PO-CH/NL/0343

Part A.

CONFIDENTIAL

(Circulate under cover and notify REGISTRY of movement)

Begins: 10/3/87.
Ends: 15/2/88.

PO -CH /NL/0343

PART A

Chancellors (Lawson) Papers:

ECONOMIC DEVELOPMENTS AND DEBT RELIEF INITIATIVES IN MEXICO

DD's: 25 Years

15/11/95.

PO -CH /NL/0343
PART A

GRS 500

CONFIDENTIAL

AMENDED DISTRIBUTION

17th MARCH '87

CONFIDENTIAL

FM MEXICO CITY

TO PRIORITY FCO

TELNO 94

OF 101400Z MARCH 87

MEXICO : MARCH 1987

SUMMARY

1. RECENT STRIKES ARE EVIDENCE OF UNDERLYING STRAIN BUT POLITICAL ATTENTION CONTINUES TO FOCUS ON THE PRESIDENTIAL SUCCESSION, AND THE RULING PARTY TO CONCENTRATE ON ITS INTERNAL UNITY. CONTADORA'S IN THE DOLDRUMS BUT MEXICO IS WARY OF THE ARIAS PLAN. THE GENERALLY GLOOMY ECONOMIC SCENE IS NOW SOMEWHAT RELIEVED BY SOME SIGNS OF IMPROVEMENT, IF ONLY IN CONTRAST WITH BRAZIL.

DETAIL

2. LADY YOUNG WILL BE VISITING MEXICO JUST OVER TWO MONTHS AFTER YOUR VISIT. THE SCENE SET IN MEXICO CITY TELNO 452 REMAINS BROADLY RECOGNISABLE. THERE HAVE HOWEVER BEEN SIGNS THAT THE POLITICAL AND ECONOMIC STRAINS ARE BEGINNING TO TELL. THE LARGEST PUBLIC UNIVERSITY IN MEXICO, UNAM, WAS ON STRIKE FOR THREE WEEKS FROM THE END OF JANUARY AND MORE RECENTLY A STRIKE BY ELECTRICITY WORKERS JUST ENDED, LOOKED FOR A TIME AS IF IT MIGHT ESCALATE DANGEROUSLY. ALTHOUGH BOTH STRIKES HAD CLEAR OBJECTIVES(AGAINST UNIVERSITY REFORMS, IN SUPPORT OF HIGHER WAGES)THEY WERE INDICATIVE OF A GROWING ABILITY TO ORGANISE PROTESTS DIRECTLY OR INDIRECTLY AGAINST THE GOVERNMENT.

3. DESPITE THESE TENSIONS POLITICAL INTEREST AND SPECULATION CONTINUES TO BE LARGELY FOCUSSED ON THE PRESIDENTIAL SUCCESSION. IN RECENT MONTHS DE LA MADRID APPEARS TO HAVE REASSERTED HIS AUTHORITY OVER THE PARTY AND THE GOVERNMENT AND SUGGESTIONS THAT HE WAS LOSING HIS GRIP HAVE LARGELY FALLEN SILENT. AT THE PRI'S RECENT NATIONAL ASSEMBLY HE APPEARED FULLY IN CONTROL, AN IMPRESSION STRENGTHENED BY THE PRESENCE ON THE PLATFORM OF FORMER PRESIDENTS ECHEVERRIA AND LOPEZ PORTILLO. BUT THE ASSEMBLY LARGELY DEVOTED ITSELF TO FORTIFYING PARTY UNITY AND CLOSING RANKS RATHER THAN TACKLING THE PROBLEM OF ADAPTING ITSELF TO CHANGING SOCIAL CIRCUMSTANCES AND DEMANDS.

4. IN FOREIGN POLICY THERE HAS BEEN FEW DEVELOPMENTS .RELATIONS WITH THE US ARE CURRENTLY IN ONE OF THEIR LESS ACRIMONIOUS PHASES . AFTER THE CENTRAL AMERICAN TOUR OF MID-JANUARY CONTADORA SEEMS TO HAVE DRIFTED INTO THE DOLDRUMS. ALTHOUGH AT A LOSS FOR IDEAS MEXICO IS LOATH TO LET THE PROCESS DIE AND IS INCLINED TO RECENT ATTEMPTS TO UPSTAGE IT:HENCE THE SOMEWHAT COOL AND NONCOMMITTAL RESPONSE MEXICO HAS GIVEN TO THE ARIAS PLAN.

5. AFTER MONTHS OF GLOOM THE ECONOMY HAS SHOWED FAINT SIGNS OF IMPROVEMENT. ENCOURAGING FEATURES INCLUDE THE GROWTH OF NON-OIL EXPORTS, CONTINUING RETURN OF CAPITAL AND SOME IMPROVEMENT IN OIL PRICES. THE DELAY IN THE ARRIVAL OF NEW MONEY UNDER LAST

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YEARS

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YEAR'S PACKAGE HAS BEEN WORRYING AND THERE IS A DANGER OF UNCONTROLLED PUBLIC EXPENDITURE AS THE PRESIDENTIAL ELECTIONS APPROACH.BUT 1986 TURNED SOMEWHAT BETTER THAN FORECAST AND IT IS POSSIBLE TO SENSE A CERTAIN SATISFACTION THAT MEXCIO HAS PERHAPS ORGANISED ITS AFFAIRS BETTER THAN BRAZIL.MEXICO MAY AFTER ALL BE WEATHERING THE STORM BETTER THAN AT ONE TIME SEEMED LIKELY

MORGAN

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GRS 840

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CONFIDENTIAL
FM MEXICO CITY
TO PRIORITY DTI
TELNO OTTER 53
OF 201610Z MARCH 1987
AND TO ROUTINE ECGD, FCO, HMT, ODA

AMENDED DISTRIBUTION 23/3/87

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MY EXCED 13 OF 10 MARCH

FROM MILTON

MEXICO: BILATERAL RESCHEDULING NEGOTIATIONS

1. I TOOK TITCHENER TO SEE ALFREDO PHILLIPS, DIRECTOR GENERAL, FOREIGN TRADE BANK (BNCE) ON 19 MARCH AS PART OF A ROUND OF POST-HOMC CALLS.

2. AFTER PRELIMINARY OPENING REMARKS, DURING WHICH IT WAS APPARENT THAT PHILLIPS WAS BURSTING TO GET SOMETHING OFF HIS CHEST, HE SAID THAT HE WISHED TO SPEAK QUITE FRANKLY ABOUT ONE MATTER WHICH WAS OF CURRENT MAJOR CONCERN. HE THEN SAID THAT MEXICO WOULD NOT BUY GOODS FROM THE UK UNLESS ECGD OPENED THEIR CREDIT LINES. MEXICO, HE SAID, WOULD ''GIVE PREFERENCE TO OTHERS'' IF ECGD PERSISTED WITH THEIR PRESENT POLICY. PHILLIPS REMINDED US ONCE MORE THAT THE MEXICANS HAD BEEN A MOST RELUCTANT SUITOR OF THE PARIS CLUB LAST YEAR : THEY HAD APPLIED FOR A RESCHEDULING AT THE BEHEST OF THE COMMERCIAL BANKS WHO HAD MADE IT CLEAR THAT CREDITOR GOVERNMENTV PARTICIPATION IN RESTRUCTURING OFFICIAL DEBT WAS A PRE-CONDITION OF THEIR OWN SUPPORT. THEY HAD EXPECTED ECGD, ALONG WITH OTHER ECAS, TO REMAIN ON COVER. AS IT WAS, ONLY ECGD AMONG THE PARIS CLUB MEMBERS, HAD GONE OFF COVER. THE MEXICANS FOUND ECGD'S ''UNCOOPERATIVE ATTITUDE'' PUZZLING, PARTICULARLY IN VIEW OF THE GOOD WORKING RELATIONSHIP AND CLOSE PERSONAL CONTACTS BETWEEN BNCE AND ECGD STAFF. PHILLIPS WONDERED WHAT COULD BE DONE TO BREAK THE IMPASSE OVER THE BILATERAL AGREEMENT.

3. TITCHENER EXPLAINED THAT ECGD HAD NOT EXPECTED TO BE OFF COVER FOR MEXICO FOR AS LONG AS HAD TURNED OUT. WITH REGARD TO THE BILATERAL AGREEMENT, ECGD WERE ONLY PROPOSING TO CHARGE MEXICO THE SAME RATE OF INTEREST AS OTHER DEBTORS. THEY WERE AIMING TO COVER THEIR COSTS AND THEY WERE NOT THEREFORE TAKING ACCOUNT OF WHAT OTHER PARIS CLUB MEMBERS WERE DOING. HE AGREED WITH PHILLIPS THAT A FRESH EFFORT WAS NEEDED TO BREAK THE DEADLOCK.

4. PHILLIPS COMMENTED THAT MEXICO TOO HAD ITS OWN RULES ABOUT THE TERMS FOR BILATERAL RESCHEDULING AGREEMENTS. IT WAS NOT GOOD ENOUGH TO SAY THAT ECGD WERE DOING NO MORE THAN APPLYING AUTOMATIC RULES TO MEXICO. SURELY, SOME ACCOUNT SHOULD BE TAKEN OF

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THE UK'S OTHERWISE GOOD RELATIONS WITH MEXICO AND MEXICO'S PARTICULAR CIRCUMSTANCES, INCLUDIN G THOSE IN WHICH IT HAD GONE TO THE PARIS CLUB. PHILLIPS THEN SAID HE HAD DISCUSSED THE MATTER WITH PETRICIOLI, FINANCE MINISTER, AND SUAREZ, DEPUTY FINANCE MINISTER. THEY HAD AGREED TO HIS PARTICIPATING DIRECTLY IN RENEWED NEGOTIATIONS IF THAT WOULD HELP. HE WAS READY TO SEND A MESSAGE TO MR GILL. BNCE WERE PREPARED TO ACT AS AN INTERMEDIARY BETWEEEN THE MEXICAN MINISTRY OF FINANCE AND ECGD IF THAT WOULD DO ANY GOOD. VILATELA, BNCE'S DIRECTOR OF FINANCE AND INTERNATIONAL AFFAIRS, WHO WAS PRESENT, WAS WORKING ON POSSIBLE IDEAS FOR A SOLUTION AND PHILLIPS HOPED TO BE IN TOUCH WITH US SHORTLY (THE IDEA OF BNCE'S ACTING AS AN INTERMEDIARY WAS RAISED BY VILATELA HIMSELF WITH VAN SLOOTEN, ECGD, DURING THE LATTER'S BILATERAL VISIT LAST WEEK : SEE MY NOTE OF 13 MARCH RECORDING THE DISCUSSION, COPIES OF WHICH ARE WITH TITCHENER, MAUD AND VAN SLOOTEN).

5. COMMENT. TO JUDGE BY PHILLIPS'S ATTITUDE, THE FACT THAT ECGD WENT OFF COVER, AND HAVE STAYED OFF COVER, HAS IRRITATED THE MEXICANS MORE THAN THEIR TERMS FOR A BILATERAL AGREEMENT. THE MEXICANS ARE BAFFLED WHY THIS SHOULD HAVE HAPPENED WHEN, IN THEIR VIEW, THEY WERE GIVEN TO UNDERSTAND THAT AN APPROACH TO THE PARIS CLUB WOULD AT MOST MEAN A TEMPORARY WITHDRAWAL OF COVER (AND NOT, AS IN OUR CASE, FOR 6 MONTHS ALREADY). NOR CAN THE MEXICANS UNDERSTAND WHY IT IS THAT ECGD ARE BEHAVING DIFFERENTLY FROM OTHER PARIS CLUB ECAS, ALL OF WHOM ARE NOW, ACCORDING TO PHILLIPS, ON COVER FOR MEXICO (THE MEXICANS HAVE NOW SIGNED BILATERALS WITH 7 OTHERS : NORWAY, PLUS THE 6 LISTED IN PARAGRAPH 3 OF MY TUR, AND AN AGREEMENT WITH THE CANADIANS IS IMMINENT).

6. IN DISCUSSION WITH TITCHENER, WE PROVISIONALLY CONCLUDED THAT ECGD SHOULD BE IN A STRONGER POSITION TO SECURE SOMETHING CLOSER TO THEIR TERMS FOR A BILATERAL AGREEMNT IF THEY RESTORED FULL MEDIUM AND LONG TERM COVER WITHOUT FURTHER DELAY. IF WE PUT OURSELVES IN LINE IN THIS WAY WITH OUR PARIS CLUB PARTNERS, THE APPARENT PRINCIPAL CAUSE FOR THE MEXICANS' IRRITATION SHOULD BE REMOVED AND THUS PERHAPS THE CHANCES OF AN ACCEPTABLE AGREEMENT TO US IMPROVED. BUT I ALSO THINK THAT WHEN THE BILATERAL NEGOTIATIONS ARE RESUMED WE SHOULD PAY AT LEAST SOME REGARED TO OUR CASE BY CASE APPROACH TO INDIVIDUAL DEBTORS' PROBLEMS. THE IFIS AND THE COMMERCIAL BANKS HAVE ACCEPTED INNOVATIVE AND PREFERENTIAL TERMS FOR MEXICO IN MAKING THEIR CONTRIBUTIONS TO THE NEW FIANCING PACKAGE AND DEBT RESTRUCTURING AGREEMENTS WITH MEXICO. CONSISTENCY AT LEAST POINTS TO OUR BEING PREPARED TO ADOPT THE SAME APPROACH WITH REGARD TO RESHEDULING OFFICIAL DEBT AND NOT TO ECGD'S TREATING ALL DEBTORS ALIKE.

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7. THE HOMC EARLIER THIS WEEK PROVIDED AN OPPORTUNITY FOR TITCHENER, MAUD AND VAN SLOOTEN TO DISCUSS AMONG THEMSELVES AND WITH US THE NEED TO OPEN THE WAY TO AN EARLY RESTORATION OF ECGD COVER. LADY YOUNG WAS ALSO PARTY TO SOME OF THE EXCHANGES. PHILLIPS' WARNING THAT UK EXPORTERS WILL SUFFER IF THAT DOES NOT HAPPEN ADDS AN ADDITIONAL NOTE OF URGENCY. THE AMBASSADOR, WHO EXPRESSED HIS VIEWS DURING THE HOMC, AND WHO IS NOW ON TOUR, WOULD CERTAINLY AGREE. WE WILL LET YOU KNOW IF BNCE FOLLOW UP AS ENVISAGED (SEE PARA 2).

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RESTRICTED
FM MEXICO CITY
TO IMMEDIATE FCO
TELNO 123
OF 271816Z MARCH 1987
AND TO ROUTINE BANK OF ENGLAND, HMT, DTI, ODA, ECGD
INFO ROUTINE UKDEL IMF/IBRD WASHINGTON, WASHINGTON

MEXICO : NEW FINANCING PACKAGE

SUMMARY

1. THE MEXICANS ARE CONCERNED THAT BRITISH BANKS HAVE NOT YET SIGNED THE NEW MONEY AND DEBT RESTRUCTURING AGREEMENTS. TAKEN TOGETHER WITH OUR POSITION ON ECGD COVER, THERE IS A RISK THAT WE MAY BE SINGLED OUT AS UNSYMPATHETIC TO MEXICO'S NEEDS, WHICH IS CONTRARY TO OUR INTERESTS.

DETAIL

2. I AM GRATEFUL TO LOEHNIS FOR TELEPHONING TO ADVISE ME OF GURRIA'S CALL TO HIM ON 26 MARCH EXPRESSING CONCERN AT A REUTERS' REPORT THAT BRITISH BANKS WERE NOT GOING TO SIGN UP FOR NEW MONEY UNTIL CERTAIN CONDITIONS WEREMET.

3. MILTON SPOKE TO GURRIA, WHO SAID THAT, IN RESPONSE TO THE REUTERS' STORY AND IN THE ABSENCE OF HIS MINISTERS, HE HAD ISSUED A PRESS STATEMENT TO THE EFFECT THAT THE BRITISH BANKS HAD ALWAYS SUPPORTED THE NEW MONEY AND RESTRUCTURING PACKAGE FOR MEXICO, THAT THE BANK OF ENGLAND HAD PL

YED A SIMILARLY SUPPORTIVE ROLE AND THAT THE BRITISH BANKS' CONCERN THAT THERE SHOULD BE THE GREATEST DEGREE OF EQUITY POSSIBLE IN DISTRIBUTING RESPONSIBILITY FOR THE NEW MONEY AMONG THE INTERNATIONAL BANKING COMMUNITY WAS UNDERSTANDABLE AND WAS BEING MET. ''EL FINANCIERO'', MEXICO'S INDIFFERENT EQUIVALENT TO THE FT'' CARRIES AN ABBREVIATED VERSION OF THE MINISTRY OF FINANCE'S STATEMENT ON 27 MARCH UNDER THE RATHER ODD HEADING ''THE MAIN BRITISH BANKS AGREE TO PARTICIPATE IN FINANCING FOR MEXICO''. THE SAME REPORT STATES THAT A LLOYDS BANK OFFICIAL HAD SAID THAT SIX BRITISH BANKS - BARCLAYS, NATWEST, STANDARD CHARTERED, MIDLAND, ROYAL BANK OF SCOTLAND AND LLOYDS THEMSELVES - DID NOT WANT TO COMMIT THEMSELVES TO CONTRIBUTING AT A LEVEL EQUIVALENT TO 12.9 PERCENT OF THEIR MEXICAN EXPOSURE AT AUGUST 1982.

4. GURRIA SAID HIS OWN UNDERSTANDING WAS THAT THE BRITISH BANKS WERE INSISTING ON TWO CONDITIONS. FIRST THE 54 BANKS WHICH CONTRIBUTED TO BRIDGING FINANCE FOR MEXICO LAST AUTUMN SHOULD PARTICIPATE IN THE PACKAGE (THE ITALIAN BANKS HAVE NOT YET COME IN).

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SECOND, THE US BANKS SHOULD CONTRIBUTE TO AT LEAST 90 PERCENT OF THEIR SHARE OF THE NEW MONEY (AT PRESENT, THEY ARE ONLY IN FOR 83 PERCENT). GURRIA SAID THAT IDEALLY THE US BANKS SHOULD CONTRIBUTE ON THE SCALE DESIRED BY THE BRITISH BANKS, BUT THE TIME WAS NOW PAST WHEN IT WAS REALISTIC TO SUPPOSE THAT A 90 PERCENT CONTRIBUTION WOULD BE FORTHCOMING. THE SMALL US REGIONAL BANKS WHICH HAVE NOT YET CONTRIBUTED, IN SPITE OF MONTHS OF PRESSURE TO DO SO, MUST NOW BE REGARDED AS MOST UNLIKELY SIGNATORIES. HE HOPED THAT THE CONSULTATIONS WHICH HE UNDERSTOOD WERE TAKING PLACE BETWEEN THE BANK OF ENGLAND AND THE FED AND BETWEEN BRITISH AND AMERICAN COMMERCIAL BANKS WOULD RESOLVE THE MATTER QUICKLY. HE FEARED OTHERWISE THAT MEXICO WOULD BE THE LOSER. WHEN ASKED WHAT THE POSITION WAS WITH OTHER BANKS, GURRIA SAID EXPLICITLY THAT THE FRENCH, SWISS, LARGE AMERICAN BANKS AND SOME CANADIAN BANKS HAD SIGNED. THE ITALIANS, WHO WERE ALWAYS ''SHORT AND SLOW'' WERE NOW SHELTERING BEHIND THE BRITISH IN NOT SIGNING. SO FAR, GURRIA SAID THAT US DOLLARS 5.558BN NEW MONEY HAD BEEN SIGNED UP (WHICH SUGGESTS THAT THERE CANNOT BE MANY OTHER NATIONAL BANK GROUP BESIDES THE BRITISH WHICH ARE STILL DELAYING). INCIDENTALLY, A SENIOR REPRESENTATIVE OF THE CANADIAN IMPERIAL BANK OF COMMERCE CARRENTLY VISITING MEXICO HAS TOLD MILTON THAT ALTHOUGH HIS BANK HAVE SIGNED THEY HAVE DONE SO ON THE SAME CONDITIONS AS THE BRITISH BANKS WANT FULFILLED.

5. GURRIA WONDERED WHETHER IN ORDER TO BREAK THE LOGJAM IN OUR CASE THE BANK OF ENGLAND MIGHT MAKE ANOTHER ATTEMPT TO PERSUADE THE BRITISH BANKS TO PARTICIPATE, PERHAPS USING THE ARGUMENT THAT IT REALLY WAS IMPORTANT TO SETTLE THE NEW PARKAGE FOR MEXICO BEARING IN MIND THE OUTSTANDING PROBLEMS WITH OTHER LATIN AMERICAN DEBTORS. I DO NOT KNOW WHETHER THE BANK WOULD FEEL ABLE TO TAKE THIS STEP, AND I AM FULLY AWARE THAT WE MUST RESPECT THE COMMERICAL BANKS' SOVEREIGN RIGHT TO MAKE THEIR OWN DECISIONS. YOU ARE HOWEVER AWARE THAT THE MEXICAN AUTHORITIES HAVE MORE THAN ONCE THANKED US FOR THE POSITIVE CONTRIBUTION THE BRITISH FINANCIAL COMMUNITY HAS MADE TO THE NEW MONEY AND DEBT RESTRUCTURING AGREEMENTS. IT WOULD BE UNFORTUNATE IF WE WERE TO PREJUDICE OUR POSITION AT THE ELEVENTH HOUR. ALSO, COMING ON T OF ECGD'S DIFFICULTIES WITH MEXICO, WE ARE IN DANGER OF BEING SINGLED OUT AS UNSYMPATHETIC TO MEXICO'S NEEDS. THAT IS INCONSISTENT WITH THE RECENT HEADS OF MISSION CONFERENCE CONCLUSION ON DEBT MATTERS (MY TELEGRAM NO 110, PARAGRAPH 25).

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COPIES TO:
TREASURY
B/ENGLAND
DTI-VIC. ST
ECGD.

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RESTRICTED
FM MEXICO CITY
TO PRIORITY FCO
TELNO 137
OF 071630Z APRIL 87
AND TO PRIORITY BANK OF ENGLAND,DTI,ECGD
(CULL)

MEXICO : INCREASES IN NATIONAL MINIMUM WAGE AND GASOLINE PRICES

SUMMARY

1. MINIMUM WAGE INCREASE OF 20 PER CENT QUICKLY FOLLOWED BY MUCH LARGER INCREASE IN THE PRICE OF PETROL.CONSIDERABLE PUBLIC DISSATISFACTION,BUT THE GOVERNMENT STANDING FIRM AND,ON PAST FORM,PROTESTS SHOULD DIE DOWN BEFORE LONG.

DETAIL

2. THE NATIONAL MINIMUM WAGE WAS INCREASED BY 20 PER CENT WITH EFFECT 1 APRIL.MINIMUM WAGE EARNERS IN THE HIGHEST COST OF LIVING ZONE,WHICH INCLUDES THE FEDERAL DISTRICT,SHOULD NOW RECEIVE 3,660 PESOS DAILY INSTEAD OF THE PREVIOUS RATE OF 3,050. THE INCREASE IS THE SECOND THIS YEAR: THE FIRST,WHICH CAME INTO EFFECT ON 1 JANUARY,WAS 23 PER CENT.THERE WERE THREE MINIMUM WAGE SETTLEMENTS IN 1986 : TWO SETTLEMENTS A YEAR HAVING BEEN THE NORM PREVIOUSLY UNDER THIS ADMINISTRATION.IT WAS TACITLY AGREED TOWARDS THE END OF LAST YEAR BY THE GOVERNMENT AND THE UNIONS THAT THERE SHOULD BE QUARTERLY MINIMUM WAGE INCREASES IN 1987,AND THIS TREND NOW SEEMS TO BE ESTABLISHED.THE GOVERNMENT IS PUBLICLY COMMITTED TO PREVENTING A FURTHER EROSION IN WORKERS' PURCHASING POWER THIS YEAR.

3. PREDICTABLY,THE MAJOR UNIONS HAVE EXPRESSED DISSATISFACTION AT THE LEVEL OF THE LATEST INCREASE IN THE MINIMUM WAGE.THEY HAVE CLAIMED THAT EVEN TAKING IT INTO ACCOUNT,MINIMUM WAGE EARNERS WOULD STILL BE WORSE OFF THAN THEY WERE AT THE BEGINNING OF THIS YEAR.SUCH COMPLAINTS ARE STANDARD.

4. THERE HAS BEEN MUCH MORE PUBLIC DISCONTENT,NOT ONLY AMONG THE MAJOR UNIONS AND OPPOSITION PARTIES BUT ALSO FROM BUSINESS AND EVEN THE CHURCH,OVER AN AVERAGE 33.6PER CENT INCREASE IN THE PRICE OF PETROL ANNOUNCED WITH EFFECT FROM 4 APRIL.THERE ARE SIMILAR INCREASES FOR OTHER FUELS.AS HAS HAPPENED BEFORE,THE GOVERNMENT'S PRACTICE OF FIRST RAISING THE MINIMUM WAGE AND THEN MAKING SIGNIFICANT INCREASES IN PUBLIC SECTOR PRICES HAS SHARPENED THE CRITICISM.IT IS HOWEVER THE FIRST INCREASE IN PETROL IN 4 MONTHS(MY TELEGRAM NO 430 OF 28 NOVEMBER).ALSO WE WERE TOLD THAT THE INCREASE WOULD HAVE BEEN MADE EARLIER BUT FOR THE GO

GOVERNMENTS TACTICAL DECISION TO AWAIT THE SIGNING OF THE NEW EXTERNAL FINANCING PACKAGE BEFORE CARRYING OUT FURTHER CORRECTIONS OF PUBLIC SECTOR PRICES(MY TELEGRAM NO 69).AS IT IS,THE GOVERNMENT ARE TAKING THE LINE THAT AN INDEFINATE POSTPONEMENT IN THE REVISION OF PRICES WOULD MEAN EITHER DELAYING THE IMPLEMENTATION OF PUBLIC WORKS AND THE PROVISION OF SERVICES TO THE COMMUNITY OR RESORTING TO PRINTING MONEY WHICH WOULD GENERATE A PERMANENT INCREASE IN INFLATION.THIS WILL NOT CONVINCE THE GENERAL PUBLIC AND THE INEVITABLE IMPACT OF THE INCREASE IN FUEL PRICES MAKES IT RATHER MORE LIKELY THAT THE GOVERNMENT'S ORIGINAL TARGET FOR INFLATION THIS YEAR OF 70-80 PER CENT WILL BE MET.EVEN SO, IT WILL BE UNUSUAL IF THE PROTESTS AGAINST THE INCREASE IN FUEL PRICES ARE SUSTAINED

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161300Z APR
GRS 112

CONFIDENTIAL
FM FCO
TO PRIORITY MEXICO CITY
TELNO 165
OF 161300Z APRIL 87
INFO ROUTINE UKDEL IMF/IBRD WASHINGTON

MEXICO: DEBT

1. MAJOR UK BANKS HAVE NOW SIGNED LOAN AGREEMENTS WITH MEXICO TO PROVIDE 12.9 PERCENT OF THEIR 1982 EXPOSURE LEVELS AS PART OF THE NEW FINANCING PACKAGE. THE US BANKS DID NOT INCREASE THEIR CONTRIBUTION AS MUCH AS UK BANKS WANTED, BUT MADE A SUFFICIENT GESTURE TO PERSUADE THE UK BANKS TO SIGN. WE EXPECT SUFFICIENT SIGNATURES TO SECURE THE 7.7 BILLION DOLLAR PACKAGE TO ENABLE MEXICO TO MAKE ITS FIRST DRAWING ON 30 APRIL.

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RESTRICTED
FM MEXICO CITY
TO PRIORITY FCO
TELNO 202
OF 111955Z JUNE 1987
INFO ROUTINE WASHINGTON, ALL OPEC POSTS

88

PS. TO CHANCELLOR OF THE EXCHEQUER.
TREASURY.

YOUR TELNO 70 TO VIENNA
FROM MILTON

PROSPECTS FOR OPEC MINISTERIAL MEETING

SUMMARY
1. THE MEXICANS ARE REASONABLY OPTIMISTIC THAT OPEC, WITH SOME COOPERATION FROM NON-OPEC PRODUCERS, SHOULD BE ABLE TO KEEP PRICES WITHIN THE US DOLLAR 18-20 BRACKET, EVEN IF THERE IS A MODEST INCREASE IN PRODUCTION LATER THIS YEAR.

DETAIL
2. I CALLED ON ALCUDIA, DEPUTY MINISTER FOR ENERGY, ON 10 JUNE. ALCUDIA SAID THAT OPEC'S RECORD SINCE LAST DECEMBER HAD BEEN POSITIVE : DISCIPLINE AMONG THEIR MEMBERS HAD BEEN QUITE GOOD. THAT, ALONG WITH COOPERATION FROM CERTAIN NON-OPEC PRODUCERS HAD HELPED TO KEEP DOWN PRODUCTION, IN OPEC'S CASE TO AROUND THE AGREED CEILING OF 15.8 MBD (ALTHOUGH THERE HAD BEEN ''SOME OPENING OF THE VALVE'' IN MAY). THE RESULT HAD BEEN PRICE STABILITY AT US DOLLARS 18-20 PER BARREL, WHICH ALCUDIA INDICATED WAS QUITE ACCEPTABLE TO MEXICO (BEARING IN MIND THAT MEXICO'S BUDGET FOR 1987 WAS BASED ON AN OIL PRICE OF US DOLLARS 12 PER BARREL).

3. LOOKING AHEAD TO THE OPEC MEETING, ALCUDIA EXPECTED THAT LAST DECEMBER'S AGREEMENT TO INCREASE PRODUCTION IN Q3 AND Q4 BY 5 PERCENT AND 10 PERCENT RESPECTIVELY, WOULD BE CONFIRMED. HE IMPLIED THAT DEMAND WOULD INCREASE SUFFICIENTLY TO TAKE UP MOST OF THIS ADDITIONAL PRODUCTION AND THEREBY ENSURE REASONABLE PRICE STABILITY. FAILING THAT, HE BELIEVED THAT OPEC PRODUCERS, AND THOSE NON-OPEC PRODUCERS WORKING WITH THE ORGANISATION TO ACHIEVE MARKET STABILITY, WOULD RESTRAIN PRODUCTION IN ORDER TO SUSTAIN PRICES. IMPONDERABLES, INCLUDING NOW POSSIBLE US ACTION IN THE GULF, COULD UPSET THIS ASSESSMENT.

4. IN THE EVENT THAT OPEC INCREASED PRODUCTION IN THE SECOND HALF OF THE YEAR, MEXICO, ACCORDING TO ALCUDIA, WOULD CONSIDER AN INCREASE IN ITS OWN SELF-IMPOSED EXPORT CEILING OF 1.32 MBD. HE SAID THAT THERE WERE NO TECHNICAL OR OTHER CONSTRAINTS TO MEXICO' INCREASING EXPORTS, AT LEAST UP TO THE PRE-1986 CEILING OF 1.5MBD. ON THE OTHER HAND, AN OFFICIAL IN PEMEX, STATE OIL COMPANY, HAS TOLD US THAT THERE MIGHT BE SOME DIFFICULTY IN RAISING EXPORTS ABOVE THE CURRENT LEVEL OF 1.32 MBD, ESPECIALLY IF DOMESTIC DEMAND WERE TO PICK UP IN THE SECOND HALF OF 1987 (WHICH IS NOT ALL THAT LIKELY).

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5. DEL MAZO, MINISTER OF ENERGY, TOLD THE AMBASSADOR A WHILE AGO THAT MEXICO WAS NOT BEING INVITED TO ATTEND THE OPEC MEETING AS AN OBSERVER. AS YOU KNOW, MEXICO, LIKE OTHER NON-OPEC PRODUCERS, HAS NOT BEEN INVITED TO MEETINGS FOR THE PAST 18 MONTHS. NEVERTHELESS, ALCUDIA CONFIRMED TO ME THAT THE MEXICANS KEEP IN CLOSE TOUCH WITH OPEC MEMBERS, NOTABLY VENEZUELA, AND WITH NON-OPEC PRODUCERS. HE INTIMATED THAT MEXICO, LIKE OPEC, WOULD LIKE TO SEE CLOSER COOPERATION WITH MAJOR NON-OPEC PRODUCERS, PARTICULARLY THE UK.

6. COMMENT. AFTER THE DRAMATIC FALL IN THE OIL PRICE LAST YEAR, WHICH COST THEM US DOLLARS 8.5BN IN INCOME, THE MEXICANS ARE NATURALLY CAUTIOUS ABOUT MAKING PREDICTIONS ON PRICES. ALCUDIA WOULD NOT HAVE EXPRESSED QUALIFIED OPTIMISM ABOUT PRICE STABILITY WITHOUT THE MINISTRY OF ENERGY FIRST HAVING MADE CAREFUL CALCULATIONS ABOUT THE LIKELY LEVEL OF SUPPLY AND DEMAND OVER THE REST OF THE YEAR AND WITHOUT LEAVING COMPARED NOTES WITH OTHER PRODUCERS. BUT THE MEXICANS ARE OBVIOUSLY CONCERNED THAT THE MARKET COULD BE UPSET BY UNFORESEEN DEVELOPMENTS.

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MOWBAN 5684

(Repetition to LIBREVILLE
referred for departmental decision,
repeated as requested to other posts.)

OIL
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ADDITIONAL DISTRIBUTION
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MR REEVE
SIR D MIERS

3767/018

FROM: P D P BARNES
DATE: 16 October 1987

MRS CASE

cc PS/Chancellor
PS/Sir P Middleton
Sir G Littler
Mr Lavelle
Mr Mountfield

VISIT BY MEXICAN FINANCE MINISTER

As I told your office this morning, the Mexican Finance Minister has cancelled his trip to Europe.

2. So the briefing we commissioned for the meeting next Tuesday will no longer be required.

PB

P D P BARNES
Private Secretary

INTERNATIONAL FINANCE CORPORATION

IFC INVESTMENT REVIEW

16/10/87

Restructuring foreign debt in Mexico

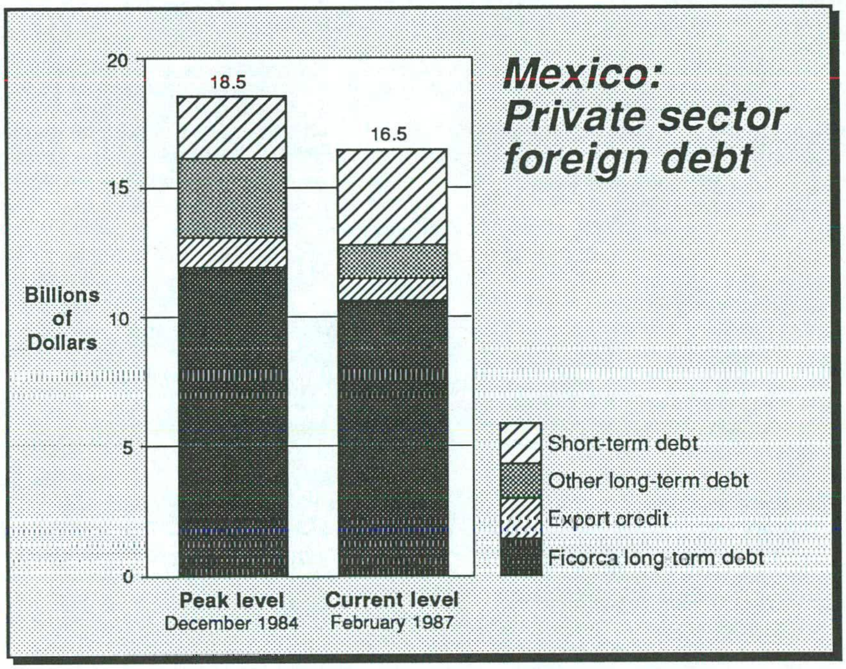
Innovative private sector solutions

AFTER six years of grappling with the debt problem, Mexico's private sector debtors and their foreign banks are beginning to make real progress. Last year, novel debt reduction programs and new options emerged, and both the lenders and the Mexican government became increasingly flexible as to what could be done with corporate debt.

Since then, new debt reduction techniques have made an encouraging transition from theory into practice. At the same time, corporations have found ways to capture the benefits of debt discounts that were previously available only to speculators and swappers in the secondary market. By combining these discounts with the government's debt-equity conversion program and applying creative financial engineering (see box on page 2), banks and debtors are finding a broad range of options that, though complex and difficult to pull off, are working out surprisingly well.

This innovative "menu" approach to debt restructuring in the private sector could go a long way toward easing the burden of some $16.5 billion in private sector foreign debt. The potential reduction of debt, perhaps in the $3–5 billion range, could make an important contribution to Mexico's overall effort to

continued on page 2



Having declined from its peak of $18.5 billion in 1984, Mexico's private sector foreign debt is now estimated by government at about $16.5 billion.

Overall, the $2 billion decline has been mainly due to repayment of export credit that was not subject to the general restructuring in 1983 and to prepayment of commercial bank loans.

Debt covered by Ficorca

Some 80 percent of the private sector's long-term debt is under Mexico's foreign exchange risk coverage program known as Ficorca (*Fideicomiso para la cobertura de riesgos cambiarios*). Ficorca coverage was at its peak in 1984 at $11.7 billion and declined to $10.8 billion by February 1987. Half the decline has been due to companies that left Ficorca voluntarily by choosing to end foreign exchange risk coverage, and half involuntarily upon defaulting on their loan payments. According to the new agreement between Ficorca and the commercial banks, expected to become effective and in force as of January 1, 1988, loans that remain under Ficorca will effectively become transformed into Mexican government IOUs for a term of 19 years.

Apart from loans covered by Ficorca, the remaining private sector foreign debt currently comprises about $0.7 billion in long-term loans mainly from commercial banks ("other long-term debt" shown in the chart), $1.3 billion in export credit, and $3.7 billion in short-term revolving credits.

The borrowers

Over 60 percent of the $16.5 billion is owed by some thirty industrial groups. The Alfa and Visa groups, which are both in the midst of comprehensive debt restructuring efforts, account for the largest single blocks, amounting to $4 billion.

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Restructuring in Mexico

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restructure its $103 billion foreign debt. It would also help relieve foreign banks of unwanted portfolio and debt management concerns and, in the process, bring back to life many of Mexico's top corporate performers at a time when entrepreneurship is most welcomed.

IFC recognized that the debt problem in Mexico could only be tackled if financial resources were channeled into a variety of novel transactions and last year launched a new initiative to provide both money and financial expertise to the private sector. The purpose was to expand the "menu" of options by developing fresh and creative approaches to the debt problem, working closely with debtors and creditors, and backing up these ideas with the willingness to inject funds. IFC's new effort has advanced quickly and has been well received by Mexican companies and foreign banks.

In 1987, IFC approved over $1[illegible] million in loans and equity investments for Mexico, of which half has already been disbursed. Three-quarters of this new money was directed toward debt reduction and corporate restructuring. Most recent was a $46 million loan to Cementos Apasco, signed in August, which helped that company, Mexico's third largest cement producer, to reduce its total debt from $200 million to $70 million. This dramatic debt reduction

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Ingredients for debt reduction

For a given case of debt reduction, it is unlikely that any single element will be sufficient to provide each creditor an acceptable solution while achieving the financial leveraging objectives of the firm and remaining within constraints set by the shareholders. Therefore, transactions often become complex, combining various debt reduction elements and implementing different schemes in parallel.

A careful design effort can lay out a number of options and provide an interesting menu from which individual creditors may choose their own combination. This is the promising direction the market has taken. IFC has joined the effort with innovative ideas and new money to help make these ideas work. Private sector debt restructuring and debt reduction techniques in Mexico are based on the following key elements.

The discount

There is nothing new about banks buying and selling debt among each other, either at a discount or swapping for other debt whose underlying value is judged to be similar. Also, speculators purchase debt at a discount. In both these cases, the debtor is left with no change for the better. He simply faces a new creditor with the same old debt.

The big change in Mexico today has been that bankers, recognizing that increasingly debtors are using intermediaries to buy back their own debt secretly, are allowing their Mexican borrowers to directly buy back debt at a discount. These direct buy-outs allow debtors to capture the benefit of the discount and actually reduce debt. Perhaps the most important example of this is the Cementos Apasco case where the shareholders and IFC financed the company's purchase of its own debt.

Discounts for private Mexican paper vary widely depending on many factors, but have ranged from a few cents per dollar of debt to close to par for companies with strong, dollar linked revenues. This compares to government paper that has been traded at discounts in the 40 to 50 percent range (currently above 50 percent). For private debt to have a smaller discount, marks a radical departure from conventional banking wisdom that viewed sovereign risk as always superior to commercial risk.

UMS paper

United Mexican States debt, referred to in the trade as "UMS paper," has become the currency of debt reduction transactions. Bankers first used it to shift the composition of their sovereign loan portfolios. UMS paper has since become useful within creditor groups to solve debt restructurings. For example, in the Alfa case, $200 million of UMS paper will be acquired by Alfa from the proceeds of new domestic borrowings and handed to its foreign creditors for a large share of existing debt.

The Mexican government's debt-equity swap program, formalized in May 1986, offers further scope for debt reduction by redemption of UMS paper for local currency, in a manner similar to the Chilean debt-equity swap program. In July 1986, the government issued its Debt Swap Manual (*Manual operativo para la capitalizacion de pasivos y substitucion de deuda publica por inversion*), outlining seven transaction schemes, although many more schemes are possible.

To date about $1.4 billion of UMS paper has been redeemed for local currency and the queue for new swaps is reportedly another $1 billion. Concern for the possible inflationary impact of this technique, as well as its misuse, has led to careful scrutiny of all aspects of each transaction and has added considerably to the time required for approval.

Ficorca program

Ficorca, the Mexican government's foreign exchange risk coverage program, with its many complexities, is also a central part of most debt reduction schemes. Loans under this program can be prepaid by using UMS debt-equity swaps. Also, cancellation of Ficorca contracts can result in the return of some funds ("rescue value") to the borrower which, in turn, becomes a resource for such options as direct debt buy-outs. Other aspects of the Ficorca program color the risk evaluation bankers give their loans. The newest development here is that, once the new Ficorca agreement with the commercial banks becomes effective in January 1988, Ficorca IOUs to the banks will qualify as UMS paper for the purpose of debt equity swaps. This new formal link of private sector debt to UMS paper is likely to provoke considerable additional debt reduction activity.

Mexican stock market

The performance of the Mexican stock market has been impressive on an international scale. Since the start of 1987, the average price of listed shares has risen over 300 percent in US dollar terms, considerably above other stock exchanges around the world. In terms of price earnings ratios and book value per share, the Mexican stock market has also achieved historical highs. More importantly for debt reduction, this growth has taken equities from near irrelevance to becoming an important source of funding. In 1982, the value of companies on the *bolsa* was about $600 million. By the end of 1984, this value had reached just over $4 billion and today it is close to $30 billion. At year-end 1986, the Mexican stock market had about 235 listings, up from 188 the year before. The listing process is relatively easy and can be achieved within 90–180 days.

Traditional work-out techniques

In combination with the above, restructurings emerging now also incorporate the usual stretch-out of senior debt, zero coupon arrangements, creation of tranches of deferrable or bullet payment debt, perhaps with interest rate relief. In important cases such as Alfa's holding company and its steel subsidiary, Hylsa, each with nearly $1 billion of debt, the banks have reportedly agreed to take important amounts of equity. Accompanying this new capital structure are shareholder commitments, divestiture programs, and cash enhancement measures for operations. A new direction in the market may be toward securitization of debt and further reliance on market forces to resolve divergent views of value.

IFC's experience in Hungary

Facilitating joint ventures in a new member country

HUNGARY became a member of IFC in 1986, the first socialist country in Eastern Europe to join the Corporation since Yugoslavia joined in 1968. The decision by the Hungarian authorities to become a member of IFC was based not so much on what they observed about IFC's extensive work in Yugoslavia, but rather is a logical consequence of Hungary's attempt to liberalize its economy and encourage foreign investment.

Several years ago, Hungary started introducing more market forces into its economic structure, encouraging independent business decision-making by enterprises and institutions and stimulating the cooperative sector which, unlike the state sector, already enjoyed considerable decentralization and autonomy. Joining IFC was the reflection of a desire by the Hungarian authorities to encourage foreign investment and to provide additional support to the cooperative sector.

IFC went to work reviewing project possibilities even before Hungary's membership was formalized and these efforts bore early fruit. IFC has played a central role as a promoter and architect of three major joint ventures that have already been incorporated. In each of the transactions to date, IFC's role, aside from helping to evaluate the basic viability of the proposal, has been that of a neutral third party between the Hungarian and foreign partners, none of whom had any experience in joint venturing in the Hungarian market.

Both sides have had confidence that IFC will help them negotiate reasonable and fair arrangements that will result in the most efficient operation possible. While not *working for* either the Hungarian or the foreign partners, IFC is in effect working for both. As a result, IFC has been intimately involved in formulating the basic documentation required to get these companies started, has been involved in negotiating asset evaluation and pricing decisions, as well as proposing management and technical assistance arrangements.

In all three cases IFC took the lead in structuring the financial plan, backed by its own willingness to take equity and loan exposure. IFC is not merely a passive equity investor in the three projects, but has been requested by all parties to continue its deep involvement by following the operations closely through the early years by having a representative on the board of the companies formed. Normally IFC does not join the boards of manufacturing companies, but was willing to do so in the Hungarian situation, where IFC has become the financial institution with the most joint venture experience and where it could fulfill a particularly useful function until joint ventures with foreign investors become more commonplace.

Projects financed by IFC

The first Hungarian project IFC financed was the establishment of UNICBANK, a commercial cum investment bank in which IFC helped to bring in DG Bank of Germany and Genossenschaftliche Zentalbank of Austria as shareholders. This new bank was one of four new banks created when Hungary decided to develop a two-tier banking structure with the National Bank of Hungary retaining its central bank functions but giving up its commercial activities. UNICBANK operates as a profit-seeking institution, mobilizing funds from cooperative, state, and joint venture enterprises and providing them with trade finance and short and long term loans. IFC holds 15 percent of the subscribed capital (which totals about $20 million), as do each of the foreign shareholders.

The second, and largest, project to date is the Hungarian-Japanese Fermentation Industry Ltd. Co., a new joint venture to produce lysine, a feed additive for poultry and livestock. This project, at an estimated cost of $45 million, is under construction and has as its principal foreign partners Kyowa Hakko and Toyo Menka of Japan. Together these Japanese investors hold 21 percent of the capital and are providing critical technical and managerial inputs into the operation. IFC holds 15 percent of the shares and is providing loan funds of about $8 million to the project. The Hungarian partners are a group of cooperatives and financial institutions. The project will bring to Hungary advanced technology to produce a product that is in considerable demand in the country's agricultural sector.

The most recent project is a glass wool insulation project where the foreign technical partners are Nitto Boseki, Paramount Glass Works, and Toyo Menka. The three Japanese investors hold 26 percent of the capital of this $20 million project; IFC is a 17 percent shareholder and a lender as well. The principal Hungarian shareholder is the Hungarian Glass Works, a state enterprise that operates eleven glass factories in the country.

IFC has a number of other projects under investigation ranging from plastic

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New IFC loan features

Flexible liability management tools

Introducing advanced financial techniques used in the industrial world to Third World corporate borrowers

NEW loan features introduced by IFC in July 1987 give borrowers better tools for debt risk management in a world of volatile exchange and interest rates. The new features introduce funding techniques, such as interest rate and currency swaps and interest rate caps, that have been available to companies in industrialized countries since the early 1980s, but that are still not widely accessible to companies in developing countries.

Using the new features (see box on page 5), fixed rate borrowers may now select an IFC loan under which the interest rate will be reset every five years, at which point, borrowers will also be able to switch to another currency or to a variable interest rate.

Variable rate borrowers now have the option of converting their loan, at any time, to a fixed rate or to purchase an interest rate cap.

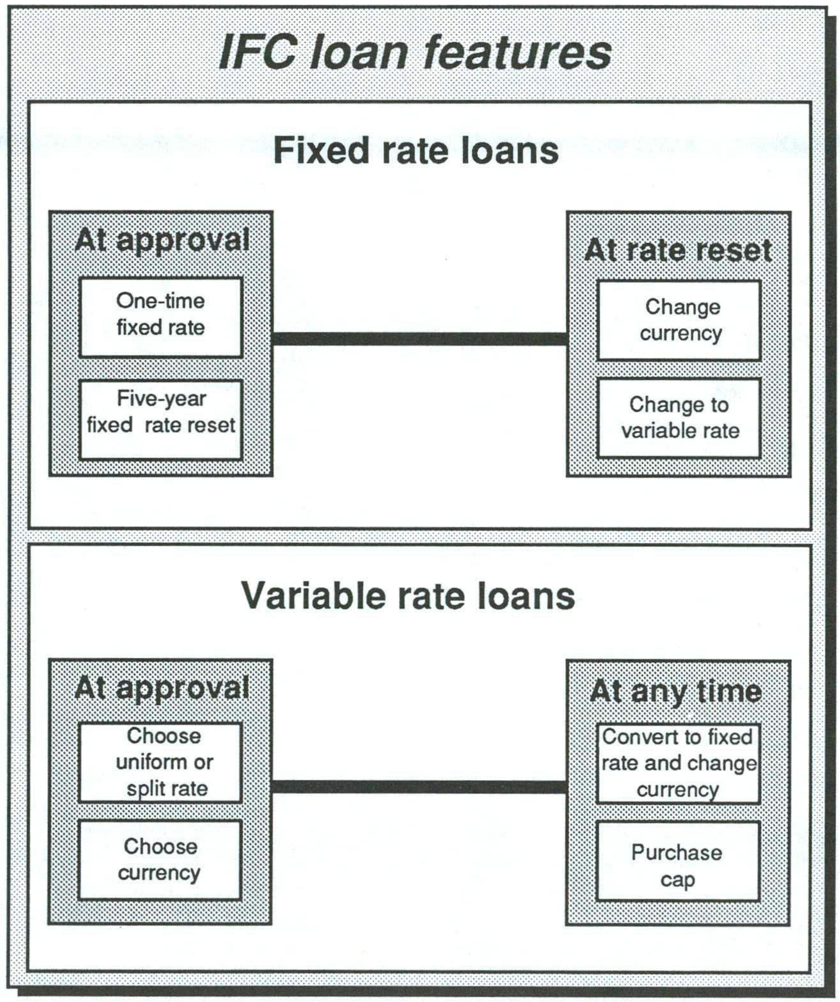
Borrowers are likely to use the new options extensively, as they have in the case of other new features introduced in recent years. In 1985, IFC started to lend at variable rates and, in 1981, began to offer as a regular feature fixed rate loans in six currencies: US dollars, deutsche marks, Swiss francs, yen, pounds sterling, and French francs. Until 1981, IFC was a fixed rate US dollar lender providing the types of loans preferred by borrowers at that time. Demand for the new features grew rapidly. Currently, variable rate lending accounts for nearly half of new loan approvals and fixed rate non-dollar loans amount to about one-third of new loans.

The latest features will help IFC borrowers to manage their foreign debt risks. For example:

• A new company using an IFC loan to purchase equipment in one foreign currency, which will earn foreign exchange in another currency after start-up, may borrow in the currency needed for buying the equipment and later switch to the other currency, thereby gaining flexibility in its foreign exchange management.

• A variable rate borrower who, at some time during the life of the loan, expects a rise in interest rates may purchase an interest rate cap or switch to a fixed rate to lock in the prevailing rate for the remaining life of the loan.

• A borrower who prefers a fixed rate loan can effectively defer setting the rate and choosing a currency by selecting the variable loan option and switching to a fixed loan whenever he wishes.



The grace period and repayment term of IFC loans have always been designed to accommodate the cash flow needs and risk profile of each project. By providing the flexibility during the life of the loan for borrowers to switch between fixed and variable interest rates and to change the currency of denomination, the new loan options will help IFC's clients to react to changing conditions in the financial market and will help IFC to achieve its developmental goals by offering its clients a flexible choice of financing instruments.

Equity opportunities in Brazil

IFC equity sale features foreign debt-equity conversion

BRAZIL postponed interest payment on its foreign debt in February this year — only official lenders of the Paris Club, international financial institutions such as the World Bank and IFC, and private banks participating in IFC loans continue to get paid — and the banking world waits anxiously for Brazil to come out of its economic and financial crisis.

In part as a result of this announcement, Citibank established three billion dollars in loan loss reserves and launched a department to study assets in Brazil and other Latin American countries that may be converted into equity opportunities.

IFC's sale in May this year of its shareholding in Papel e Celulose Catarinense S.A. (29 percent of the equity), a medium-size integrated pulp and paper producer, to the Bank of Scotland and Norwest Bank of Minneapolis for a total of $25 million offers a good example of the role IFC can play in foreign debt-equity conversions.

The banks purchased the shares by converting $25 million of Brazilian foreign debt into local currency. The registration certificates issued by the Central Bank of Brazil permit the local currency equivalent of the purchase price in U.S. dollars, or the fair market value at the time of sale, to be remitted in twelve years. For additional comfort to the banks, IFC guaranteed for eighteen months after this twelve year period the repatriation into US dollars up to $25 million of the local currency proceeds that the banks will receive if they in turn sell their shareholding.

The sale of Papel e Celulose Catarinense gave IFC a capital gain of $16.5 million which, together with dividends received, yielded a discounted return in US dollars of 12 percent over the 21 year investment period.

This transaction represents one of the first foreign debt-equity conversions in Brazil. It serves to lock for twelve years foreign bank debt into the equity of a mature company. As IFC continues to invest in Brazil, the remittance to IFC of the sale proceeds will only be a temporary outflow of funds, more than compensated by new investments. In the fiscal year ending June 30, 1987, IFC approved $125 million of loan and equity investments in Brazil.

IFC also realized a substantial capital gain on another Brazilian equity investment when it sold for $20 million its 15 percent shareholding in Oxiteno S.A. Industria e Comercio, a successful chemical company which started operations in 1973. Idemitsu Petrochemical Ltd. of Japan purchased 49.2 percent of IFC's shares for $9.6 million. The remaining 50.8 percent were sold through a public offering in Brazil. The sale resulted in a capital gain to IFC of $18.8 million and a discounted return in US dollars, including dividends received, of 30 percent over the fourteen year period IFC held the shares.

Since 1956, when IFC started investing in developing countries, Brazil has offered some of the best project financing opportunities and some of the largest equity payoffs for IFC.

The new IFC loan features

Fixed rate loans

In addition to the traditional IFC fixed rate loan on which the rate is set once at the outset (*one-time fixed rate loan*), a new *five-year fixed rate reset loan* is now available. Under the latter, at the time the rate is reset, the borrower may choose to maintain the original currency of the loan with a new five-year fixed rate or switch to another currency (among the currencies normally quoted by IFC), which would carry a new five-year fixed rate. Alternatively, the borrower may switch altogether to a variable rate loan. No fees are charged for switching currency or switching to a variable rate.

The fixed interest rate applied at the time of resetting is objectively determined on the basis of the rate paid in swap markets for a five-year loan in the particular currency in exchange for the prevailing six-month US dollar LIBOR plus the same spread as on a variable rate loan. In this manner, the new fixed five year rate will reflect market conditions for the relevant currency at the time of rate setting.

In the normal environment of a positive sloping yield curve, the rate applied to a five-year reset loan will be lower than the rate for a longer period, although there would be a risk that the interest rate could be higher at resetting time.

Prepayment of the *one-time fixed rate loan* is allowed any time beginning at the end of the fifth year from the date of signing of the loan agreement, subject to a premium. The *five-year fixed rate reset loan* may be prepaid any time beginning at the end of the third year from the date the interest rate is initially set, or from each subsequent interest resetting date, and is also subject to a repayment premium.

Variable rate loans

The interest rate applied to US dollar variable loans is six-month LIBOR plus a spread reflecting the particular risk profile of the project. Variable rate loans in the other currencies that IFC normally offers can be made available provided IFC is able to fund itself adequately (on the same rate basis) in the required currency.

Variable rate loans may either have a uniform spread for the life of the loan, or a split spread under which a lower spread is applied to the first half of the loan term and a higher spread to the second half.

Borrowers selecting IFC's variable rate loans now have the options of, at any time during the life of the loan, *converting to a fixed rate* in a major currency of their choice, or *purchasing an interest rate cap*. Caps are provided by IFC when available to IFC from the financial markets. The borrower may purchase a cap either at signature, or any other time during the life of the loan. Fees for the interest rate conversion and cap options are charged only if and when these options are exercised.

Conversion to a fixed rate may be requested in any of the currencies normally quoted by IFC. The fixed rate to be paid after conversion would be set on a swap basis in a similar way to that used in five-year rate settings. Variable rate loans are not subject to a prepayment premium.

Standby and second tranche loans

Standby loans, used for contingent financing of project cost overruns, and second tranche loans, often used for financing the second stage of projects with unusually long implementation periods, allow the borrower to defer rate setting and currency selection of fixed or variable rate loans for up to twelve months after loan approval, unless a longer deferment has been previously arranged. During the deferment, a reduced commitment fee of 1/4 percent is charged.

Latin American investment climate

A private sector perspective

LATIN America is a region in distress. Overall performance over the past few years has been volatile with relatively short periods of satisfactory economic growth alternating with recessionary conditions.

Apparently successful economic programs launched in some major debtor countries have shown fragility. Brazil, while implementing the Cruzado Plan, was still looked upon as on the road to an extended period of strong growth under a more stable economic environment. In November 1986, however, a new set of economic measures was announced, as it became clear that the overheated economy, fueled by real wage increases and by expansionary monetary and government spending policies, had revived inflationary pressures and reduced exports, once the productive sectors approached full capacity utilization. More recently, on June 12th, the Brazilian administration, still faced with threats of hyperinflation and major disruption in economic activity, implemented new economic stabilization measures combined with a temporary price freeze and redefined wage policy.

Argentina, which had also made impressive gains under its own innovative economic program by reducing the annualized inflation rate from about 1,200 percent in the first half of 1985 to 40 percent in the second half, is now once again confronted with double digit monthly inflation rates and weakening trade and current account balances, all of which traditionally would call for a further tightening of economic management — this at a time of mounting domestic political opposition to an economic austerity program.

The problems faced by these heterodox economic programs may well have eroded the credibility of future programs. At present, these two nations, centerpieces of the region's recent transition from military authoritarianism to democracy, confront mounting popular pressure to improve national standards of living. As this pressure continues to rise, so will the risk that future government decisions will be unduly influenced by the need to generate immediate political support and avoid social unrest, rather than by sound long-term economic objectives.

Overall, 1986 proved to be a complex year for the region, with aggregate macroeconomic statistics suggesting noticeable improvement in economic growth and price control performances while, at the same time, a weakening in

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IFC activity in Latin America

Investments

IFC has probably become the most important source of voluntary foreign lending for private project financing in Latin America. During the fiscal year ending June 30, 1987, IFC approved $410 million worth of investment in projects with total costs estimated to reach about $1.8 billion. This represents a 45 percent increase above IFC's previous year and about one-half of its total worldwide investment approvals this year.

The expansion of IFC investment in Latin America at this time reflects both the severe shortage of foreign funds to support sound private sector undertakings and, equally important, the attractive returns IFC feels will be available from these undertakings.

Long-term policy

Fully aware of the nature and magnitude of the risks, IFC has adopted a long-term policy of expanding its presence in the region. Indeed, the Corporation, as a developmental institution and a promoter of the private sector in member countries, has devoted significant resources to analyzing the prospects and needs of entrepreneurs in Latin America.

IFC is participating actively in three distinct arenas: first, IFC has noticeably expanded its advisory role, helping some government authorities analyze privatization alternatives for large public sector enterprises; IFC has also been advising governments on the structuring of new proposals which are being undertaken jointly by local and foreign private investors; and lastly, IFC has been working with large private sector groups which are in financial difficulty to design business restructuring packages.

Second, IFC has significantly expanded its direct project financing, particularly in countries where foreign funds for investment financing are not available. At the end of fiscal year 1987, the Corporation held $908 million in 126 ventures in 21 countries in the region. During the first quarter of fiscal year 1988, IFC has already approved $196 million in project loan and equity financing, the bulk of which is of quick disbursing nature.

Third, through its Capital Markets Department, IFC will assist in the establishment of one of the first Brazilian privately-placed equity funds under Brazil's new foreign portfolio investment regulations. IFC is also well advanced in the launching in Chile of the first Latin American debt conversion fund.

Opportunities

IFC's presence in the region has provided it with valuable insights into where opportunities for sound investments might be developing. In Chile, Uruguay, Ecuador and Mexico, the business sector is, in general, adapting well to the hostile economic environment by restructuring operations in order to cope with problems posed by high debt burdens, weaker domestic demand, and stronger competition from abroad.

Bankruptcies have been numerous and widespread, but IFC has also been able to identify a sizeable group of companies which have weathered the storm and face better prospects.

In Chile and Uruguay, IFC is in fact, already starting to witness a strong recovery of private sector investments in green field proposals in sectors soundly based on real competitive advantages.

Indeed, in these, as well as in some other Latin American countries, IFC has found good opportunities to work with local business groups on ways to strengthen balance sheets and improve business prospects, most commonly through cost reductions and reorientation of production facilities to the export market.

Not surprisingly, therefore, IFC's fiscal year 1988 project pipeline in Latin American countries continues to be strong.

Latin America

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the external sector. Gross domestic product in Latin America, after having contracted in 1980-1983 and recovered at an average 3 percent in 1984-1985, increased by 3.8 percent in 1986, yielding a 1.5 percent growth in income per capita, the highest growth in six years.

Growth was unevenly distributed, however, with a 3.8 percent decline in Mexico's GDP at one end and with a group of South American nations at the other, namely Argentina, Brazil, Colombia, Chile, Peru, and Uruguay, all with GDP growth above 5 percent.

Regional inflation, as measured by the December to December consumer price index, is estimated to have been 65 percent in 1986, reversing the rising trend which started in 1980 and which peaked in 1985 with an annual inflation rate of 275 percent. Except for Mexico and Nicaragua, all countries in the region whose rates of inflation were above 30 percent during 1985, managed to reduce the pace of price increases during 1986; the most impressive results were achieved in Bolivia, where a severe austerity program and tight monetary control in a liberalized economic environment, brought an end to hyperinflation, and resulted in a dramatic decline in the CPI from over 8,000 percent in 1985 to 66 percent in 1986.

Higher growth did, however, have a negative impact on the external sector in Argentina, Brazil, and Peru, where strong domestic demand translated into higher imports and lower exports. As a result, the combined trade surplus of these three nations, which surpassed $18 billion in 1984 and 1985, dropped to $11 billion in 1986. These developments, together with major oil export revenue losses in Venezuela, Mexico, and Ecuador, translated into a significant weakening of the regional balance of payments, as indicated by a current account deficit approximately $12 to $14 billion larger than in 1984 and 1985, and an estimated drop of $10 billion in official reserve holdings.

As we look into the region at present, it is difficult to foresee a significant improvement in this already difficult situation. In fact, while 1986 was a positive year for the non-oil exporting economies in the region, with gross domestic product growing at about 6.7 percent, the situation seems to have deteriorated noticeably during the first half of 1987, for most of these nations. Moreover, there has been a sharp reversal in the progress in controlling inflation and, except for the oil-exporters, the external sector has also performed very poorly during the first half of 1987.

Brazil is the most dramatic case with its trade balance on a roller coaster ride. Its monthly trade surplus of $1.2 billion achieved in the second quarter of 1986, turned rapidly into an average $100 million deficit per month in the last quarter of 1986 and then rebounded to record surpluses of $1.4 billion per month in July and August 1987. For the whole of 1987, however, Brazil is unlikely to match the $12.5 billion trade surplus previously achieved in 1985. In Argentina, the largest regional non-oil exporter after Brazil, the trade surplus continues to slide and only about one-half of the $1.9 billion surplus targeted for 1987 is expected to materialize.

No magic

These recent developments compound a problem that is obviously already severe; the region has been transferring net resources to the outside world: interest payments and net factor services have exceeded the inflow of long and short-term loans and capital transfers by about $132 billion for the period 1982-1986. This net outflow of funds is equivalent to 30 percent of the

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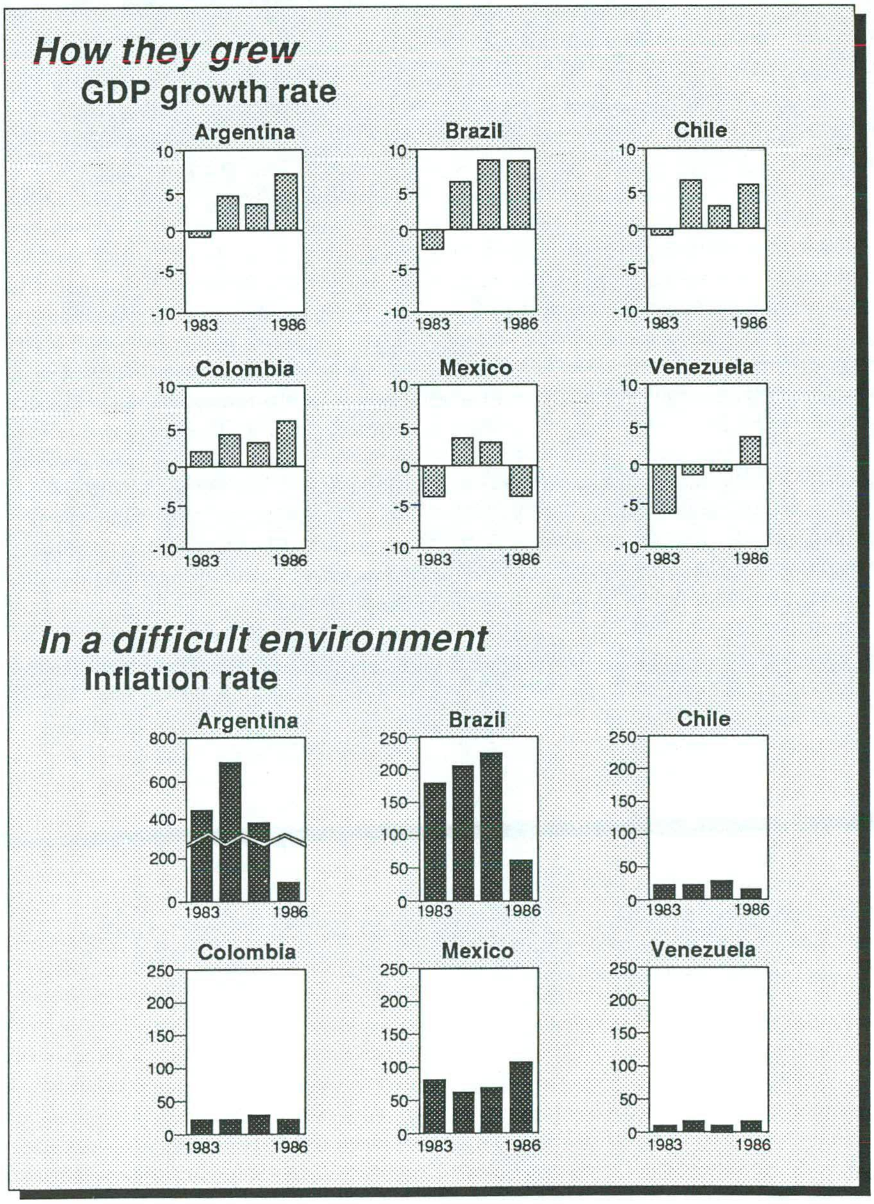

Latin America

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export of goods revenues generated by the region during the same period. The effect of this net transfer of resources is partly reflected in both a 9 percent decline in regional product per capita since 1980, and in rates of open urban unemployment between 10 percent to 22 percent in most countries in the region.

The seriousness of the situation should not be ignored by international creditors and regional policy makers. Regional authorities must acknowledge that there are no short-term "magical" cures to inflation, economic growth, and weak external accounts. Foreign creditors, on the other hand, must view their presence in the region in the long-run context, and support policies and actions which can improve their Latin American portfolio prospects but only in the long-run and without the need for short-term "fixes."

Intra-regional differences

Although these prospects appear dim there are marked intra-regional differences and exceptions. For example, in Chile and Uruguay, prospects for continued growth under a stable domestic economic environment, conducive to private sector investments, seem promising. Also Mexico, which was the center of attention a year ago when it was perceived as entering a particularly difficult period, has generated a sizeable export surplus during the first semester of 1987 and has accumulated $15 billion in foreign exchange reserves. Mexico, is expected to show modest economic growth this year, compared to the 3.8 percent GDP contraction in 1986; business opportunities will continue to concentrate in the non-traditional export oriented sector. (In 1986, Mexico's non-oil exports rose by 21 percent).

Private sector investment opportunities are also improving in Venezuela and neighboring Colombia. In Venezuela, where the major contraction in oil revenues has shifted the developmental focus into the promotion and development of non-oil export oriented or import substitution sectors, prospects are good for the establishment of joint ventures to tap into the country's vast natural resources, especially natural gas-based petrochemicals and energy intensive industries. A number of large joint venture proposals are already at an advanced stage of discussion. The norms for debt-equity swaps announced in April and the recently issued decree on direct foreign investment — which help clarify the exchange rate regime to be applied to these investments — are steps which should help such proposals to materialize. Colombia, perhaps the most stable economy in the region, has had the highest and most consistent growth in domestic product per capita during the eighties, and continues to develop opportunities for the implementation of private sector initiatives.

Of course, in several other countries interesting investment opportunities have also developed. Some of these opportunities respond to both a more liberal attitude towards foreign investment and policy reforms which aim to promote private sector participation in areas previously reserved for the public sector. A most recent example is the change in the regulations governing private participations in the Dominican Republic's mineral industry, reforms which have already produced interest from companies abroad which are examining possible joint ventures.

In short, despite the difficult regional economic environment, IFC has seen numerous economically sound and financially attractive investment opportunities, some of which are not materializing due to the unavailability of foreign funds. This is not surprising given that the Latin American nations have tremendous human and natural resource potential, and a well developed industrial base run by people with proven and impressive entrepreneurial skills.

The critical issue at this juncture is, therefore, to devise a politically viable strategy to provide for a more stable economic environment, aiming at improved growth prospects while, at the same time, generating a sustainable trade surplus to help meet external obligations. The proper solution of this issue is a long-term one and is the responsibility of two main groups of players. First, there are the governments of high-debt countries, especially those in countries with relatively recent return to democratic regimes, who could find themselves locked into trading sound long-term economic management for short-term political support and avoidance of social unrest. And second, the international commercial banks which have total exposure in the region of about $300 billion (including trade finance).

Solutions and broader options

The past year has proven most difficult and in some cases, commercial banks and government authorities, seem to have become more distant and moving away from a consensus solution. The risk being that a point could be reached where the dialogue is interrupted and the burden of this painful process of adjustment could be unilaterally shifted to only one of the interested parties. To prevent this from happening, commercial banks must continue to support economic adjustment processes and take full advantage of new ways to help relieve these countries' short- and medium-term debt service burdens, by helping the local private sector to work more effectively, while still making reasonably sound portfolio investments.

In this regard, certain recent developments may represent a turning point for the better in the nature of foreign banks' participation in the region. Creditor banks are now faced with a broader number of options in dealing with regional debt, including debt-equity swaps, repurchase agreements, exit bonds, debt-to-debt swaps, and others. Though it is difficult to pinpoint an equilibrium point for the conversion of credit into risk capital through a system that would be equally beneficial to debtors and creditors, debt-equity swaps are gaining momentum and wide acceptability within the international banking community and the economic authorities in the region.

While this mechanism will certainly not be adequate to make a substantial dent in the debt problem, it does represent a move in the right direction. Consequently, IFC is engaged in the promotion of several debt conversion funds, which would exchange debt for local currency and invest in a diversified portfolio of equity securities. A portion of the fund's shares would be subscribed by IFC and paid partially in "new money;" the balance of the shares would be subscribed by international commercial banks. A diversified professionally-managed portfolio vehicle of this nature could prove an attractive mechanism for commercial banks to increase the *real* worth of their regional portfolios and, in so doing, help local companies to strengthen their finances and prospects and foster an active private sector role in economic recovery.

Modernizing India's automotive industry

IFC finances Hindustan Motors Limited

FOR almost two decades the Indian heavy commercial vehicle market has remained virtually unchanged. But this year Hindustan Motors Limited will launch a modern and fuel-efficient heavy commercial vehicle in the Indian market with the technical collaboration of Isuzu Motors of Japan. Simultaneously, Hindustan Motors is starting to modernize its line of passenger cars by introducing a new engine, gear box, and axle, also with the technical collaboration of Isuzu Motors.

The projects will be at two different locations: the production of 15,000 heavy commercial vehicles at Vadodara, Gujarat State; the production of 15,000 fuel-efficient power trains for the passenger car line at Indore, Maharashtra State. Both projects are expected to be completed by 1991 at an estimated cost of $275 million. To satisfy the market until completion of the planned production facilities and development of local parts suppliers, Hindustan Motors will initially assemble imported CKD (completely knocked down) components.

Hindustan Motors

One of the earliest automobile producers in India, Hindustan Motors was incorporated in 1942. It operated under license from Morris Nuffield in the U.K. Although the license agreement has long expired, the principal product today is still the Ambassador — a locally manufactured version of the Morris Oxford car of 1957, partially updated in 1979. Hindustan Motors has over 26,000 shareholders. Management control is exercised by the Birla Group, one of the largest business groups in India, traditionally in textiles, chemicals, fertilizers, and manufacturing.

Isuzu Motors

Isuzu Motors is one of the major Japanese automotive manufacturers, especially strong in engine design and in commercial vehicles. Since 1971, Isuzu has been associated with General Motors which owns 34 percent of its capital. Fifty-eight percent of Isuzu's production in Japan is exported. Although Isuzu accounted for about one-fourth of the Japanese heavy commercial vehicle market, it represented about 40 percent of Japanese truck exports. Its major export markets for heavy commercial vehicles include China, U.S.A., Australia, Thailand, Malaysia, and Pakistan.

Auto industry in transition

The Hindustan Motors modernization program is a direct reflection of a new wave of government policy in India. Until recently, government-administered capacity licensing restricted the entry, growth, exit, and consolidation of domestic firms. Owing to a virtual ban on imports of vehicles and most components, Indian automobile producers enjoyed complete protection from international competition. Equipment and machinery imports, foreign technology licensing, and direct foreign investment were also closely restricted. As a result, the Indian automotive industry is highly indigenized, with over 95 percent domestic content. But, until recently, it has also remained largely out of date.

Reacting to relaxation of government control, domestic producers scrambled to expand and modernize their plants

Recognizing this, the Government of India in 1982 initiated a program to modernize the automotive sector and relaxed the rules on capacity licensing, choice of product lines, approval of foreign collaborations, and access to imported components and technology. Reacting to this liberalization, domestic producers scrambled to expand and modernize their plants and product lines to meet the demands of the Indian consumer.

The Indian automotive industry is now in transition — a transition that represents a market opportunity. As a result of government's emphasis in the last two decades on buses for public transport and medium and heavy trucks for goods movement, commercial vehicles account for 60 percent of output, while passenger cars represent only 15 percent. Demand for passenger cars is limited owing to low disposable incomes and the high levels of domestic taxation used to suppress demand. In spite of this demand suppression, there is a large demand for modern, fuel-efficient cars to meet the transportation needs of tourists and Indian corporations. The ratio of people per car in India is about 800; only China, Bangladesh, Burma, and Ethiopia have higher ratios.

Hindustan Motors is strategically well placed to respond to the government's policy initiatives and to grasp the developing market opportunities. However, after years of little change in the industry, management faces major challenges in absorbing the manufacturing technology from Japan, developing ancillary suppliers to meet stringent quality specifications, and in producing cars and heavy commercial vehicles that meet the standards now demanded by the Indian public.

IFC support

In support of India's modernization efforts and of Hindustan Motors as it meets these challenges, IFC provided a $36 million loan in May, 1987 to finance the two projects. The loan is denominated in four currencies, all at fixed interest rates, with grace period and repayment terms appropriate to the cash flow needs of the project. IFC's entire appraisal process, from initial discussions to loan signature, including visits to India and to Isuzu in Japan, was completed in just over three months.

On the local financing side, Hindustan Motors is obtaining rupee funds partly from Indian financial institutions and partly from two large public issues of rupee debentures in the Indian market. The presence of a large IFC financial commitment to the project can also be expected to provide some indirect support for this issue when it is made.

Letter from the EVP

Annual meetings: IFC luncheon speech

Each year at the annual meetings of the IMF, World Bank, and IFC, the Corporation hosts a luncheon for private bankers. Here is the text of the speech given on this occasion by Sir William Ryrie, Executive Vice President, IFC's chief executive

I first want to welcome you all to another IFC luncheon and I especially want to welcome a number of members of the new Business Advisory Council for IFC which we established during the year. We are delighted and honored that so many very distinguished businessmen from a number of countries have agreed to serve as honorary members of this Council and give us their advice and guidance both in their own countries and generally. Their work will complement the work of our long-standing Banking Advisory Group and I am very pleased that we also have a number of members of that Group with us again today.

I said at this lunch last year that the work of IFC in many ways consists of helping markets to work in favor of development. In recent years many international markets seem increasingly unpredictable, even chaotic, so the task may be seen as trying to bring a little order out of the chaos. But the seeming chaos of the markets these days is, as we all know, often a source of creativity and invention. I believe that the challenge of helping markets to work for development calls for these qualities — creativity and invention — and I believe we can claim that IFC is providing them in a number of ways.

Financial markets

We can see three major trends in the financial markets which are relevant here. First, we see a ferment of innovation and the introduction of new techniques. We have been trying in IFC to bring the benefits of some of the new techniques to our borrowers. Secondly, we see continuing efforts to find ways of dealing with the debt problem through market-based initiatives and we in IFC are active in this field. Thirdly, we are seeing in the markets a rising interest in equity investment in the developing world, and of course IFC is actively involved in that. We need to bring these forces together creatively.

One way of doing this is by promoting portfolio investment. As you know, IFC has in the past launched a number of funds designed to step up the flow of capital in the form of portfolio investment to developing countries. In the last year we launched the Emerging Markets Growth Fund — a portfolio fund investing in not one but a variety of developing country stock markets. It began at $50 million and within a year its net book value had risen by some sixty percent. This was of course a reflection of the strength of equity markets lately, but interest in the EMGF is strong and we are now planning to double the size of the Fund. And there are other portfolio funds in the pipeline.

Equity investments

If you want another demonstration that equity investment in Third World countries can be profitable it is provided by IFC's financial results in the year just ended. Our net income at $54 million was more than double the previous year's figure, mainly because we realized substantial capital gains on a number of equity investments made some years ago, namely in Asia and Latin America. And in fact we also have a healthy stock of unrealized capital gains in our portfolio. The improvement in our net income, by the way, was after making increased provisions for losses, because of a limited number of problem cases in our portfolio, although all the main indicators show IFC's portfolio generally improving.

But to come back to our capital markets initiatives, we have been working with a number of debtor governments on plans to establish debt-equity conversion funds — a mechanism which would, so to speak, wholesale the process of conversion of debt into equity. No one imagines that this can be a solution to the debt problem; but it can free up resources for investment in companies and for privatization, and the use of funds for this purpose can also help to develop stock markets. Some debtor governments have been hesitant and the technical problems are considerable so the work on establishing debt-equity conversion funds has not proceeded as rapidly as we hoped, but there is now a good chance that at least two of these funds and perhaps more will be brought into operation in the coming months.

There is much talk about other market initiatives involving the securitization of debt and some recent initiatives on this subject have not been realistic. There are no easy solutions but some possibilities to be considered in this field are voluntary market-based schemes which would bring the interests of creditors and debtors together. I was interested to see that Mr. Miyazawa, the Finance Minister of Japan, recently suggested that IFC should be charged with producing a scheme for securitization. We are of course prepared to help in whatever way our shareholders as a whole wish.

Partnership

We shall go on expanding our activities in the capital markets, including underwriting activity to help corporate borrowers in developing countries to raise funds on the major capital markets. In most of these activities we are in partnership with private financial houses. In that partnership we can bring to the

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Letter from the EVP

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table not only market skills but a special relationship with governments who are our members. And by the way we shall soon be marketing our own Emerging Markets Data Base, a unique source of information about companies and securities in seventeen developing country markets.

But of course most of IFC's activity consists of helping and supporting many individual private companies in developing countries — some new companies and some long established. Our traditional role of project finance is really only part of a wider role of supporting sound companies in a variety of ways. In the year just ended our Board approved a record number of 92 new operations — loans and equity investments — in 41 countries. The total investment by IFC itself will be about $800 million, also a record. The total cost of the investments we will thus be supporting will be about $4.3 billion.

Increasingly we are supporting companies in other ways too. We are providing finance in the form of corporate credits, to help sound, sometimes substantial, companies to expand, modernize, and diversify. Often this is the continuation of a relationship with a client company built up over some years. And we are doing more to finance smaller businesses through the technique of agency lines, providing credit or equity funding, which we introduced two years ago.

Advisory services

We have always provided technical advice and help, usually in association with finance; but lately we have been expanding these advisory services in new fields. In a number of countries, such as Mexico, there are companies whose basic business is sound but whose financial structure has become unviable. Some of them have sought IFC's help. What we can offer, for a suitable fee of course, is a combination of skills in corporate finance with a technical capability and also, in appropriate cases, the ability to make investments ourselves. This kind of restructuring work will be increasingly important in the future. Here too we shall often be working with private financial houses.

Advisory work is not only aimed at corporations. I mentioned last year that we had established the Foreign Investment Advisory Service, advising governments on how to attract foreign investment to support development. In the last year interest in this service has grown fast. We have now done work or are doing work for eight Asian governments on this subject, and eight other (African) countries have requested our services.

Swaps

The variety of ways in which we can help grows as we bring in new financial techniques and here we have made important innovations in the past year. Companies in developing countries do not often benefit from the innovations which are going on in world financial markets. By making use of swap techniques and other instruments we are now able to offer our clients many new options such as variable rates with a cap, fixed rate lending with a rate adjustment after five years, variable rate loans with the option of deferring the selection of currency and interest rate. Fortunately we have been able ourselves to borrow at very favorable rates on the markets and have made full use of the swap markets in that process also, thus transmitting the benefits of our financial strength to our borrowers.

Our traditional role of project finance is really only part of a wider role of supporting sound companies in a variety of ways

Adapting our services to the need of the client is the name of the game, and the need varies very much from one area to another. In Sub-Saharan Africa the private sector is less developed than elsewhere and it is difficult to find opportunities to make big new investments. The main challenge in Africa is to find effective ways of helping smaller businesses. As IFC we cannot do this directly and we are working hard at identifying or creating good intermediaries for this purpose. The history of official development banks in Africa has not been a happy one. What we need are sound institutions in the private sector, subject to market disciplines and free from political pressures, which will not only make loans and investments in small companies, but continue to support and advise them.

Management support in Africa

The African Project Development Facility which I mentioned last year, has now come into full operation with teams in Abidjan and Nairobi. It is managed by IFC and provides advice and technical help to smaller businesses, including assistance in raising funding for investments.

And we have just announced a new plan to help address the problems of management in Africa which is particularly interesting. The African Management Services Company will provide management support on a commercial basis to companies that need it. This is a wholly new idea backed not only by IFC, UNDP, the African Development Bank, and a number of governmental bodies which are investing in it, but also, and very significantly, by about fifty major international companies many of whom are members of the Industry Council for Development based in New York. Each company will make only a small investment but the Management Services Company, or AMSCo, will be able to draw on them for staff and training. AMSCo will be managed by Coopers & Lybrand who will be taking ten percent of the equity. All in all, it is a way of bringing the private sector of the world to the aid of the private sector in Africa.

So you see an IFC which is growing and changing. We have to grow because the need is far greater than the scale of our activities now and the demand for our services is more than we are meeting. And we have to change and adapt our services to a rapidly changing world, while keeping up the high professional quality for which I think IFC is known. In my three years at IFC I have developed an increasing respect for the quality of the staff of the Corporation. Most of them would agree that IFC is a good place to be, and I think it will be a still more exciting place in the few years ahead as we respond to the many challenges we face.

But as I said at the beginning, we cannot do our work without you. I take the fact that so many business friends have joined us today as evidence that you too want to work with us.

Restructuring in Mexico

continued from page 2

was achieved through a complex series of transactions involving debt-equity swaps as well as debt buy-outs and exchanges, which used IFC funds together with new equity subscriptions from Apasco's local and foreign shareholders. Offering a range of choices to the company's creditors made debt reduction feasible in the Apasco case and its success has already provided new momentum in the market, encouraging further debt reduction activity.

Company reviews

Over the last year, working on a fee basis, IFC undertook several company reviews, with the purpose of establishing an objective estimate of cash flow upon which to base debt restructuring proposals. IFC also played a significant part in developing innovative concepts that have already been put to use in a number of restructurings.

Although IFC normally finances "productive" investments for new or expansion projects, involving additional physical output, IFC has decided to support debt restructuring in Mexico because this is an effective way for IFC to promote economic development through the private sector. Debt relief is vital, especially under the Mexican government's policy of an open economy and greater emphasis on private sector-led growth. Without success in this area, many of Mexico's premier industrial groups will be unable to respond to new growth opportunities offered by the low value of the Mexican peso and by freer access to imported components and technology.

Debt burden and investment delay

Since the debt crisis began in 1982, instances abound where high indebtedness has impeded or blocked timely investments in key replacement equipment and technology up-grading. In such cases, industrial plant is wearing out and edging closer and closer toward obsolescence. Because there is no accounting for this type of disinvestment, it is a process that remains unseen until it takes its toll in operating efficiencies and output capacity.

The steel sector in Mexico is an example of disinvestment and erosion of capital base caused by overindebtedness. Once competitive and efficient by world standards, steel firms have long lists of overdue investments needed just to bring their plants up to date. Until this investment occurs, the burgeoning *maquiladora* (in-bond assembly) industry, which has been one of Mexico's success stories, will continue to import much of its steel and fall short of its potential for higher local value added.

Need for debt relief

Mexico's manufacturing industry needs debt relief to improve technology as a means of making the transition from the highly protected domestic economy of the past to the more competitive environment of the future where efficiency will be the key to survival. This transition of the economy began in earnest in 1986 when Mexico decided to enter GATT. Also, recent talks with the United States have opened the prospects of sweeping trade reforms between the two countries.

Some firms such as Cementos Apasco are, in fact, up to date in technology, but have to reduce debt to restore their competitive strength and become a more vital force in the overall effort toward economic recovery. Even Mexican firms with reasonably low financial leveraging may be strapped down by excessively stringent financial covenants because of the general concern among banks for Mexican risk.

IFC's ability to help

As an international development institution that understands the private sector in both industrial and developing countries, IFC is in a unique position to help solve the debt problems of Mexican companies. First, its character and its image of neutrality helps it build consensus and agreement among the various parties of a debt restructuring. Second, IFC can speed up negotiations by using its financial and technical expertise and experience in project financing to verify facts and to help establish an objective basis for taking difficult decisions. It can also help to design transaction schemes and propose solutions for corporate restructuring and debt reduction. Third, IFC's ability to contribute fresh money in complex restructuring schemes can have a catalytic effect in solving problems and closing deals. Finally, IFC can provide needed flexibility by investing through a wide array of financial instruments such as equity and quasi-equity instruments and various forms of guarantees, in addition to its direct loans.

Experience in Hungary

continued from page 3

molds, to chemicals, to hotels, and is encouraged by both the investment opportunities and the pragmatic approach and policies the Hungarian authorities and enterprises are following in dealing with joint venture activities.

IFC is impressed by the determination of the Hungarian authorities to press forward with their reforms and has found a practical and business-like approach to the establishment of joint venture projects. We see considerable potential for additional joint venture activity. Hungary is blessed with a sophisticated and hard working labor force; domestic engineering skills are considerable; labor costs are advantageous; and the country's geographical location is attractive for a number of markets. Because of these factors and IFC's experience to date, the Corporation would be pleased to discuss possibilities in Hungary with any interested potential investors to try to define areas where specific assistance could be provided.

Poland joins IFC

As this newsletter goes to press, Poland is becoming a member of IFC, and already several new proposals are being entertained by the Corporation in that country as well. A year from now we hope that we can report on further successes in both these newest members of the IFC family.

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An address on the occasion of the annual IFC luncheon
28 September 1987

Sir William Ryrie
Executive Vice President
International Finance Corporation

Bank/Fund Annual Meetings
Washington D.C.

I first want to welcome you all to another IFC luncheon and I especially want to welcome a number of members of the new Business Advisory Council for IFC which we established during the year. We are delighted and honored that so many very distinguished businessmen from a number of countries have agreed to serve as honorary members of this Council and give us their advice and guidance both in their own countries and generally. Their work will complement the work of our long-standing Banking Advisory Group and I am very pleased that we also have a number of members of that Group with us again today.

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MEXICO : ECONOMIC DEVELOPMENTS

SUMMARY
1. DEPUTY MINISTER OF FINANCE CONFIRMS THAT THE GOVERNMENT ARE WORRIED ABOUT THE RATE OF INFLATION, WHICH HAS ACCELERATED FOLLOWING THE DEVALUATION OF THE PESO REPORTED IN MY TUR. THERE HAS EVIDENTLY BEEN RENEWED DISCUSSION WITHIN THE GOVERNMENT OF SHOCK TREATMENT TO DEAL WITH THE PROBLEM, BUT THE PRESIDENT HAS RULED THIS OUT.

DETAIL
2. CRAWFORD (BANK OF ENGLAND) AND MINISTER/COUNSELLOR CALLED ON FRANCISCO SUAREZ, DEPUTY FINANCE MINISTER, ON 24 NOVEMBER FOR AN ASSESSMENT OF THE MEXICAN GOVERNMENT'S ECONOMIC POLICY IN THE AFTERMATH OF LAST WEEK'S SUDDEN DEVALUATION OF THE FREE PESO AND THE SHARP RISE IN INTEREST RATES. SUAREZ SAID THAT THERE WERE STILL A NUMBER OF IMPORTANT POSITIVE FACTORS. MEXICO HAD MET IMF TARGETS UP TO END OF Q3, INCLUDING THE BUILDING UP OF A PRIMARY BUDGET SURPLUS, A REDUCTION IN PROGRAMMED EXPENDITURE AND SOME IMPROVEMENT IN REVENUE (DESPITE THE RECESSION). ECONOMIC RECOVERY WAS WELL UNDER WAY, WITH GROWTH RUNNING AT 4 PERCENT FOR Q4 AND WITH A PROJECTED OUTTURN FOR 1987 OF 1.1 PERCENT. THE RECOVERY WAS EXPORT LED : IT WAS NOT THE RESULT OF PUBLIC SECTOR INVESTMENT. THE TRADE SURPLUS WAS ESTIMATED AT US DOLLARS 10BN, WITH A CURRENT ACCOUNT SURPLUS OF 3.5BN. SAVINGS WERE SATISFACTORY.

3. INFLATION WAS BY FAR THE MOST IMPORTANT NEGATIVE FACTOR AND VERY WORRYING. PREDICTABLY, THE DEVALUATION OF THE FREE PESO WAS PROVING TO BE INFLATIONARY, WITH RETAILERS AUTOMATICALLY RAISING THEIR PRICES, ALTHOUGH THERE WAS NO RATIONAL BASIS FOR THEIR DOING SO. ANOTHER ROUND OF PRICE INCREASES FOR PUBLIC SECTOR GOODS AND SERVICES WAS OVERDUE, BUT THE GOVERNMENT WERE CONSCIOUS THAT RISES IN FUEL PRICES GAVE A PARTICULAR BOOST TO INFLATION AND WOULD BE

AGAINST THE DOLLAR. TOWARDS THE END OF LAST WEEK IT WAS BEING QUOTED AT 2,500 OR MORE : IN THE LAST DAY OR TWO IT HAS COME DOWN TO AROUND 2,100. NEVERTHELESS, THE DAMAGE HAS ALREADY BEEN DONE IN TERMS OF INFLATION, AND THAT IS CLEARLY EXERCISING THE GOVERNMENT A GREAT DEAL. THEIR IMMEDIATE DILEMMA IS WHETHER TO GO AHEAD WITH THE DELAYED ROUND OF PUBLIC SECTOR PRICE INCREASES OR DELAY UNTIL 1988 AND THEREBY CREATE A PARTICULARLY HIGH INFLATIONARY PLATFORM FROM THE BEGINNING OF THE YEAR. MOST OBSERVERS DO NOT THINK THAT A GENERAL STRIKE IS LIKELY, BUT THE GOVERNMENT ARE NOT IGNORING THE RISK.

MORGAN

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AND TO IMMEDIATE BRASILIA, BIS BUENOS AIRES, MONTEVIDEO, LIMA
AND TO IMMEDIATE CARACAS, BOGOTA, PANAMA CITY, WASHINGTON
AND TO IMMEDIATE UKDEL IMF/IBRD WASHINGTON

TELECON DRUMMOND/MILTON ON 30 NOVEMBER

MEETING OF EIGHT LATIN AMERICAN PRESIDENTS IN MEXICO, 27-28 NOVEMBER

SUMMARY
1. THE ACAPULCO SUMMIT HAS NOT PRODUCED ANY REAL SURPRISES. THE COMMUNIQUE LANGUAGE ON DEBT, WHICH TOPIC SEEMS TO HAVE BEEN GIVEN MOST ATTENTION, GOES FURTHER THAN ANYTHING THE LATIN AMERICANS HAVE PREVIOUSLY AGREED COLLECTIVELY, BUT STOPS WELL SHORT OF ANY SUGGESTION OF A DEBTORS' CARTEL OR OF CONCERTED RADICAL ACTION IN THE SHORT TERM. THERE ARE ROUTINE PASSAGES ON CENTRAL AMERICA, LATIN AMERICAN COOPERATION AND INTERNATIONAL PEACE AND SECURITY. THE AMERICANS HAVE ESCAPED ANY OBVIOUS CRITICISM. ARGENTINA'S POSITION ON THE FALKLANDS IS GIVEN STOCK SUPPORT. A FOLLOW UP SUMMIT IS ENVISAGED FOR THE SECOND HALF OF 1988, IN URUGUAY.

DETAIL
2. THE SUMMIT MEETING OF 8 LATIN AMERICAN PRESIDENTS WAS HELD ON 27-28 NOVEMBER AND ISSUED THE ''ACAPULCO DECLARATION FOR PEACE, DEVELOPMENT AND DEMOCRACY''. THE MEXICAN FOREIGN MINISTER, SEPULVEDA, IS BRIEFING COMMUNITY AMBASSADORS LATER TODAY. IN THE MEANTIME, THE FOLLOWING WERE THE MAIN SUBJECTS COVERED AT THE SUMMIT MEETING.

EXTERNAL DEBT
3. THE PARTICIPANTS WERE AGREED THAT IN ORDER TO ACHIEVE SUSTAINED ECONOMIC RECOVERY, AN IMPROVEMENT IN THE STANDARD OF LIVING OF THEIR PEOPLES AND THE STRENGHTENING OF DEMOCRATIC PROCESSES, A ''JUST AND PERMANENT SOLUTION'' OF THE DEBT PROBLEM HAD TO BE FOUND, INCLUDING IMMEDIATE MEASURES TO REDUCE THE BURDEN OF DEBT SERVICING. IT WAS NECESSARY TO OVERCOME THE UNCERTAINTY RESULTING FROM INTERNATIONAL ECONOMIC INSTABILITY AND TO REVERSE NET TRANSFERS OF RESOURCES ABROAD. THE RESULTS OF EXTERNAL DEBT

NEGOTIATIONS THUS FAR WERE INSUFFICIENT AND REPRESENTED ''TEMPORARY PALLIATIVES ONLY''. GIVEN THE IMPOSSIBILITY OF THE DEBTOR COUNTRIES GOING BEYOND THEIR CAPACITY TO PAY, THE PARTICIPANTS AGREED ON THE NEED FOR STEPS :

(A) TO ENSURE SUFFICIENT CREDITS, ON ACCEPTABLE TERMS, FROM THE COMMERCIAL BANKS WHICH WOULD ALLOW THEIR COUNTRIES TO CONTINUE THEIR DEVELOPMENT PROGRAMMES, LIMIT THE NET TRANSFER OR RESOURCES AND FINANCE AN APPROPRIATE PROPORTION OF INTEREST PAYMENTS AND OTHER COMMITMENTS WITH THE BANKS THEMSELVES. WITHOUT SUCH FINANCING REGULAR DEBT SERVICING WOULD NOT BE POSSIBLE : AND

(B) TO ESTABLISH INTEREST RATE LIMITS IN LINE WITH MODALITIES TO BE DECIDED UPON AMONG THE PARTIES CONCERNED WITH A VIEW TO CONTRIBUTING TO GREATER CONTINUITY IN DEVELOPMENT AND PREDICABILITY IN ECONOMIC MANAGEMENT.

4. THE PRESIDENTS INSTRUCTED MINISTERS TO NEGOTIATE WITH INDUST-RIALISED COUNTRIES' GOVERNMENTS, IFI'S AND THE COMMERCIAL BANKS WITH A VIEW TO :

(I) CREATING MECHANISMS WHICH WOULD ALLOW THEIR COUNTRIES TO BENEFIT FROM THE DISCOUNTS AT WHICH THEIR OWN DEBT IS SOLD IN THE SECONDARY MARKET :

(II) DEVELOPING MECHANISMS TO COMPENSATE FOR TEMPORARY FLUCTUATIONS OUTSIDE THE CONTROL OF DEBTOR COUNTRIES, SUCH AS INTEREST RATES :

(III) COORDINATING EFFORTS TO WIDEN THE RESOURCE BASE OF THE IFIS, INCLUDING THE CORRECTION OF IMF POLICIES TO ENSURE ADJUSTMENT WITH GROWTH, A MORE ACTIVE ROLE BY THE WORLD BANK IN FORMULATING NEW MECHANISMS TO CONTRIBUTE TO THE SOLUTION OF THE DEBT PROBLEM, INCLUDING GUARANTEES, AND MAINTAINING THE MULTILATERAL CHARACTER OF THE IDB :

(IV) AVOIDING LINKAGE BETWEEN THE PROVISION AND DISBURSEMENT OF COMMERCIAL BANK CREDITS ON THE ONE HAND AND IMF AND WORLD BANK SUPPORT ON THE OTHER.

(V) OBJECTING TO CROSS CONDITIONALITY IN MULTILATERAL FINANCING PROGRAMMES AND THE ESTABLISHMENT OF PRIOR CONDITIONS IN PARIS CLUB NEGOTIATIONS.

(VI) PRESSING CREDITOR GOVERNMENTS TO ADOPT DEBT RELIEF FORMULAE IN THE CASE OF DEBT OWED TO EXPORT CREDIT AGENCIES :

(VII) SUPPORTING THE RELATIVELY LESS DEVELOPED COUNTRIES OF THE REGION IN OBTAINING ESPECIALLY FAVOURABLE CONDITIONS IN THE NEGOTIATION OF THEIR EXTERNAL DEBT : AND

(VIII) ENSURING, WITHIN THE FRAMEWORK OF THE URUGUAY ROUND, LINKAGE BETWEEN FINANCIAL OBLIGATIONS AND ACCESS FOR EXPORTS.

5. THE PRESIDENTS WARNED THAT IF THESE MEASURES WERE NOT AGREED UPON QUICKLY, SOME COUNTRIES, IN THE LIGHT OF THEIR OWN CIRCUMSTANCES, COULD BE OBLIGED TO TAKE UNILATERAL MEASURES TO LIMIT DEBT SERVICING. THEY EXPRESSED THEIR SOLIDARITY WITH COUNTRIES WHICH TOOK MEASURES TO LIMIT DEBT SERVICING IN ACCORDANCE WITH THEIR CAPACITY TO PAY.

CENTRAL AMERICA

6. THE PRESIDENTS NOTED THAT THE GUATEMALAN PEACE AGREEMENT WAS A SOVEREIGN EXPRESSION OF THE POLITICAL WILL OF THE CENTRAL AMERICAN COUNTRIES TO SOLVE THEIR CONFLICTS THROUGH DIALOGUE, OUTSIDE THE FRAMEWORK OF EAST/WEST CONFRONTATION. THEY RECOGNISED THE ''ENORMOUS DIFFICULTIES OF IMPLEMENTING FULLY AND PROMPTLY THE ESQUIPULAS AGREEMENTS'', BUT PROGRESS SO FAR WAS ENCOURAGING AND THEY CALLED ON THE PARTIES CONCERNED TO CONTINUE THEIR EFFORTS. THEY REAFFIRMED THEIR OWN RESPONSIBILITIES IN THE INTERNATIONAL COMMISSION FOR VERIFICATION AND FOLLOW UP. THE PRESIDENTS CALLED ON GOVERNMENTS WITH ''INTEREST AND TIES IN THE REGION'' TO CONTRIBUTE GENUINELY TO THE PEACE PROCESS.

7. IT WAS AGREED TO PUT IN HAND AN INTERNATIONAL EMERGENCY ECONOMIC COOPERATION PROGRAMME FOR CENTRAL AMERICA, INCLUDING MEASURES TO STIMULATE CENTRAL AMERICAN INTER REGIONAL TRADE, BETTER ACCESS FOR CENTRAL AMERICAN EXPORTS TO THE COUNTRIES OF THE EIGHT AND SPECIFIC PROJECTS IN THE AREAS OF EMERGENCY FOOD AID, AGRICULTURAL AND AGRO-INDUSTRIAL PROJECTS AND MANPOWER TRAINING. THE UNHCR WAS CALLED ON TO ORGANISE AN EMERGENCY INTEGRATED PROGRAMME FOR REFUGEES AND DISPLACED PERSONS.

OTHER REGIONAL DISPUTES

8. PANAMA CANAL. THE PRESIDENTS CONSIDERED THAT THE FAITHFUL IMPLEMENTATION OF THE PANAMA CANAL TREATIES, WHICH INCLUDED HANDING OVER THE CANAL TO EXCLUSIVE PANAMANIAN CONTROL, WAS OF PRIMARY IMPORTANCE FOR THE PRESERVATION OF PEACE AND SECURITY IN THE REGION.

9. FALKLAND ISLANDS. THE COMMUNIQUE CONTAINS THE FOLLOWING PASSAGE : ''WE REITERATE, AT THE SAME TIME, OUR SUPPORT FOR THE LEGITIMATE SOVEREIGN RIGHTS OF THE ARGENTINE REPUBLIC OVER THE FALKLANDS ISLANDS, AND WE EXPRESS THE NEED TO REACH A RAPID SOLUTION OF THE DISPUTE THROUGH NEGOATIATIONS BETWEEN THE PARTIES''.

LATIN AMERICAN INTEGRATION

10. THE PRESIDENTS CONFIRMED THEIR COMMITMENT TO REINFORCING THE PROCESSES OF INTEGRATION AS AN INDISPENSABLE INSTRUMENT FOR MORE EFFECTIVE LATIN AMERICAN PARTICIPATION IN INTERNATIONAL RELATIONS. WITH THIS IN VIEW, THE EIGHT AGREED TO STRENGTHEN THEIR INITIATIVES FOR COOPERATION AMONG THEIR COUNTRIES AND TO WIDEN AND DIVERSIFY THEIR RECIPROCAL TRADE, INCLUDING THE SUBSTITUTION OF EXTRA REGIONAL IMPORTS. THE FINAL OBJECTIVE WOULD BE A LATIN AMERICAN COMMON MARKET.

INTERNATIONAL AND REGIONAL SECURITY

11. PARTICIPANTS COMMITTED THEMSELVES TO CONCERTED ACTION TO STIMULATE MEASURES IN FAVOUR OF INTERNATIONAL DISARMAMENT AND SECURITY : TO ENCOURAGE REGIONAL SOLUTIONS TO REGIONAL PROBLEMS INCLUDING PEACE ZONES : AND TO WIDEN THE POLITICAL DIALOGUE WITH OTHER GROUPS OF STATES, WITHIN AND WITHOUT THE REGION. THEY ALSO AGREED ON THE IMPORTANCE OF UNDERTAKING AN ACTIVE AND COORDINATED FIGHT TO ERADICATE POVERTY AND ON REINFORCING COOPERATION AGAINST DRUGS AND TERRORISM.

INDUSTRIALISED COUNTRIES

12. THE ACAPULCO DECLARATION CALLS ON THE HEADS OF STATE OF THE INDUSTRIALISED COUNTRIES TO PARTICIPATE IN A ''POLITICAL DIALOGUE'' TO CLEAR THE WAY TO OVER COMING OBSTACLES TO DEVELOPMENT, THE REORGANISATION OF THE WORLD ECONOMY AND THE TAKING OF DECISIONS ON PEACE AND SECURITY.

FOLLOW UP ACTION

13. THE PRESIDENTS INSTRUCTED THEIR FOREIGN MINISTERS, AT THEIR NEXT MEETING IN CARTAGENA, TO EXAMINE A PROGRAMME OF GUIDELINES FOR COOPERATION AMONG THE EIGHT BASED ON THE ACAPULCO DECLARATION. THE PRESIDENTS THEMSELVES AGREED TO MEET AGAIN, IN URUGUAY, IN THE SECOND HALF OF 1988.

COMMENT

14. PRESS REPORTS OVER THE WEEKEND HAD SUGGESTED THAT THE SUMMIT COMMUNIQUE WOULD DEAL WITH OTHER TOPICS : THE INTEGRATION

OF CUBA WITHIN THE INTER AMERICAN SYSTEM, SUBJECT TO CUBA'S OWN READINESS TO REJOIN THE OAS : THE PARTIAL CAPITALISATION OF INTEREST PAYMENTS : THE CANCELLATION OF DEBTS, ON HIGHLY FAVOURABLE TERMS, AMONG THE COUNTRIES OF THE EIGHT THEMSELVES : AND A MORE DETAILED ASSISTANCE PROGRAMME FOR CENTRAL AMERICA. NONE OF THESE POINTS HAVE FOUND THEIR WAY INTO THE COMMUNIQUE. IT LOOKS AS IF THE MEXICANS, WHO WORKED HARD BEFOREHAND TO PREPARE FOR THE CONFERENCE, HAVE SECURED WHAT THEY WANTED ON MOST POINTS. BUT THE MAIN ACHIEVEMENT MAY BE THAT THE CONFERENCE TOOK PLACE AT ALL GIVEN THE VARIETY OF ECONOMIC AND OTHER CIRCUMSTANCES AMONG THE PARTICIPANTS.

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MY TELNO 411, PARAGRAPH 2.

SUMMARY
1. SEPULVEDA DULY GAVE A COMMUNITY BRIEFING ON 30 NOVEMBER. IT ADDED LITTLE TO MY TUR. SOME POINTS OF DETAIL WERE OF INTEREST.

DETAIL
FOLLOW-UP

2. SEPULVEDA WAS PRESSED ABOUT WHAT HAPPENED NEXT. HE SAID THAT SOME LARGE SCALE IDEAS HAD BEEN FLOATED, EVEN A NEW BRETTON-WOODS CONFERENCE, BUT IN THE END IT HAD BEEN DECIDED THAT THE NEXT MEETING OF FOREIGN MINISTERS IN CARTAGENA WOULD HAVE THE DIFFICULT TASK OF DECIDING ON FOLLOW UP ACTION. ASKED ABOUT PRESS SPECULATION CONCERNING CANCELLATION OF DEBTS WITHIN THE GROUP OF EIGHT, SEPULVEDA REPLIED THAT THIS WOULD BE LEFT TO CENTRAL BANK GOVERNORS TO DEAL WITH.

GROUP OF EIGHT/EEC RELATIONS

3. SEPULVEDA SAID THAT THESE SHOULD BE AT TWO LEVELS. HE PROPOSED THAT AT THE HAMBURG MEETING ON 29 FEBRUARY THERE SHOULD BE SEPARATE MEETINGS BETWEEN THE GROUP OF EIGHT AND THE TWELVE. THESE WOULD FOLLOW THE DISCUSSIONS IN NEW YORK LAST SEPTEMBER. HE THOUGHT THAT IT WOULD CARRY AN IMPORTANT MESSAGE IF THE GROUP OF EIGHT AND THE TWELVE WERE SEEN TO MEET IN THIS WAY. SECONDLY, HE HOPED THAT THERE WOULD BE CLEAR ECONOMIC SUPPORT FROM THE COMMUNITY FOR CENTRAL AMERICA. HE EMPHASISED THAT THIS NEED ENTAIL ONLY SMALL SUMS OF MONEY.

ENLARGEMENT OF THE GROUP OF EIGHT

4. I SAID THAT THERE HAD BEEN PRESS SPECULATION ABOUT CUBA'S RETURNING TO THE INTER-AMERICAN SYSTEM AND EVEN ABOUT ENLARGING

THE GROUP SPECIFICALLY TO INCLUDE CUBA. DID HE ENVISAGE CUBAN PARTICIPATION IN THE GROUP'S MEETING IN URUGUAY NEXT YEAR? HE SAID DEFINITELY NOT. THE GROUP OF EIGHT WOULD REMAIN THE GROUP OF EIGHT. THEY HAD NOW WORKED TOGETHER ON MANY TOPICS AND DID NOT SEE A NEED FOR ENLARGEMENT. THE GROUP OF EIGHT WERE NEVERTHELESS IN FAVOUR OF INCREASED CUBAN PARTICIPATION IN DISCUSSION OF MATTERS OF INTEREST TO THE AREA.

CENTRAL AMERICA

5. SEPULVEDA SAID THAT PRESIDENT GARCIA OF PERU HAD PLANNED A VISIT TO CENTRAL AMERICA SUBSEQUENT TO THE ACAPULCO SUMMIT. HE WOULD TAKE WITH HIM A LETTER SIGNED BY THE EIGHT PRESIDENTS ON THEIR PRE-OCCUPATIONS IN THE AREA.

ATTITUDE OF THE UNITED STATES

6. SEPULVEDA SAID THAT HE DID NOT EXPECT DETAILED SPECIFIC US COMMENT ON THE CONCLUSIONS OF THE SUMMIT. HE THOUGHT THAT SUCH OCCASIONS WERE NOT WELCOME TO THE UNITED STATES. A US OFFICIAL HAD TOLD HIM THAT HE HAD FOUND DEALINGS WITH THE EUROPEAN COMMUNITY MUCH EASIER ON A BILATERAL BASIS AND MUCH HARDER WHEN THEY WORKED AS A GROUP. HE THOUGHT THAT THE AMERICANS WOULD THINK THE SAME ABOUT THE ACAPULCO SUMMIT.

FALKLANDS

7. AFTER THE MEETING I ASKED SEPULVEDA HOW THE DISCUSSION ON THE FALKLANDS HAD GONE. HE SAID THAT THE PARAGRAPH IN THE COMMUNIQUE HAD IN FACT PROVED ONE OF THE EASIEST TO DRAFT (PARA 9 OF MY TUR).

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YOUR TELNOS 411 AND 413 (NOW REPEATED TO CERTAIN POSTS)
ACAPULCO SUMMIT
1. WE WERE MOST GRATEFUL FOR REPORTS IN TURS, WHICH PROVIDED HELPFUL BACKGROUND FOR MEETING ON 1 DECEMBER BETWEEN MR EGGAR AND AMBASSADORS OF THE SEVEN G8 COUNTRIES REPRESENTED IN LONDON.

2. THE CALL, AT THE AMBASSADORS' URGENT REQUEST, WAS PRIMARILY TO HAND OVER A COPY OF THE ACAPULCO SUMMIT COMMUNIQUE. AMBASSADOR NAVARRETE OF MEXICO INTRODUCED IT, STRESSING THE FOLLOWING POINTS. THE ACAPULCO SUMMIT HAD BEEN A LATIN AMERICAN INITIATIVE, AND WAS INTENDED TO PUT FORWARD A JOINT LATIN AMERICAN RESPONSE ON A WIDE RANGE OF ISSUES. THE DEVELOPED COUNTRIES HAD THE G7 SUMMIT, THE AFRICANS THE OAU, AND NOW LATIN AMERICA THE G8. THE G8 WOULD MEET ANNUALLY, BUT WOULD NOT BE SUPPORTED BY A FORMAL SECRETARIAT. THE SUMMIT WAS ALSO AN IMPORTANT STEP ON THE WAY TO INCREASED ECONOMIC AND POLITICAL INTEGRATION AND COOPERATION, AIMED IN THE LONG RUN AT PARALLELING THE EC EXPERIENCE. THE G8 HAD WELCOMED IMPROVEMENTS IN EAST/WEST RELATIONS, PARTICULARLY THE INF TREATY. THEY WELCOMED PROGRESS IN THE CENTRAL AMERICAN PEACE PROCESS, STRESSED THE IMPORTANCE OF AN INTERNATIONAL ECONOMIC COOPERATION PROGRAMME FOR CENTRAL AMERICA AND URGED FULL COMPLIANCE WITH THE PANAMA CANAL TREATY. CENTRAL AMERICAN PROBLEMS SHOULD BE HANDLED THROUGH A PROCESS OF NON-INTERVENTION AND SELF-DETERMINATION. THE FALKLANDS PROBLEM SHOULD BE SOLVED THROUGH NEGOTIATION. (MR EGGAR INTERJECTED THAT THEY WERE APPLYING SELF-DETERMINATION TO CENTRAL AMERICA, BUT NOT TO THE FALKLANDS.)

3. ON EXTERNAL DEBT, THE SUMMIT HAD CALLED FOR A JUST AND PERMANENT SOLUTION, BUT IN THE SHORTER TERM DEBT SERVICE PAYMENTS MUST BE REDUCED TO ALLOW LATIN AMERICAN COUNTRIES TO GROW. NAVARRETE EMPHASISED THAT THERE WAS NO DEPARTURE FROM THE NORMAL

COOPERATIVE APPROACH AND CONTINUATION OF NEGOTIATIONS WITH CREDITOR GOVERNMENTS. BUT PROGRESS WAS URGENTLY NEEDED, AND WITHOUT IT UNILATERAL ACTION MIGHT BECOME UNAVOIDABLE. EARLY PROGRESS WAS ALSO NEEDED IN INTERNATIONAL TRADE ISSUES AND TO REVENUE DISTORTIONS IN THE INTERNATIONAL ECONOMIC SYSTEM. ALL OF THIS REQUIRED A POLITICAL DIALOGUE.

4. NAVARRETE SAID THAT THE GROUP WOULD BE INTERESTED IN DUE COURSE TO HEAR HMG'S REACTIONS TO THE COMMUNIQUE. MR EGGAR PASSED ON SECRETARY OF STATE'S APOLOGIES FOR NOT SEEING THEM HIMSELF. HE HAD ASKED MR EGGAR TO REPORT. WE WOULD NOW STUDY THE COMMUNIQUE NAVARRETE EXPRESSED THE HOPE THAT THE GROUP WOULD BE ABLE TO SEE THE SECRETARY OF STATE IN DUE COURSE TO GET HMG'S REACTIONS.

COMMENT

5. THIS MEETING REVEALED LITTLE THAT HAD NOT ALREADY BEEN COVERED IN YOUR TURS, AND CONFIRMED YOUR VIEW THAT, CONTRARY TO THE INITIAL PRESS REPORTING HERE (ESPECIALLY IN THE FT), THE SUMMIT HAD NOT REALLY PRODUCED ANY SURPRISES. THE AMBASSADORS WERE AT PAINS TO STRESS THEIR COOPERATIVE APPROACH ON DEBT, BUT THE IMPORTANCE THE LATIN AMERICANS ARE CLEARLY ATTACHING TO THIS DECLARATION SHOULD NOT BE UNDERESTIMATED. WE SHALL NOW STUDY THE LENGTHY COMMUNIQUE.

5. IN THE MEANTIME, GRATEFUL IF G8 POSTS WOULD REPORT ANY REACTIONS TO THE SUMMIT, IN PARTICULAR ANYTHING WHICH INDICATES A CHANGING ATTITUDE TOWARDS DEBT NEGOTIATIONS. IF ASKED ABOUT THE SUMMIT, YOU SHOULD SAY THAT WE ARE NOW STUDYING THE REPORT, BUT WELCOME THE G8 COMMITMENT TO CONTINUE TO SEEK NEGOTIATED SOLUTIONS TO THE DEBT PROBLEM. WE RECOGNISE THE SEVERITY OF MANY COUNTRIES' DIFFICULTIES, AND THE NEED FOR THE INTERNATIONAL COMMUNITY TO PROVIDE ADEQUATE SUPPORT TO COUNTRIES IMPLEMENTING ECONOMIC REFORM PROGRAMMES. HENCE OUR SUPPORT FOR AN EARLY AND SUBSTANTIAL GENERAL CAPITAL INCREASE AT THE WORLD BANK, AND OUR CONTINUED FLEXIBLE APPLICATION OF EXPORT CREDITS. WE ALSO RECOGNISE THE NEED FOR STRENGTHENED INTERNATIONAL COOPERATION TO COPE WITH THE PROBLEMS POSED BY THE RECENT FALL IN THE STOCK MARKETS. BUT LATIN AMERICA'S DEBT PROBLEMS ARE PRIMARILY A MATTER FOR NEGOTIATION BETWEEN THE DEBTOR COUNTRY AND COMMERCIAL BANKS, IN WHICH CREDITOR GOVERNMENTS SHOULD NOT INTERVENE. WE BELIEVE THAT ANY UNILATERAL ACTION BY DEBTORS WOULD NOT BE IN THEIR OWN BEST INTERESTS.

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MEXICO CITY'S TELNOS 411 AND 413 TO FCO: G8 SUMMIT, ACAPULCO

SUMMARY

1. WHILE CONCEDING SOME SIGNIFICANCE TO THE OUTCOME OF THE SUMMIT AS AN EXPRESSION OF A JOINT CONCEPTUAL APPROACH, BRAZILIAN PUBLIC REACTION TO THE MEETING HAS SO FAR TENDED TOWARDS SCEPTICISM AND DISMISSIVENESS ABOUT LIKELY EFFECTS.

DETAIL

2. FACTUAL COVERAGE IN THE BRAZILIAN PRESS HAS LARGELY FOCUSSED ON TWO ASPECTS - THE EXTERNAL DEBT AND THE MOVE TO BRING CUBA BACK INTO THE INTER-AMERICAN SYSTEM. THE CONSENSUS ON DEBT HAS BEEN REPORTED AS REFLECTING BRAZILIAN INITIATIVES AND POSITIONS. IT HAS BEEN ASSESSED HERE AS A MILDLY SIGNIFICANT AFFIRMATION OF COMMON THINKING, THOUGH STOPPING SHORT OF A COMMITMENT TO CONCERTED ACTION. THE CONSENSUS ON CUBA (ANNOUNCED BY SARNEY) HAS BEEN REPRESENTED AS THE RESULT OF AN INITIATIVE OF PRESIDENT SARNEY. SEVERAL REPORTS HAVE UNDERLINED WHAT THEY DESCRIBED AS PRESIDENT SARNEY'S PROMINENT ROLE AT THE SUMMIT AND THE MEDIA INTEREST WHICH HE APPARENTLY ATTRACTED IN THIS CONTEXT. REPORTING ON THE ACTUAL TEXT OF THE COMMUNIQUE HAS HIGHLIGHTED TWO PASSAGES: THE REFERENCE TO THE POSSIBLE ADOPTION OF UNILATERAL MEASURES ON DEBT, AND THE PASSAGE RELATING TO TRADE RELATIONS WITH DEVELOPED COUNTRIES. THESE ARE BEING INTERPRETED HERE AS VEILED EXPRESSIONS OF SOLIDARITY WITH BRAZIL, OVER THE DEBT MORATORIUM AND OVER BRAZIL'S CURRENT TRADE DISPUTE WITH THE UNITED STATES.

3. ALTHOUGH THE PRESIDENCY HAS PROJECTED THE SUMMIT AS A FURTHER PROOF OF SARNEY'S STATESMANSHIP, EDITORIAL COMMENT HAS RANGED FROM THE SCEPTICAL TO THE SARCASTIC. TWO OF THE MOST INFLUENTIAL, OPINION FORMING NEWSPAPERS - JORNAL DO BRASIL AND FOLHA DO SAO PAULO - USED HEADLINES LIKE ''DAYDREAMS IN ACAPULCO'' AND ''FUTILE RHETORIC'' AND SUMMED UP THE OUTCOME

OF THE MEETING AS EMPTY POSTURING AND EVEN AS A THINLY DISGUISED ADMISSION OF IMPOTENCE. THE MAIN JORNAL DO BRASIL EDITORIAL SAID IT WAS TIME LATIN AMERICA STOPPED ALLOWING ITSELF TO BE CARRIED AWAY WITH ITS OWN RHETORIC, AND STOPPED BLAMING FOREIGNERS FOR ITS OWN MISMANAGEMENT. ONE SHREWD COMMENTATOR, IN GAZETA MERCANTIL, OBSERVED THAT THE STATEMENT ON DEBT HAD ACTUALLY RESTRICTED BRAZIL'S FREEDOM OF MANOEUVRE IN THE DEBT NEGOTIATIONS.

4. INFORMED OBSERVERS HERE GENERALLY BELIEVE THAT DESPITE THE CONSENSUS ON DEBT EACH COUNTRY WILL CONTINUE TO GO ITS SEPARATE WAY IN NEGOTIATIONS WITH THE CREDITORS.

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YOUR TELNO 342 TO MEXICO CITY AND OUR TELNO 282 (NOT TO ALL):
ACAPULCO SUMMIT

SUMMARY

1. URUGUAYAN FOREIGN MINISTRY DISAPPOINTED THAT NO AGREEMENT WAS REACHED AT SUMMIT ON SPECIFIC PROPOSALS FOR LIMITING INTEREST PAYMENTS ON OLD DEBT.

DETAIL

2. IN THE ABSENCE OF THE DIRECTORS OF ECONOMIC AND POLITICAL AFFAIRS AT THE MFA (BOTH ARE TRAVELLING) I CALLED ON EHLERS IN THE DIRECTORATE OF ECONOMIC AFFAIRS IN THE MINISTRY TO GET A FIRST REACTION TO WHAT HAD BEEN AGREED ON DEBT AT THE SUMMIT.

3. EHLERS SAID THAT THE MFA WERE FRANKLY DISAPPOINTED THAT NO PROGRESS APPEARED TO HAVE BEEN MADE ON PLACING A CEILING ON INTEREST RATES ON OLD DEBT.

4. THE FOREIGN MINISTRY VIEW WAS THAT IN ORDER TO SOLVE THE DEBT PROBLEM RATHER THAN SIMPLY MANAGE IT, A LIMIT HAD TO BE SET ON INTEREST RATES ON OLD DEBT. IF THIS WERE DONE THE PROBLEM OF DEBT COULD PROBABLY BE SOLVED OVER A PERIOD OF TWENTY YEARS OR SO.

5. THIS APPROACH DID NOT REPRESENT A CHANGE IN STRATEGY. URUGUAY CONTINUED TO MANAGE ITS DEBT PROBLEMS IN A SENSIBLE WAY. BUT THE EMPHASIS WAS ON QUOTE MANAGING THE DEBT UNQUOTE. THIS INVOLVED CONTINUALLY RE-SCHEDULING, RATHER THAN SOLVING THE DEBT PROBLEMS. THE FOLLY OF DEFAULTING WAS WELL RECOGNISED. QUOTE OF COURSE THERE WOULD BE NO NEW MONEY, BECAUSE THE CREDITORS WOULD HAVE NONE TO GIVE UNQUOTE. SOLVING THE DEBT PROBLEM HOWEVER WAS NOT SIMPLY AN ECONOMIC PROBLEM, A POLITICAL SOLUTION WAS ALSO REQUIRED.

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6. EHLERS SAID THAT IN HIS VIEW ACAPULCO DID NOT GO BEYOND WHAT HAD BEEN DISCUSSED BY THE CARTAGENA CONSENSUS. HE DID NOT KNOW WHY THE ACAPULCO MEETING HAD NOT GRASPED THE NETTLE ON THE OLD DEBT PROBLEM. HE SUSPECTED THAT AGREEMENT MAY HAVE FOUNDERED ON THE FACT THAT THE STRUCTURE OF EACH COUNTRY'S DEBT WAS DIFFERENT. THERE WERE ALSO DIFFERENCES IN QUOTE MENTALITY UNQUOTE AND ON ATTITUDES TO SOVEREIGNTY AMONG THE G8. BUT WHEN THE DIRECTOR OF ECONOMIC AFFAIRS RETURNED IN A WEEK OR SO, EHLERS HOPED TO HAVE MORE NEWS ON THIS.

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MY TELNOS 404 AND 424 : MEXICO : POLITICO/ECONOMIC DEVELOPMENTS

SUMMARY
1. THE GOVERNMENT, EMPLOYERS AND UNIONS ARE LIKELY TO REACH A SETTLEMENT IN THE NEXT 24 HOURS DESIGNED TO AVOID THE GENERAL STRIKE CALLED FOR 18 DECEMBER. THE CHANCES HAVE BEEN IMPROVED BY THE AUTHORITIES' DECISION ON 14 DECEMBER TO DEVALUE THE CONTROLLED PESO BY 18 PER CENT, THUS SIGNIFICANTLY NARROWING THE GAP BETWEEN THE CONTROLLED AND FREE RATES.

DETAIL
2. THE ECONOMIC CABINET HAVE BEEN MEETING ON THEIR OWN OR WITH EMPLOYER AND LABOUR REPRESENTATIVES ALMOST CONTINUOUSLY OVER THE LAST THREE DAYS. IT IS EXPECTED THAT THE GOVERNMENT WILL SHORTLY PUT FORWARD PROPOSALS FOR A SETTLEMENT OF FIDEL VELASQUEZ'S ORIGINAL DEMAND ON BEHALF OF THE UNIONS FOR A 46 PER CENT EMERGENCY INCREASE IN THE MINIMUM WAGE BACKDATED TO 18 NOVEMBER (THE DATE ON WHICH THE FREE PESO WAS DEVALUED BY OVER 30 PER CENT - MY TELNO 396). AS ANTICIPATED, THERE IS A FAIR AMOUNT OF ROOM FOR MANOEUVRE. AT THE MOMENT ONE POSSIBILITY BEING CANVASSED IS AN IMMEDIATE 15 PER CENT INCREASE FOLLOWED BY ANOTHER 20 PERCENT FROM 1 JANUARY (WHICH LOOKS TO BE ON THE LOW SIDE). THE PACKAGE MIGHT ALSO INCLUDE SOME FOR OF WAGE/PRICE INDEXATION. THERE IS ALSO TALK OF A NEW TRIPARTITE OVERNEMENT/EMPLOYERS/LABOUR SOCIAL PACT TO TACKLE THE PROBLEM OF INFLATION AND OTHER ECONOMIC ILLS.

3. THE UNIONS HAVE CONTINUED TO PROTEST AT THE DEVALUATION OF THE FREE PESO, WHICH HAS LED TO A SURGE IN RETAIL PRICES (THOUGH, A LITTLE SURPRISINGLY, THE BANK OF MEXICO'S NOVEMBER INFLATION FIGURE WAS NO HIGHER THAN 7.9 PER CENT, PRODUCING 125.8 PER CENT AS THE RATE FOR THE FIRST 11 MONTHS OF THIS YEAR). THEY HAVE BEEN PARTICULARLY IRRITATED THAT IMPORTERS AND EXPORTERS HAVE CONTINUED TO BENEFIT FROM THE MUCH MORE FAVOURABLE CONTROLED PESO RATE. CONTRARY TO INITIAL GOVERNMENT HOPES, AND SOME EARLY SUPPORTING EVIDENCE, THEFREE PESO HAS NOT SIGNIFICANTLY

STRENGHTENED SINCE 18 NOVEMBER AND, UNTIL THIS WEEK, THERE HAS BEEN A GAP OF 25-30 PER CENT BETWEEN THE TWO RATES. AS IN THE PAST, IMPORTERS AND EXPORTERS HAVE BEEN QUICK TO EXPLOIT THIS DIFFERENTIAL AND CHEAT ON INVOICING.

4. CONFRONTED WITH THESE CONSIDERATIONS, THE PRESIDENT'S OFFICE ANNOUNCED LATE ON 14 DECEMBER THAT THE CONTROLLED RATE WAS BEING DEVALUED BY 18 PER CENT WITH IMMEDIATE EFFECT. THE SPREAD BETWEEN THE BUYING AND SELLING RATES HAS MOVED FROM 1700/1797 PESOS TO THE DOLLAR, TO 2189/2200 TO THE DOLLAR. THE FREE PESO WAS TRADING ON 14 DECEMBER AT BETWEEN 2275 (BUYING) AND 2475 (SELLING), AND IN SOME PLACES HIGHER THAN THAT. THERE IS THUS STILL A GAP OF 10 PER CENT OR MORE BETWEEN THE TWO RATES, BUT THE AUTHORITIES WILL BE HOPING THAT THIS WILL NARROW BEFORE TOO LONG.

5. AT THE SAME TIME, THE PRESIDENT'S OFFICE ANNOUNCED THAT THE MAXIMUM IMPORT TARIFF WAS TO BE REDUCED FROM 40 PERCENT TO 20 PER CENT AND THAT OTHER IMPORT CHARGES WOULD BE ADJUSTED DOWNWARDS. IT WAS EXPLAINED THAT THESE CHANGES WOULD OFFSET THE INCREASED COST OF IMPORTS ARISING FROM THE DEVALUATION OF THE CONTROLLED PESO (WHICH IS PROBABLY DISINGENUOUS SINCE IMPORT PRICES HAVE USUALLY BEEN MORE AFFECTED BY THE EXCAHNGE RATE THAN ANY OTHER FACTOR).

6. THE GOVERNMENT HAVE EVIDENTLY CALCULATED THAT THESE STEPS SHOULD HELP TO DEFUSE THE LABOUR MOVEMENT'S DEMANDS AND FACILITATE A SETTLEMENT OF THE MINIMUM WAGE CLAIM. FIDEL VELASQUEZ HAS NOW BECOME DISTINCTLY LESS BELLIGERENT ABOUT A STRIKE.

MILTON

YYYY

<u>DISTRIBUTION</u> 155

<u>MAIN</u> 155

MONETARY MR FEARN
MCAD

NNNN

35/1/4173/013/LP

19/6/1

CONFIDENTIAL

FROM: J M HALLIGAN
DATE: 6 January 1988

1. MR MOUNTFIELD
2. CHANCELLOR

Ch/ Content with line in para 7?

OK

cc PS/Economic Secretary
Sir P Middleton
Sir G Littler
Mr H Evans
Mrs Lomax
Mrs Case
Mr Walsh
Mr Bush

MEXICAN DEBT BUYBACK SCHEME

You may like a short report on this scheme that was announced on 29 December.

Details of the Scheme

2. The scheme has been put together by the Mexicans, Morgan Guaranty and the US Treasury. The US Treasury became involved when the World Bank had declined to do so. The details are as follows:-

i. Mexico uses $1.9 billion of its reserves to buy a US Treasury zero coupon bond for $10 billion redeemable after 20 years.

ii. The US Treasury bond would be earmarked to repay a Mexican bond issue, of the same maturity paying 1-5/8 per cent over LIBOR.

iii. Mexico will invite its creditor banks to tender for these new bonds in exchange for existing claims. The Mexicans are apparently hoping for only a 40 per cent discount, compared with a market discount of 50 per cent at end-December.

iv. To become effective Mexico's creditor banks with half or more of total exposure will have to agree that the scheme can go forward, although not necessarily participate themselves. This reflects the need to obtain a waiver of "negative pledge" covenants in existing bank agreements. [These are undertakings by the borrower not to give any privileged treatment to any other creditor].

Effects of the Scheme

3. If successful, Mexico would be able to cancel obligations of a greater value than it issues, ie capture the discount that emerges from the tender. The cash-flow benefit would depend upon the discount achieved offset by the loss of interest income from the immediate expenditure of $1.9 billion and the higher interest rate they would pay on these new bonds compared with that on existing debt (spread of 1-5/8 compared with 13/16 per cent). A 40 per cent discount would enable Mexico to retire nearly $17 billion of debt in exchange for an immediate outlay of $1.9 billion and would seem a cost-effective way of utilising some of their large reserves (currently $14 billion).

4. Participating banks would have the certainty that, having taken an immediate loss through the discount, eventual repayment of the remaining principal was secure. They would also have the assurance, though not the certainty, of being exempted from future new money arrangements or reschedulings of these securities. The bonds would attract a higher margin than existing debt but the interest would be subject to Mexican country risk, although Mexico might give priority to servicing these bonds. Participating banks would have to realise losses, offset to the extent that existing provisions cover the discount. Another concern would be whether participation might require increased provisioning against all claims on Mexico. This could arise both because of rulings by bank regulators and because of fears that once Mexico had secured a discount on some of its debt it would be unwilling to service normally its other debts. These issues will affect both the willingness of banks to participate and the willingness of non-participating banks to grant waivers and allow the scheme to go ahead.

5. If the scheme succeeds in alleviating Mexico's cash-flow position the repayment prospects for official creditors should improve. However, they may be expected to participate in a similar scheme at a later date or provide equivalent relief.

6. The involvement of the US Treasury in a securitisation discount scheme is bound to mean pressure for similar treatment from other debtors. In particular Brazil may resuscitate their earlier scheme, withdrawn at US request. It will be open to the creditors to argue that the Mexican Scheme creates no new precedent being a simple extension of existing buy-back schemes that some banks have previously engaged in as a commercial matter. Unlike the Brazilian proposal the scheme is voluntary and put forward by a country with an IMF programme. Although the US Treasury is involved in the issue of a zero coupon bond to Mexico it is not involved in the marketing of the discount scheme to banks. That will remain a matter for commercial banks judgment. However, these points are likely to be overlooked by other debtors who may now be even more reluctant to meet their commitments in full.

UK Attitude

7. We presume that any UK Government comment about this scheme should be on the usual lines - this is another extension of the market based menu approach to commercial bank debt; as such it is additional welcome flexibility to deal with the problem; whether individual banks elect to participate is a matter of commercial judgment in which the Government will not interfere; but it will certainly not put any obstacles in the way of participation. If asked whether the UK would be prepared to issue similar instruments in support of a debt securitisation scheme, we would say that we have no plans to do so. (We have no need to borrow dollars from anyone at present.)

8. UK banks have not yet formed a view. We shall via the Bank of England keep in touch with their thinking but (as stated above) without trying to influence them. If we come under pressure from the US authorities to encourage them to participate

we should give them the same message, as we did in the Bolivan buy-back case.

9. We will need to take a view on one point in the near future. Before the scheme can go ahead the World Bank will have to agree to waive negative pledge clauses in its own loans. The staff are prepared to agree to this waiver provided the Mexicans give an assurance that they will meet all their scheduled commitments to the World Bank. We are considering our line on this but the Bank must clearly remain a preferred creditor for the Mexicans if they want future access to Bank loans.

10. In the longer-term we might need to consider our response if such an offer was also made to official creditors. Hitherto we have always taken the line that we expect Sovereign debt to be repaid in full and have rejected any proposal for full or partial write-offs. At the same time ECGD have earmarked a general provision out of its reserves against the contingency that not all such debt would be fully recovered. However, making provisions against possible non-payment is different from particpating in an arrangement with a debtor which abandons our full claims. To do so would be a major policy change requiring the fullest consideration. There are no signs that other export credit agencies would agree to such a scheme. If the question is put to us hypothetically we would propose to stick to our previous line. But, if a concrete proposal was made by Mexico, or indeed another debtor, we would have to think about it.

Conclusion

11. Immediately we should be grateful for your agreement to the line set out in paragraph 7 above. We will keep in touch with the reaction of UK banks and others.

J.M. Halligan.

J M HALLIGAN

ps2/13T

CONFIDENTIAL

PUP

FROM: J M G TAYLOR
DATE: 7 January 1988

MR HALLIGAN

cc PS/Economic Secretary
Sir P Middleton
Sir G Littler
Mr H Evans
Mrs Lomax
Mr Mountfield
Mrs Case
Mr Walsh
Mr Bush

MEXICAN DEBT BUYBACK SCHEME

The Chancellor has seen your minute of 6 January, and is content with the line you propose.

JT

J M G TAYLOR

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MDLIAN 6997

RESTRICTED
FM MEXICO CITY
TO PRIORITY FCO
TELNO 29
OF 022005Z FEBRUARY 88
AND TO ROUTINE HMT, BANK OF ENGLAND, DTI, ECGD, ODA
AND TO ROUTINE UKDEL IMF/IBRD WASHINGTON

MEXICO : ECONOMIC DEVELOPMENTS

SUMMARY
1. IN THE FIRST TWO DAYS OF FEBRUARY THE GOVERNMENT HAS ANNOUNCED INFLATION FIGURES FOR THE FIRST HALF OF JANUARY, AN ADJUSTMENT OF ITS EXCHANGE RATE POLICY, AND A PACKAGE INTENDED TO CUT GOVERNMENT SPENDING.

INFLATION
2. THE BANCO DE MEXICO HAS PUBLISHED FIGURES FOR THE FIRST 15 DAYS OF JANUARY SHOWING AN INCREASE OF 13.47 PERCENT IN THE CONSUMER PRICE INDEX COMPARED TO THE AVERAGE FOR DECEMBER. THE FIGURE FOR THE FULL MONTH OF JANUARY IS NOT YET AVAILABLE AND WILL BE AN AVERAGE OF THE FIGURES FOR THE TWO HALVES OF THE MONTH.

EXCHANGE RATE AND RESERVES
3. THE DIRECTOR GENERAL OF THE BANCO DE MEXICO, MIGUEL MANCERA, HAS ANNOUNCED THAT THE CONTROLLED RATE OF EXCHANGE BETWEEN THE PESO AND THE DOLLAR WILL BE DEPRECIATED BY 3 PESOS EVERY WORKING DAY DURING FEBRUARY. THIS WILL RESULT IN A DEPRECIATION OF 2.7 PERCENT OVER THE MONTH, STILL SIGNIFICANTLY LESS THAN THE RATE OF INFLATION. MANCERA DEFENDED THE POLICY OF ''STABILITY'' OF THE EXCHANGE RATES BY POINTING TO THE GOVERNMENTS PRIMARY FISCAL SURPLUS (PROJECTED AS 8.3 PERCENT OF GDP FOR 1988) AND HIGH INTERNATIONAL RESERVES. HE SAID THAT THE RESERVES WERE ABOVE US DOLLARS 13.5BN AT THE END OF 1987.

4. THE RESUMPTION OF THE DEPRECIATION OF THE PESO HAS BEEN CRITICISED BY THE LABOUR SECTOR, WHO CLAIM THAT UT WILL INTRODUCE INFLATIONARY PRESSURES AND IS A VIOLATION OF THE PRINCIPLES OF THE ECONOMIC SOLIDARITY PACT (PSE).

GOVERNMENT SPENDING
5. THE GOVERNMENT ISSUED A CIRCULAR ON 1 FEBRUARY INSTRUCTING ALL DEPARTMENTS TO CUT THEIR PERSONNEL BY 10 PERCENT AND THEIR USE OF

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OFFICE SUPPLIES BY 30 PERCENT. SINGLED OUT FOR CUTS ARE RESEARCHERS AND ADVISERS, AND OVERSEAS REPRESENTATIVES. FURTHERMORE, NO NEW POSITIONS MAY BE CREATED, OVERTIME WILL BE REDUCED AND ENTERTAIMENT ALLOWANCES HAVE BEEN STOPPED.

COMMENT

6. THE RESUMPTION OF THE DEPRECIATION IS AN ATTEMPT BY THE GOVERNMENT TO DEFUSE SOME OF THE PRESSURES THAT ARE EXPECTED IN THE EXCHANGE MARKETS TOWARDS THE END OF FEBRUARY, AS THE SECOND PHASE OF THE PSE (DUE TO ENTER INTO EFFECT ON 1 MARCH) APPROACHES. THERE IS STILL MUCH NERVOUSNESS ABOUT THE GOVERNMENT'S INTENTIONS HOWEVER, WITH RUMOURS OF SHOCK PLANS OR NATIONALISATION OF SAVINGS RIFE, AND THERE WILL BE MANY WHO TRY TO MOVE INTO DOLLARS AT THE END OF FEBRUARY AS A HEDGE AGAINST THIS UNCERTAINTY. THE GOVERNMENT'S ANNOUNCEMENT OF CUTS WILL HELP ITS CREDIBILITY AND FISCAL POSITION, BUT IT IS THE RESULTS AGAINST INFLATION WHICH REALLY COUNT.

MORGAN

YYYY

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MONETARY MCAD

NNNN

CONFIDENTIAL

FROM: N J KROLL

DATE: 5 February 1988

1. MISS ~~NOBLE~~

2. ECONOMIC SECRETARY

cc PS/Chancellor
Sir P Middleton
Sir G Littler
Mr H P Evans
Mr Mountfield
Mrs Case
Mrs Lomax (OR)
Mr Walsh
Mr Bush

MEXICAN DEBT BUY-BACK SCHEME - IMPLICATIONS FOR BANK PROVISIONING

You may have seen reports in the newspapers today (copies at annex A) about the position which the Bank of England have taken, and indicated to the clearing banks, on the implications of the Mexican debt buy-back scheme for provisioning. Under the scheme Mexico is inviting bank creditors to exchange by auction rescheduled debt for higher-yielding bonds whose principal, but not interest, is backed by US government securities.

2. Clearly the level of provisioning required by the supervisory authorities in connection with the scheme is an important factor for banks in deciding whether to participate in it. At a meeting of the Clearing Bank Sovereign Risk Committee (CBSRC) on 4 February the Bank of England explained their position on provisions.

Bank of England position

3. The Bank did not table a paper for their meeting with the CBSRC. But their speaking note is attached (annex B).

4. There are four main elements to the position which the Bank have taken:-

a. **risk treatment** - the bonds are to be regarded as Mexican risk. This reflects the fact that interest payments are not collateralised, and that the US government securities providing collateral for the principal will remain under Mexico's direct control (ie Mexico remains as obligor; the US is not guarantor);

b. **bonds held for trading purposes** - these are to be valued by reference to the level at which they are traded in the market. This is the conventional valuation approach for marketable bonds;

c. **bonds held for long-term investment** - provisions are to be assessed "by reference to the Bank of England matrix". However, in recognition of the probable high discount involved in converting existing bank debt into the new bonds, the Bank has indicated to the CBSRC that it is "not likely to look for provisions to be made against the new bonds in the immediate future". The Bank have explained to us that they will not require provisions against bonds in the foreseeable future, but that they considered it essential to refer to the matrix in their discussions with the CBSRC so as to forestall claims for automatic exemption from provisioning against all collateralised exposures in future;

d. **residual debt** - provisions against debt which is not exchanged for bonds will continue to be assessed by reference to the matrix, and not by reference to discount suffered on the debt exchanged.

Discussion

5. The practical effect of the Bank of England's decision is that, although the new bonds will be classified as Mexican risk, no provisioning against them will be required for the foreseeable future. This will serve to allay the concern of banks interested in bidding for the bonds that they could face a double penalty of accepting a discount against the value of the debt exchanged (over and above existing levels of provisioning) and having to make new provisions for the new bonds according to the Bank's matrix. The Bank's decision that residual debt should continue to be provisioned by reference to the matrix is also important: the alternative of discounting its value to the value of the bonds could have required further substantial provisioning.

6. The competitive position of the UK banks, and the likely success of the scheme as a whole, will be affected by the position taken by the other supervisory authorities. None has yet offered as clear a statement as the Bank of England. It emerged at a recent meeting of the Cooke committee that the Bank's European G10 partners had not yet considered the issues fully. The US and Canadian authorities appear to be taking a position broadly similar to the Bank's. One difference is that the US authorities have not stated explicitly that the bonds are or are not to be regarded as Mexican risk, although the practical effect of this as against the Bank's position may not be significant. Another is that US banks must increase provisions against debt unsuccessfully tendered for bonds to reflect the discount on the successfully tendered bonds: the discount will not affect the value of debt not tendered, for which existing current practice on provisioning continues. The Ministry of Finance in Japan will reportedly not require Japanese banks to discount the balance of their Mexican loans to the expected lower value of the bonds. This is in line with the Bank's position.

Conclusion

7. It will now be for the UK banks, in the light of the clarification provided by the Bank together with other considerations, to decide whether to participate in the scheme. Bidding is scheduled for 19 February but may be delayed until 26 February.

NJKroll

N J KROLL

5/4

ANNEX A

FINANCIAL TIMES

5th February 1988

cc Mrs Lennox
Miss Noble
Mr Kroll
NJKroll
5/2

UK compromises on Mexican loan swap

BY ALEXANDER NICOLL, EUROMARKETS EDITOR

THE BANK of England has adopted a compromise position which should at least not deter British banks from participating in Mexico's bond-for-loan offer, which reaches a key point today.

Mexico's creditor banks have been asked to provide by today a waiver of existing loan clauses. If banks holding more than 50 per cent of each public sector loan do so, the country will be able to proceed with an auction on February 19. It is offering up to $10bn of bonds in exchange for existing loans, to be tendered at a discount to face value.

Banks are expected to provide the waiver. Not to do so would be seen as a snub to attempts to find new ways of chipping away at debt servicing burdens.

Provision of the waiver will carry no obligation to participate in the auction. The amount and pricing of debt likely to be tendered remains very uncertain, with most UK banks likely to put in only token bids, if any.

British bankers were told yesterday by the Bank of England that the new bonds will be treated as Mexican risk as to both principal and interest even though principal repayment on the 20-year securities will be collateralised by a special issue of nonmarketable US government securities to Mexico.

Despite this, banks holding the bonds as long-term investments will not be expected in the immediate future to make new loss provisions if they hold the bonds. Banks receiving the bonds would have to take a loss larger than their existing provisions – which are probably about 18 per cent for Mexico. The Bank is understood to feel that it would be unfair to make them take a further hit on the new holdings.

The Bank's decision contrasts with that of the US authorities which regard the Mexican bonds as US risk. However, the Bank has adopted a more accommodative position than the US on the valuation of loans not exchanged.

Influencing the Bank's decision on the new bonds was the expectation that they are expected to fall to a discount to face value in the market because interest payments remain Mexican risk.

Mexican bonds

The Bank of England's guidance on bad debt provisions by UK banks participating in Mexico's proposed debt exchange offer is a sensible compromise, even though it may be regarded by the more conservative bankers as a further sign that the Bank is softening its approach to the Third World debt problem. The Bank could have killed any hope of British bank involvement by insisting that, if banks did participate in the Mexican offer, they should revalue the rest of their Mexican portfolio to reflect the discount of, say, 50 per cent on the assets swapped for the new bonds. The Bank has taken a softer line than the US authorities in this respect, but it has refused to accept that the bonds, which have an effective US Treasury guarantee, should be considered as a US risk. This is likely to limit their attractiveness to UK banks, but the Bank insists that since the bonds are expected to trade at a discount and the interest is not collateralised, they are for all intents and purposes a Mexican risk.

While the Bank's guidance will have cleared the air, it is unlikely, on balance, to have encouraged major UK banks to take part in the Mexican offer. Nevertheless, it is important that UK banks support the waiver of the existing loan clauses – due today – which will allow the Mexicans to proceed with their bond auction, even if they do not like the conditions on offer. The initiative provides a useful exit vehicle for the smaller banks, and this should help the bigger banks deal more speedily with Mexico's financial problems.

J/L

TIMES
5th February 1988

cc Mrs Lomax
Miss Noble
Mr [illegible]
MKW
5/2

Guidelines stay for Mexico debt

By David Smith, Economics Correspondent

Mexico's decision to offer US-backed bonds in exchange for existing loans will not lead to any change in the treatment of this debt for provisioning purposes, the Bank of England told the clearing banks yesterday.

At a meeting with bank representatives, Bank officials said the new bonds should be regarded as "Mexican risk". As a result, banks should apply the Bank of England's existing matrix guidelines on debt provisions to the bonds.

The Mexican authorities are planning to offer up to $20 billion (£11.3 billion) of bonds backed by US Treasury bonds, but indications are that the biggest lenders to Mexico will not take up the offer.

Mr Robin Leigh-Pemberton, the Governor of the Bank of England, is due to meet officials from the Mexican finance ministry next week to discuss the programme. The Bank of England's proposed treatment of the bonds is similar to that in other leading countries, except the US.

Senior bankers in London said the bonds were unlikely to appeal to banks with substantial Mexican debt, but they could appeal to smaller lenders seeking to extract themselves from Mexican debt. The British clearing banks are unlikely to exchange their loans for the new bonds.

ANNEX B

Speaking Note.

IMPLICATIONS FOR PROVISIONS OF THE MEXICAN DEBT/BOND CONVERSION SCHEME

1 The bonds to be issued by the Mexican Government are in the Bank of England's view to be regarded as Mexican risk. Their valuation will depend on whether they are held
(i) for trading purposes or (ii) for the long term or until maturity.

2 Bonds that are held for trading purposes should be marked to market.

3 Bonds that are held as a long term investment should in principle be treated no differently from other claims on Mexico. The level of provisions required against them should be assessed by reference to the Bank of England's Matrix. However, in the Bank's view some allowance should be made for the level of discount likely to be required for a successful tender of debt for the bonds. The Bank is not likely to look for provisions to be made against the new bonds in the immediate future.

4 The adequacy of provisions against Mexican debt that is not exchanged for bonds (whether tendered or not) will continue to be assessed by reference to the Matrix.

CONFIDENTIAL

FROM: P D P BARNES
DATE: 8 February 1988

MR SPENCE - IR

cc PS/Chancellor
Sir P Middleton
Sir G Littler
Mr H P Evans
Mr Mountfield
Mrs Lomax
Mr Case
Miss Noble
Mr Bush
Mr Kroll

Mr Painter - IR
Mr McGivern - IR
PS/IR

MEXICAN DEBT BUY BACK SCHEME - IMPLICATIONS FOR BANK PROVISION

Mr Kroll has kindly produced the attached note (not copied to Treasury recipients) on the implications for bank provisioning of the Mexican debt buy back scheme.

2. You kindly said that you would provide a note on the tax consequences of this.

PB.

P D P BARNES
Private Secretary

FROM: VIVIEN LIFE
DATE: 9 February 1988

1. MR PICKFORD

2. PARLIAMENTARY SECTION

CC: PS/Chancellor
PS/Paymaster General
Mr Evans
Mr Mountfield
Mrs Lomax
Mrs Case
Miss Noble
Mr Halligan
Mr Kroll
Mrs Lester

TEACH-IN ON INTERNATIONAL DEBT

1. The Paymaster General's Private Secretary's minute of 8 February asked for up-to-date information on the Mexico debt buy-back scheme and on the Bank of England's guidance on provisioning both in relation to the scheme and more generally.

2. I attach* two recent minutes on the scheme itself and on the Bank of England's meeting with the commercial banks at which they explained their position on provisioning.

3. On the scheme itself the latest position is that the 50% of commercial banks needed have agreed to give the waiver in relation to their rights to encumbered assets. However, some banks have attached conditions to their waivers so it is not yet clear that the scheme can go forward. We will report any further developments tomorrow.

4. On provisioning generally, the Governor of the Bank of England's recent speech (copy of extract attached*) is relevant. He explains that the Bank now provide an analytical basis for provisioning decisions in the form of a matrix and warned against provisioning which has no such sound analytical base. There is a risk of this being misinterpreted to imply that current levels of provisioning are sufficient. But the statement was in fact against "competitive" provisioning (ie banks with high reserves and relatively low amounts of third world debt raising their provisions to levels which they know their competitors will have

* top copy & PMG copy only

difficulty in matching and which is reflected in share prices. The statement implies only that provisions should reflect the underlying risks of the debt concerned, and does not rule out higher than present provisions where these are justified. If the Paymaster general would like to discuss provisioning in more detail, Miss Noble or Mr Kroll from FIM should be invited to the meeting.

5. A further aspect is whether provisions can be set against profits for tax purposes. Inland Revenue decisions are based on whether debts will <u>ever</u> be recovered, while the Bank of England's matrix is devised for prudential and supervisory purposes. They therefore apply a discount of about 5-7 percent to the figures produced by the Bank's matrix.

6. I assume the Paymaster General already has a copy of the subject brief on debt from last month's first orders.

Vivien Life

VIVIEN LIFE

CONFIDENTIAL

Inland Revenue

Policy Division
Somerset House

From: I R SPENCE
Date: 15 February 1988

ECONOMIC SECRETARY

MEXICAN DEBT BUY-BACK SCHEME - TAX CONSEQUENCES

1. You asked for a note on the tax consequences of this scheme, as a rider to Mr Kroll's 5 February note on the implications for bank provisioning.

SUMMARY

2. The short point is that we think the tax consequences should, in essentials, be straightforward and uncontroversial. Our conclusion, shared with the Bank (who discussed the tax implications with us before they issued their 4 February statement) is that:

a. the tax treatment should fit comfortably with the Bank's stance on provisioning implications etc;

so

b. banks considering participation in the scheme should have a pretty clear idea of the tax consequences - and are unlikely to complain overmuch about them; and

c. banks' decisions on whether or not to participate will not be tax-driven (or tax-inhibited);

---

cc PS/Chancellor
Financial Secretary
Sir P Middleton
Sir G Littler
Mr H P Evans
Mr Mountfield
Mrs Lomax
Mr Case
Miss Noble
Mr Bush
Mr Kroll
Mr Mallet (B of E)

Chairman
Mr Painter
Mr McGivern
Mr Spence
Mr Skinner
Mr Templeman
Mr Bolton
Mr Keenay
PS/IR

3. Exchequer costs. The cost of tax relief for provisions on existing (ie unconverted) debt will be unchanged. If UK banks participated in the scheme on a large scale, there would be a considerable Exchequer cost (though much of the reduction in Exchequer receipts would be deferred from 1989/90 - the first year - because a number of banks would have no taxable profits to absorb the extra relief). But the indications are that UK banks will not show much interest in the scheme. So the effect of this scheme on Exchequer receipts is unlikely to be significant.

DETAIL

4. Background - application of the Bank's matrix for tax purposes. As you will be aware, we are now taking the Bank's matrix as the base-point for tax relief for banks provisions for sovereign debt. But we are applying a discount to the matrix provision figures for tax purposes. This reflects the fact that the tax test for deductibility (the extent to which the debt is irrecoverable) is tighter than the supervisory/ prudential criteria on which the Bank's matrix is based. (The reasons for this are set out in Mr McGivern's 31 July 1987 note to the Chancellor - paragraphs 7 to 14).

5. The current provisions on Mexican sovereign debt. The Bank's matrix produces a provisioning range of 16% - 25%, with a 19% provision as the direct read-across from the scoring system. Applying our discount for tax purposes, the tax deductible provision will normally be about 16%.

Implications of the buy-back scheme

6. Tax position where banks do not participate in the buy-back scheme. The position will be unchanged - ie the same as in paragraph 4 above. The Bank are taking the line that provisions against debt which is not exchanged for bonds will continue to be assessed by reference to the matrix for

prudential purposes (ie without reference to the value of the bonds). So we should be able to maintain the status quo for tax if (and it seems unlikely) banks make increased provisions and claim bigger tax deductions.

7. Tax consequences of a bank taking up the new bond. Assume (and this is just an illustrative guess) that the auction price of the bonds is 65% of the nominal value of the existing Mexican debt. For tax purposes, we will treat this as the crystallisation of a loss (which is indeed the commercial reality). The bank will therefore get relief for the difference between the nominal value of the new bond (taken as 65) and the nominal value of the original debt (100) less the tax deduction already given (16) for the provision against that 100 debt. So the conversion would give rise to additional tax relief on 19% (84 - 65) of the nominal value of existing debt. The tax relief on that 19% represents, of course, the additional Exchequer cost from a bank's participation in the Mexican buy-back scheme.

8. If the bank holds the bond as a long-term debt, the tax treatment will, again, fit in with the line the Bank are taking. We would regard the bonds as "capital certain" (because the principal is backed by US Government securities). So we would resist any claims for further provision. But the point is likely to be academic. The Bank are taking the line that, while the matrix will apply to the bonds in principal, they are not looking for provisions to be made against the new bonds in the foreseeable future. This reflects the Bank's view that the bonds can reasonably be regarded as capital certain.

Possible complications

9. There are two areas of potential difficulty. We do not expect either of them to be much of a problem in practice on this Mexican buy-back scheme. But they are worth a mention. Both problems stem from the fact - explained in Mr Kroll's note

- that the bonds are expected to trade at a discount from their auction price.

10. The amount of the bank's loss on conversion. As explained in paragraph 7 above, if a bank's bid (accepted) for the bonds is at an auction price of 65% of the nominal value of the original debt, this will be the base figure for computing the banks loss for tax purposes. However, it is conceivable that a bank might recognise a loss in its end-year accounts down to the "market value" of the bonds - ie taking the discounted value at which the bonds were being traded. If a bank claimed this additional loss for tax purposes, we would resist it. But the legal position is uncertain, and we are checking it out as a contingency exercise. However, it seems unlikely that in practice any bank converting into Mexican buy-back bonds will in fact mark them down to the level at which they are traded in the market.

11. Bonds held for trading purposes. As Mr Kroll says in his minute, if the bank transfers the bonds to its trading portfolio with a view to disposing them as soon as possible, the Bank would expect them to value them at the level at which they are traded in the market. Whether a bank would get this value accepted for tax purposes (or only be allowed the bonds at cost value) depends on whether the bonds are held as dealing stock (market value allowed) or not. This is a knotty area. If the issue arises, it will have to be settled on a case by case basis. However, we doubt whether it will be much of a problem on this particular exercise, because it seems unlikely that the bonds will be transferred to banks' trading portfolios to a significant extent.

CONCLUSIONS

12. At this stage - and of course it has to be a preliminary view - it looks as if tax issues are unlikely to be much of a problem on the Mexican buy-back exercise. The Bank's stance

on how banks should deal with the provisioning consequentials of the scheme seems to match with some straightforward - and we hope uncontroversial - tax results.

13. The Exchequer cost of the scheme is potentially considerable - ie if there is a substantial take up of the bonds (though we do not at present have figures to quantify the potential loss and some of the impact on Exchequer receipts would in any event be deferred - paragraph 3 above). On present expectations the take up (and hence the tax loss) will be low from this particular exercise. But future variations on the theme could be more attractive, and more costly to the Exchequer (though, again, the impact on Exchequer receipts would depend on the level of bank profitability at the time).

14. Future variations on the buy-back theme may also produce more difficult tax issues and/or a less comfortable fit between the Bank's stance and the tax consequences. But the experience on this first run on a buy-back issue is encouraging.

15. One final, more general point. Our experience of applying the matrix for tax purposes is limited, and the real tests are yet to come. However, on our experience so far - and this Mexican debt issue is now part of the experience - the matrix does seem to be proving a robust and effective framework for dealing with the tax issues on provisioning.

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