of GDP. The bulk of the adjustment is to fall on expenditures, with emphasis on current outlays. The budget assumes a reduction in the rate of inflation to 50 percent and a decline of about 1 percent in real GDP. Key assumptions behind this scenario are the net budget

price of crude petroleum at US$22.5 per barrel and exports at 1.5 million barrels per day on average for 1986.

On the monetary front, the authorities project a decline in monetary aggregates in real terms of about 11 percent for the year as a whole. The contraction in total credit in real terms allows for an accumulation in net international reserves of about US$1.1 billion. The current account of the balance of payments is projected to register a small surplus (US$0.3 billion) similar to that in 1985. Net official capital inflows are contemplated to reach US$4 billion--required to finance the public sector--but private sector operations (including errors and omissions) are expected to result in a net outflow of around US$3.2 billion.

IV. Policy issues

During the discussions in Washington with Mexican officials the staff has raised a number of issues with reference to the budget and other projections submitted by them for 1986. Stress was laid on the need for prompt positive results under the 1986 budget. The authorities have yet to present the detailed projections that would confirm such objectives. The biggest challenge in achieving rapid adjustment in the fiscal accounts will be in assuring implementation of the expenditure cuts. There remain important questions concerning contingency plans that will be needed to cope with the fall in petroleum prices below the level assumed. The staff has noted that a shortfall in fiscal receipts from the petroleum sector would need to trigger further adjustment measures and that contingency plans should be developed for this purpose. A fall of US$1 dollar per barrel in the price of oil represents about US$590 million at an annual rate in forgone revenues. Working with an assumption of an average price of oil of US$15 dollars per barrel for 1986 would represent a loss of US$4.4 billion or the equivalent of about 2 1/2 percent of GDP on a yearly basis.

The staff has proposed to raise the target of accumulation of net international reserves for 1986 to at least US$2 billion. This target, if sufficient room for the growth of private credit is also to be provided, will require the pursuit of sufficiently flexible interest rate and exchange rate policies. The staff has also insisted on the need to unify the two exchange markets in order to eliminate the distortions still present. The staff believes that if the proposed monetary and fiscal policies are in place, the current account surplus should be larger and private capital outflows would be smaller than calculated by the Mexican authorities. Consequently, even allowing for a larger accumulation of international reserves than envisaged in the Mexican program, financing requirements for the public sector would be around US$3.1 billion (under the assumption of oil prices at US$22.5 per barrel).

V. Relations with IBRD

The Bank is currently negotiating a Trade Development Program Loan of about US$500 million in support of Mexico's trade liberalization as well as a second export development loan of about US$250 million. A reconstruction loan is also being contemplated. Gross disbursements in 1986 could reach US$1.1 billion for a net contribution of US$0.8 billion. The Bank and the Fund staff have been in contact in discussions in a number of areas including the macroeconomic framework and the medium-term scenario, but important differences remain, with the Bank staff projecting a higher profile of inflation, fiscal deficits and financing needs than the Fund staff; the work that the authorities are doing with the Bank in the area of trade policy will be incorporated into the adjustment program. Following Mexico's request to join the GATT, the authorities have been reluctant to commit themselves to further trade liberalization beyond the measures adopted last July on the grounds that they do not want to reveal their hand before the negotiations with the GATT. This attitude seems to be causing some delays in Mexico's negotiations with the Bank on the Trade Development Program loan.

VI. Relations with commercial banks and other creditors

The signing of the MYRA was completed on August 29, 1985. An event of default could have been declared since Mexico was not in compliance or had not purchased the total amount of resources available under the extended arrangement. So far, banks have given no signs of invoking this clause and the resolution of this issue will hinge on a new agreement with the Fund. In October 1985, banks accepted to roll over for 6 months US$950 million corresponding to the prepayment of the jumbo loan of 1983. Before the fall in oil prices of late January-early February, Mexico was requesting US$2.5 billion net (US$3.7 billion gross) from commercial banks as part of the financial package for 1986. Assuming no change in the net exposure to the private sector this lending would represent an increase of about 3.3 percent in bank's exposure to Mexico in 1986. Reflecting a large current account surplus and smaller private capital outflows, staff projections envisage net disbursements from commercial banks to the public sector in Mexico of US$1.6 billion in 1986 corresponding to gross drawings of US$2.8. This is to cover US$250 million of amortizations due in 1986 under the MYRA, and the restructuring of the US$950 million prepayment of the 1983 loan. Mexican officials met with the Steering Committee of commercial banks on February 4, 1986 to discuss the impact on the economic program of the recent steep decline in oil prices and the timing of substantive discussions on the financing requirement for 1986.

In the discussions with the Mexican authorities the banks have raised the question of a MYRA with official creditors under the Paris Club. In the past, the Mexican authorities have resisted such a restructuring so as to not impair access to new credits, and have kept payments on such debts current.

VII. Medium-term outlook

Mexico's outlook for the medium-term is extremely uncertain and will hinge on the behavior of petroleum prices. The scenario presented in Table 1 is based on the parameters of the December WEO--including an average petroleum price of US$22.5 per barrel for 1986--and assumes that Mexico continues pursuing appropriate policies. During 1987-88, the fiscal deficit averages 3 1/2 percent of GDP per year and inflation drops from 50 percent in 1986 to 12 1/2 percent in 1988. The external current account remains virtually on balance and public sector external financing requirements are estimated at about US$2.4 billion per year. By 1989-90 the economy recovers traditional growth rates of 6 percent per year, inflation approaches that of trading partners, and the public sector deficit is equivalent to about 3 percent of GDP. Under these circumstances the external current account evolves toward a deficit of around one half of 1 percent of GDP, private capital flows turn positive, and net external financing needs of the public sector are estimated at about US$2.7 billion.

07-Feb-86

MEXICO - MEDIUM TERM BALANCE OF PAYMENTS PROJECTIONS --
(In billions of US dollars)

	1985-Rev.	1986	1987	1988	1989	1990	1991
CURRENT ACCOUNT	0.3	1.4	0.1	-0.6	-1.5	-2.0	-2.8
Trade balance	9.8	10.0	8.6	8.3	7.9	7.5	7.4
Exports	22.9	23.2	24.1	25.9	27.7	29.8	32.0
Imports	-13.1	-13.2	-15.5	-17.5	-19.8	-22.3	-24.6
Factor income	-9.0	-8.5	-7.9	-7.8	-7.9	-8.1	-8.2
Of which:int.pmts.on pub.debt	-7.3	-7.0	-6.9	-6.9	-7.0	-7.2	-7.3
Other serv. & transf.	-0.5	.0	-0.6	-1.2	-1.5	-1.4	-1.9
CAPITAL ACCOUNT	-3.7	0.6	1.0	2.1	3.0	3.7	4.8
Official capital	0.3	3.1	2.3	2.5	2.7	2.7	2.9
Private capital	-4.0	-2.5	-1.3	-0.4	0.3	1.0	1.9
MONETARY AUTHORITIES (Increase-	3.4	-2.0	-1.1	-1.4	-1.5	-1.7	-2.1
MEMORANDUM ITEMS:							
Current acct. as % of GDP							
At 1979 real exch.rate	0.1%	0.6%	.0%	-0.2%	-0.5%	-0.6%	-0.7%
At current exch.rate	0.2%	0.8%	0.1%	-0.3%	-0.6%	-0.8%	-1.0%
Gross reserves,end period 1/							
In billions of dollars	4.5	7.2	8.1	9.1	9.9	10.9	12.4
In months of imports & int.pym	2.3	3.8	3.9	4.1	4.1	4.1	4.3
In months of imports	4.1	6.5	6.3	6.2	6.0	5.9	6.0
Imports/GDP	-5.8	-5.7	-6.6	-6.8	-7.1	-7.3	-7.3
Nonoil exports/GDP	3.7	4.1	4.4	4.5	4.6	4.6	4.6

Source: Fund staff projections

1/Excludes gold and payments agreements

SYNDICATED EURO-LOANS

X

Mexico

A breakthrough FRN-based debt reorganisation

In what bankers are characterising as a potentially important step in the way that debt restructuring is handled, a plan is underway to transform the external banking dollar debt of Mexico's Valores Industriales SA — **Grupo Visa** — into floating rate notes.

Grupo Visa is Mexico's second largest industrial conglomerate. It ran into deep trouble on its external borrowings — totalling just over $1bn and almost wholly in the form of dollar bank loans and credits — after the drastic devaluation of the peso which accompanied Mexico's debt crisis of August, 1982.

A proposal is now being made to Visa's 70 bank creditors, chiefly in the US, Canada and Europe, to translate these loans into FRNs. *Continental Illinois* is chairman of the steering committee of bank creditors.

"The proposal for an FRN base for Grupo **Visa's** debt is now in the process of being approved by all of the creditor banks," a US banking source said Friday. While details of the scheme remain to be resolved in fine detail, reaction among some creditors is said to be very positive.

The main rationale for employing FRNs is that debt in this form is capable of being exempt from Mexico's withholding tax. Another factor is that such notes may allow **Visa's** debt to be extended into longer maturities. Additionally, FRNs would contain roughly the same form of indentures and safeguards as bank loans.

At this stage, it is not clear how many FRNs will be floated for the rescheduled debt. It may be as few as two, or as many as five. The banks are also working on the number of FRNs which would finish up as essentially US domestic instruments and the number needed as "Euro-FRNs", because of the presence of foreign bank creditors. Consequently, the issue of the spread on the floaters has not yet been resolved.

Another key point of the FRN scheme also remains unclear — whether banks holding the paper would be able to dispose of them in a secondary market, either formed by the 70 creditors or available in the financial markets generally. If such disposal at a significant price discount is possible, it could contain problems for the US banks, in classifying the health of these facilities with the SEC and US regulatory bodies.

Says a US source: "We have not yet determined if there will be a secondary aspect, and this is obviously a sensitive point with US creditors in particular."

The banks claim that, by transforming the debt into FRNs, they are not attempting to gain prior treatment over other classes of creditors. In most sovereign debt reschedulings around the world, FRNs have been up to now exempt — as opposed to bank loans. Says the US source: "I don't think that legally there are grounds for claiming that FRNs should necessarily have preferential treatment. They generally don't get rescheduled because public debt is such a logistical nightmare to refinance."

The whole shape of the **Grupo Visa** debt reorganisation should be in place by January, and should mark a unique milestone on the tortuous global debt rescheduling road. While it applies to a corporate situation, it will encourage the major banks in New York and elsewhere which believe more flexible rescheduling techniques should be employed in connection with sovereign debt problems. One of the world's largest banks is working on a plan to apply the FRN formula to at least a portion of Brazil's near-$100bn of foreign debt.

Pemex sterling line

(*)

A £15m line of credit, supported by the UK Export Credits Guarantee Department (ECGD), is being extended to **Pemex**. The loan is being provided by *Baring Bros* heading a 5-bank syndicate. These are: *Bank of Scotland, CIBC, Grindlays Bank, Lloyds Bank, Royal Bank of Scotland.* Proceeds are to assist in the financing of the supply of UK capital goods and services in connection with the operation and development of Mexico's oil, natural gas, refining and basic petrochemical industries.

Chile

Last Monday morning saw the receipt by creditor banks of the long awaited model RESCHEDULING package which refers to **Banco Central de Chile's** debt. The documentation, once approved, will be used for all the other Chilean public sector RESCHEDULING. It lists the names of the borrowers, the amounts owed, the terms and conditions of 2-1/8% above Libor or 2% over the higher of the Agent's prime rate or adjusted CD rate, the Agent inovled in each loan and proposed signing date. The **Republic of Chile** acts as guarantor for each borrower. Out of a list of 20—25, the first 5 are: **Banco Central de Chile** with just under $50m of debt, **CAP** ($120m), **ENDESA** ($195m), **Banco de Chile** ($452m), **Banco de Santiago** ($520m). These 5 together, in fact, account for around 53% of the country's public sector indebtedness. The Agent of each old loan will approach the lending syndicate and propose a deadline for the creditor banks' acceptance to the documentation. Chile hopes to be able to draw down the $300m remainder of its new money facility by December 31, but in order to do so, signing of 40% of the debt to be RESCHEDULED should be attained.

Bolivia

The Steering Committee has received $17.5m from **Bolivia** in payment of 2 instalments of $30m that remains outstanding. The money has still to be actually received by the creditor banks. On December 15, a third instalment is expected to be paid by the Bolivians.

Uruguay

The final drawdown of the $240m new money facility is being made by **Uruguay**. The loan was part of a $869m RESCHEDULING package which was signed on July 29. The RESCHEDULED amount includes short and medium term debt of the public sector maturing in 1983 and 1984.

Mexico

INTERNATIONAL MONETARY FUND

2/14/86

Mr. Finch
✓Mr. Watson

You may already have the attached, but Mr. Rhodes gave them to me during the course of a conversation the other day.

Attachments

Richard D. Erb

Copies -
Mexico
Baker
MW
Bole S

NEW RESTRUCTURE AGREEMENTS

Dated as of August 29, 1985

Among

MEXICAN PUBLIC SECTOR OBLIGORS

and

THE UNITED MEXICAN STATES

as Guarantor

and

BANCO DE MEXICO

as the Central Bank of
the United Mexican States

and

THE SERVICING BANKS

and

THE ADMINISTRATIVE AGENT

and

THE BANK SIGNATORIES

European Currency Units due on such date and (b) the sum of the Dollar Equivalents (as defined in the definition of European Currency Unit) on such date of all Specified Component Amounts (as so defined).

SECTION 5.11. Capitalization of Credits. (a) General. Subject to written agreement between the Obligor and any Bank and subject to all required Mexican governmental authorizations, including authorization by the Ministry of Finance and Public Credit, the National Commission on Foreign Investment and the Ministry of Foreign Relations of the United Mexican States, all or a portion of the Credits held by such Bank may be exchanged for Qualified Capital Stock. The Obligor and such Bank will promptly notify the Servicing Bank in writing of any such agreement that has been so authorized, which notice shall specify each Credit (or portion thereof) to be exchanged for such Qualified Capital Stock. Upon delivery of such Qualified Capital Stock by or on behalf of the Obligor to such Bank or its designee, (i) each Credit (or portion thereof) in respect of which such Qualified Capital Stock is delivered shall cease to be a "Credit" and "External Indebtedness" for all purposes of this Agreement and the Obligor shall have no further obligations in respect of any such Credit (or portion thereof) and (ii) the Obligor and such Bank shall deliver to the Servicing Bank a Correction Notice reducing the principal amount of each such Credit by the principal amount exchanged for such Qualified Capital Stock.

(b) Qualified Capital Stock. For purposes of this Section, "Qualified Capital Stock" means capital stock of any Mexican public sector entity or Mexican private sector company (i) which is issued in registered, certificated form in the name of such Bank or a Person designated by such Bank which is not a Mexican Entity (as defined below), (ii) which is not transferable on the registration books of such public sector entity or private sector company before January 1, 1998 to any Mexican Entity and the certificate of which bears a legend with such restriction, (iii) which is not by its terms subject to redemption on a basis more favorable to such Bank or its designee than the amortization of the Credit or Credits exchanged for such capital stock, (iv) which is not entitled to guaranteed dividends payable irrespective of earnings and profits, except as expressly contemplated by Article 123 of the Ley General de Sociedades Mercantiles, and (v) which is not convertible into any instrument or security other than Qualified Capital Stock. As used herein, the term "Mexican Entity" means any Person who, in the case of an individual, is a resident of or, in the case of an entity, has its principal place of business in the United Mexican States.

IBRD PARTICIPATION IN THE BAKER INITIATIVE

IN CONNECTION WITH THE BAKER INITIATIVE, IT IS ANTICIPATED THAT FOR AT LEAST SOME LARGE DEBTOR COUNTRIES ADDITIONAL LARGE SYNDICATED LOANS TO THE DEBTOR COUNTRY ITSELF (THE CENTRAL BANK OR OTHER OBLIGORS UNDER THE REPUBLIC GUARANTEE) WILL BE REQUIRED. THE BANKS BELIEVE THAT, CONSISTENT WITH SECRETARY BAKER'S SPEECH, A CENTERPIECE IN THESE PACKAGES, IN ADDITION TO THE IMF, WOULD BE A SUBSTANTIAL INCREASE IN THE ROLE OF THE IBRD AND A CHANGE TO SOME EXTENT IN ITS RELATIONSHIP WITH THE COMMERCIAL BANKS. IN EFFECT THE BANKS ARE LOOKING TO BUILD A NEW AND ENHANCED PARTNERSHIP WITH THE WORLD BANK.

WHILE WE UNDERSTAND SPECIFIC ISSUES WILL BE HANDLED ON A CASE-BY-CASE BASIS, WE WILL ALL BE WORKING UNDER SEVERE TIME CONSTRAINTS. THUS THE BANKS BELIEVE THAT IT IS IMPORTANT TO ADDRESS AS MANY OF THE ISSUES AS SOON AS POSSIBLE. THE BANKS BELIEVE THAT THE FOLLOWING REPRESENTS ESSENTIAL NEW ELEMENTS OF THE IBRD PARTICIPATION.

1. IBRD WOULD SUBSTANTIALLY INCREASE THE RATE AND MAGNITUDE OF ITS DISBURSEMENTS (INCLUDING DISBURSEMENTS TO THE COUNTRIES COVERED BY THE BAKER INITIATIVE).

2. A COMPREHENSIVE IBRD STRUCTURAL ADJUSTMENT/POLICY PROGRAM SHOULD BE DEVELOPED FOR EACH SUCH DEBTOR COUNTRY WHICH WOULD BE CONSISTENT WITH THE RELEVANT IMF PROGRAM AND INCLUDE INPUT FROM THE COMMERCIAL BANKS WITH RESPECT TO SUCH PROGRAM'S GOALS AND OBJECTIVES. IT IS ANTICIPATED THAT THE COMMERCIAL BANK VIEWS WOULD BE OBTAINED THROUGH CONSULTATIONS BY THE IBRD WITH THE RELEVANT COUNTRY ADVISORY COMMITTEE FROM AN EARLY POINT IN THE DEVELOPMENT OF THE IBRD PROGRAM AND THROUGHOUT ITS REVIEW AND APPROVAL PROCESS.

3. THE CO-FINANCING PROGRAMS SHOULD BE EXPANDED. IBRD STRUCTURAL ADJUSTMENT LOANS, POLICY LOANS, SECTORAL LOANS, TRADE LOANS, ETC. OUGHT TO BE ELIGIBLE FOR INCLUSION IN CO-FINANCINGS.

4. TO THE EXTENT THAT IBRD GUARANTEES ARE TO BE UTILIZED, SUCH GUARANTEES SHOULD BE MADE MORE COMPARABLE TO A CUSTOMARY COMMERCIAL BANK GUARANTEE. IN ADDITION, THE IBRD WOULD NOT BE SUBROGATED TO THE RIGHTS OF THE BANKS UNTIL THE BANKS HAVE BEEN FULLY REPAID PRINCIPAL AND INTEREST ON THE GUARANTEED LOAN, THE CO-FINANCING LOAN AND/OR ANY ADDITIONAL COMMERCIAL BANK LOAN TO THE BORROWER UNDER THE PROGRAM WITH OR WITHOUT IBRD PROTECTION.

5. THE DEFAULT PROVISIONS OF THE IBRD LOAN (SAL, POLICY LOAN, ETC.) SHOULD CONTAIN CROSS-DEFAULTS TO THE COMMERCIAL BANK LOANS IN THE PROGRAM (INCLUDING ANY GUARANTEED LOAN, CO-FINANCING LOAN AND ANY ADDITIONAL COMMERCIAL BANK LOAN TO THE BORROWER UNDER THE PROGRAM WITH OR WITHOUT IBRD PROTECTION). THE PROVISIONS OF THE IBRD STRUCTURAL ADJUSTMENT POLICY LOAN AND THE COMMERCIAL BANK CO-FINANCING LOAN SHOULD PROVIDE FOR SHARING OF PRINCIPAL AND INTEREST PAYMENTS ON A PRO-RATA BASIS.

THERE ARE ALSO PROVISIONS IN EXISTING IBRD AND COMMERCIAL BANK LOANS, SUCH AS CROSS-CONDITIONALITY OF DRAWDOWNS, WHICH WILL CONTINUE TO BE OF GREAT IMPORTANCE TO BANKS AS REGARDS FUTURE FINANCING BY COMMERCIAL BANKS. IT MAY ALSO BE WORTHWHILE TO CONSIDER NEW VEHICLES TO FACILITATE INCREASED COOPERATION BETWEEN THE IBRD AND THE INTERNATIONAL BANKING COMMUNITY. OBVIOUSLY, THE INTER-RELATIONSHIP OF THE PARTS OF A PARTICULAR TRANSACTION WILL BE EXTREMELY IMPORTANT TO THE OVERALL STRUCTURE OF ANY SPECIFIC COUNTRY FINANCING PLAN.

DECEMBER 23, 1985

spmexbaker
1/2/86

MEXICO

1. Relations with the Fund

On December 23, 1982 the Executive Board approved Mexico's use of Fund resources for an amount of SDR 3,611.25 million (450 percent of quota), including SDR 200.6 million under the first credit tranche and SDR 3,410.6 million under an extended arrangement for the three-year period ended December 31, 1985. Mexico purchased SDR 2,207 million during the first two years of the arrangement, representing the entire entitlement for that period, and SDR 295.8 million following the approval of the program for the third year of the arrangement in June 1985. Because of noncompliance with quantitative performance criteria, Mexico has not made the purchases scheduled for end-August and end-November 1985; a total of SDR 907.9 million remained undrawn under the arrangement as of December 31, 1985.

Mexico has requested a purchase for SDR 291.375 million (25 percent of quota) under the Fund tranche policies for emergency assistance following the September 1985 earthquakes. This request is scheduled to be considered by the Executive Board on January 10, 1985. In their letter requesting the emergency assistance from the Fund, the Mexican authorities have indicated their intention to seek Fund support for their 1986 economic program in the form of a stand-by arrangement. Following a visit of Mexican officials to the Fund in mid-January a Fund mission is scheduled to visit Mexico in late January to negotiate such an arrangement.

2. Relations with the IBRD

The World Bank has been studying ways to increase its lending to Mexico. The attached table assumes that net disbursements from the World Bank would increase by some US$600 million in 1986 over the level achieved in 1985. This increase would reflect partial disbursement in 1986 of a reconstruction loan (for US$300 million), which is being processed by the Bank, a new development program loan (for US$500 million) and a second export development loan (for US$250 million) which are currently under negotiation. The latter two loans are likely to have a more rapid disbursement rate than the reconstruction loan. The disbursements from the IBRD foreseen for the period 1987-88 have been projected on the basis of the loans already in existence or in the process of being negotiated; should there be additional development program loans during this period, disbursements would be raised above the levels shown in the table.

3. Relations with commercial banks and other creditors

The attached table assumes that net disbursements from commercial banks to Mexico will amount to US$1 billion in 1986, US$1.8 billion in 1987, and US$1.9 billion in 1988. Gross drawings from commercial banks in 1986 are projected to amount to US$2.8 billion, in order to cover US$250 million of amortizations due in 1986 under the multiyear restructuring agreement, the restructuring of the US$950 million prepayment of a 1983 loan which had been rolled over for six months following the September earthquake, and some US$600 million of amortizations due on loans outstanding to the Mexican private sector. Projections for 1987 and 1988 take into account the amortization schedules established under the 1984 multiyear restructuring agreement. Under the terms of that agreement, a total debt of US$48.7 billion falling due in 1985-90 was restructured over a 14-year period.

Disbursements in 1986 from commercial banks to the Mexican public sector shown in these projections are smaller than the US$2.5 billion net financing requested by the Mexican authorities in their communication to commercial banks of October 1, 1985 (which was later reiterated in a meeting held in New York in early December). The difference between our projection and that of the Mexican authorities is based on our expectations that the banks will not disburse in 1986 the full amount requested by the authorities because the arrangements with the Fund and other creditors will not start before the second quarter of the year.

With regard to other official lenders, it is possible that the commercial banks will request an increase in official lending if they were to provide additional fresh money in 1986. In their discussions with the Mexican authorities, the banks have raised the question of a multiyear restructuring of the debt covered by the Paris Club. In the past, the Mexican authorities have resisted such a restructuring, so as not to impair access to new credits, and have kept payments on such debt current.

tb6mex001
1/2/86

Table 1. Mexico: Selected Economic Indicators, 1984-86

	1984	1985	1986
(Annual percentage changes, unless otherwise specified)			
GDP at constant prices	3.7	3.9	-1.0
CPI index (December-December)	59.2	67.8	50.0
Export volume	7.3	-5.2	2.9
Import volume	26.1	17.9	-2.0
(In percent of GDP)			
Public sector deficit	-6.2	-8.3	-4.2
Gross investment	20.3	20.5	22.9
Current account balance	2.3	-0.4	0.1

tb6mex002
1/2/86

Table 2. Mexico: Balance of Payments, 1984-88

	1984	1985	1986	1987	1988
	(In billions of U.S. dollars)				
Current account balance	4.0	-0.7	0.2	-0.2	-0.5
Capital account	-1.0	-3.3	1.8	1.7	1.6
Net commercial bank lending 1/	2.5	-1.1	1.0 2/	1.8	1.9
(percentage change) 3/	(3.4)	(-1.4)	(1.3)	(2.3)	(2.3)
Net World Bank lending	0.4	0.2	0.8	0.3	0.3
Disbursements	0.7	0.6	1.1	0.7	0.7
Amortizations	-0.3	-0.4	-0.3	-0.4	-0.4
Net lending by other multilateral development banks	0.2	0.2	0.3	0.1	0.1
Disbursements	0.3	0.3	0.4	0.2	0.2
Amortizations	-0.1	-0.1	-0.1	-0.1	-0.1
Net official lending	-0.4	-0.1	0.1	0.3	0.3
Paris Club	...	-0.2	-0.3	-0.2	-0.2
Other	-3.7	-2.3	-0.1	-0.6	-0.8
Change in net international reserves (increase -)	-3.0	4.0	-2.0	-1.5	-1.1
Change in gross international reserves (increase -)	-3.9	3.5	-2.6	-1.4	-0.7
Change in Fund position	1.1	0.5	0.6	-0.1	-0.4
Change in external arrears	-0.3	--	--	--	--
Change in other liabilities	0.1	--	--	--	--

1/ Includes lending to private (MLT), public sector, and nationalized banks; except for 1984 when data are for public sector only.

2/ The Mexican authorities have requested a total of US$2.5 billion in net new drawings from foreign commercial banks for 1986, but in these projections only US$1 billion of net disbursements are assumed to take place within the calendar year 1986.

3/ In relation to the stock at the end of the previous year.