PO-CH/NL/0460 PT B

Part. B.

CONFIDENTIAL

(Circulate under cover and notify REGISTRY of movement)

Begins: 8/11/88.
Ends: 19/4/89.

THIS FOLDER HAS BEEN REGISTERED ON THE REGISTRY SYSTEM

PO CH/NL/0460.
Pt. B.

Chancellor's (Lawson) Papers:
Debt Relief In South America and the Caribbean.

DD's: 25 Years

[signature]
9/2/96.

PO CH/NL/0460. Pt. B.

aef.tp/mountfield/min/175

FROM: P MOUNTFIELD
DATE: 8 NOVEMBER 1988

CHANCELLOR OF THE EXCHEQUER

cc: Chief Secretary
Economic Secretary
Sir P Middleton
Sir G Littler
Mr Lankester
Mr Evans
Mr Bottrill
Mrs Thomson
Mr Call

Ch/ Agree with proposed line (para 10?) + draft letter to Perez de Cuellar?

9/11

yes

BOLIVIAN DEBT

Should the new Toronto terms be extended to Bolivia? What line should the UK take at next week's Paris Club meeting?

Background

2. Following the final agreement at Berlin, we have now successfully applied the Toronto terms to two African countries - Mali and Madagascar. Several more are in the pipeline, including Uganda and Tanzania from the Commonwealth.

3. The Paris Club has studiously avoided defining too closely the criteria of eligibility. They have been provided with an "illustrative list" which is limited to Africa. But the four tests which the Club will apply are not quantified. They are, of course: a heavy level of debt; extreme poverty; conformity with an IMF programme; and a determined but unsuccessful attempt to meet its debt service obligations.

4. At last month's meeting, there was an attempt to clarify the question of geographical coverage. Spain (looking to its

Latin American constituency) made a determined effort to draft the terms of reference wide enough to include Bolivia. Belgium, Sweden and Netherlands agreed. The United States, with strong support from Japan, made an equally determined attempt to keep her out. The Chairman produced a compromise formula which leaves the issue unresolved. It cannot stay that way much longer.

Inclusion of Bolivia?

5. On any objective criterion, Bolivia would not qualify for inclusion. It is heavily indebted (debt service ratio before rescheduling, about 70% in 1988), but according to the IMF its financing gap for 1988 and 1989 can be closed without exceptional treatment. It is fairly poor (GDP per capital about $570) and eligible for IDA - only status; but above the $470 point which is the qualification for the World Bank's African programme. It does have a current IMF adjustment programme in place and has a good adjustment record; and it has never tried to shirk its debt service obligations and has managed to meet its post-rescheduling payment requirements. And even the Spanish could not persuade us that it was in Africa.

6. UK exposure is very small - to the point where, under the "de minimis" rule, we shall probably not be a signatory of next week's agreement. Our exposure is only $80 million, of which $75 million is previously rescheduled debt. But, as observers (and because of our authorship of the Toronto scheme) we shall be asked what we think. Last time, I said I was without ministerial instructions. This time, we shall have to show my hand.

Present demand

7. The Bolivian demand goes well beyond even Toronto terms: for example, they want 40-year terms for old aid loans, 25 year terms for all commercial credits, and a highly-concessional rate of interest of 1%. These terms are set out in a memorandum presented to all creditors (banks as well as governments) last month; and reinforced when the Bolivian Ambassador came to see me last week. There will be no difficulty about rejecting the more exotic

elements of this package, which are a "try-on". But the question of Toronto terms is a live one.

8. We discussed this briefly at the Paris Club last month. The United States is very anxious not to risk contagion spreading to Latin America. So is Japan. FRG and Canada also oppose the inclusion of Bolivia.

9. Our interest is different. We have always seen the "debt distress" problem as largely confined to Africa, but have recognised that there might be one or two small exceptions. In practice, Bolivia is one of the two significant border-line cases. The other is Guyana (GNP per head $380), but a Commonwealth country, with the Ramphal factor an added complication. UK is a very small creditor. If Bolivia got Toronto terms, we should have to extend them to Guyana when it finally settled with the IMF. Of the rest, Bangladesh is not heavily-indebted; and Burma is not in favour at the IMF at present. Within Africa, the main problems are Egypt and Nigeria. Egypt, with GNP per capita of about $690, wouldnot qualify on present tests. Nigeria probably would (GNP per capita now $370); and a separate decision on Toronto terms for Nigeria will be needed eventually (probably not in 1988). Mr Lankester is making a separate submission about the whole Nigerian problem in the next few days. Neither case is decisive in deciding what to do about Bolivia.

Recommendation

10. It does not matter much to us whether Bolivia qualifies. On balance, I would prefer to get the Toronto scheme settled down in Africa before contemplating its extension. The American and Japanese vetoes are likely to be decisive. The best solution, for us, would be to let others make a running, and to shelter behind the refusal of the Americans and Japanese to extend Toronto terms. If we are forced to show our hand, I propose we say that Bolivia does not appear to need this exceptional relief; and is rather less poor than most of the countries for whom the scheme was originally designed. If pressed further, or if others are disposed to vary the criteria, we would say that we want to get

the Toronto scheme off to a good start in Africa, the original beneficiaries, before considering its extension. We would not close the door to any subsequent extension, but equally we would say that, in our view, it would be premature to include Bolivia.

attached.

11. There is also a letter from the Secretary-General of the United Nations, still requiring a reply, which urges all donor/creditors to be generous. Similar letters have gone to most creditors. The Paris Club agreed that we should all reply in fairly non-committal terms. The FCO has produced the attached draft reply for the Foreign Secretary to send. I recommend we agree, so that the letter can be despatched before the meeting.

12. I have discussed this with ECGD and with FCO, who are content. May I proceed on these lines, please?

PM

P MOUNTFIELD

DSR 11 (Revised Sept 85)

DRAFT: minute/letter/teleletter/despatch/note	TYPE: Draft/Final 1 +
FROM: Secretary of State DEPARTMENT: TEL. NO: BUILDING: ROOM NO:	Reference SS1AHH Your Reference

SECURITY CLASSIFICATION

Top Secret
Secret
Confidential
Restricted
Unclassified

PRIVACY MARKING

.... In Confidence

CAVEAT ....

TO:

The Secretary General

The United Nations

Copies to:

SUBJECT:

Thank you for your letter of 13 October about Bolivia's request for rescheduling in the Paris Club. I believe Bolivia is now due to be considered at the Club's next meeting on 14 November. I appreciate Bolivia's serious economic difficulties, and share your admiration for the tenacity and vigour with which Bolivia has approached the task of economic reform. Britain's aid programme to Bolivia is our largest in Latin America. We are currently making available programme aid which will assist with purchasing essential imports; the counterpart funds are earmarked for Emergency Social Fund. I am sure that Paris Club creditors will take full account of Bolivia's difficulties and her good adjustment record in determining the terms of any new rescheduling.

However, whether Bolivia will benefit from a new concession agreed following the Toronto summit is a decision for creditors collectively. Since the scheme is so newly established, creditors will not

Enclosures flag(s) ....

SECURITY CLASSIFICATION

Top Secret

Secret

Confidential

Restricted

Unclassified

PRIVACY MARKING

....

In Confidence

have an opportunity to reach a decision in advance of the meeting. In considering Bolivia's request, creditors will take into account their assessment of Bolivia's financing needs as well as the agreed criteria of poverty, indebtedness, and pursuit of an internationally agreed reform programme. A critical question will be the interpretation of the income criterion; while Bolivia is very poor compared with other Latin American countries, it has a considerably higher GNP per capita than the African countries for which the Toronto concessions were initially designed.

aef2.cj/typing/minute/bolivia

CONFIDENTIAL

FROM: P MOUNTFIELD
DATE: 16 November 1988

CHANCELLOR

cc Chief Secretary
Economic Secretary
Sir P Middleton
Sir G Littler
Mr Lankester
Mr Evans
Mr Bottrill
Mrs Thomson
Mr Call

BOLIVIAN DEBT

The Paris Club reached an agreement with Bolivia on Monday, well within the limits you had approved (my note of 9 November, and Mr Taylor's reply of 11 November). I attach the reporting telegram.

2. The United States made no attempt to press for "Toronto terms" for Bolivia; Spain was happily below the "de minimis" level, and could not speak; the rest of us agreed to confine Toronto terms to Africa for the time being.

3. There is one great unspoken problem behind all this: drugs. Bolivia's balance of payments is probably a lot stronger than the official figures record, as a result of the drugs traffic. (On the other hand, none of this goes to benefit the official reserves, or do much to alleviate the poverty of the bulk of the population). Ironically, the enormous increase in Bolivian coca production is, in part, the result of the adjustment programme vigorously pursued by the present government. They managed to get inflation down from 25,000 per cent (this is not a mis-type) to its present single figures. In the process they closed down many of the loss-making state-owned mining enterprises. The workforce simply moved downhill into the valleys and grew coca instead. One of the less-desirable side effects of the debt policy, I fear.

PM

P MOUNTFIELD

146730
MDHIAN 1697

CONFIDENTIAL
FM PARIS
TO IMMEDIATE FCO
TELNO 1128
OF 151652Z NOVEMBER 88
INFO IMMEDIATE LA PAZ
INFO ROUTINE UKDEL IMF/IBRD WASHINGTON, UKMIS NEW YORK

FROM MOUNTFIELD
PARIS CLUB: BOLIVIA

1. BOLIVIAN OFFICIAL DEBT RESCHEDULED ON CONVENTIONAL BASIS WITHOUT EXTENSION OF TORONTO TERMS.

DETAIL

2. 100 PER CENT OF ALL BOLIVIAN PUBLIC SECTOR DEBT FALLING DUE TO OFFICIAL CREDITORS IN PERIOD UP TO 31 DECEMBER 1989 (INCLUDING ARREARS AS AT 30 SEPTEMBER 1988) BOTH NEW MATURITIES AND PREVIOUSLY-RESCHEDULED DEBT, WILL BE RESCHEDULED OVER 10 YEARS, INCLUDING SIX YEARS' GRACE. COMMERCIAL DEBT CARRIES MARKET RATES OF INTEREST: OLD AID LOANS CONTINUE TO CARRY PREVIOUS CONCESSIONAL RATES. PAYMENT WILL BE MADE BETWEEN 15 NOVEMBER 1995 AND 15 MAY 1999. LAST THREE MONTHS OF CONSOLIDATION PERIOD, IE OCTOBER - DECEMBER 1989, WILL ONLY BE RESCHEDULED IF BOLIVIA MEETS PERFORMANCE BENCHMARKS UNDER ESAF AT SEPTEMBER 1989. A GOODWILL CLAUSE PROMISES A REPEAT OPERATION AFTER 1989 PROVIDED BOLIVIA HAS AN ESAF OR SBA AT THE TIME.

COMMENT

3. THIS AGREEMENT WAS CONSIDERABLY LESS GENEROUS THAN ORIGINAL BOLIVIAN DEMAND, WHICH APPLIED TO ALL DEBT FALLING DUE DURING PERIOD OF ESAF (IE UP TO JULY 1991) AND SOUGHT 40 YEARS FOR OLD AID LOANS AND 25 YEARS FOR OLD COMMERCIAL LOANS, BOTH AT CONCESSIONAL RATES OF INTEREST. HOWEVER, PARIS CLUB WAS UNANIMOUS IN REJECTING THESE QUOTE EXOTIC UNQUOTE TERMS, AND ALMOST UNANIMOUS (SPAIN IN A MINORITY) IN WISHING TO CONFINE TORONTO TERMS TO AFRICAN COUNTRIES, DESPITE ELOQUENT APPEAL FROM MISS ANSTEE (UN). CONTRARY TO PREVIOUS REPORTS (LA PAZ TEL EISER 74) USA WAS FAIRLY HAWKISH AND DID NOT ATTEMPT TO ARGUE FOR MORE GENEROUS DEAL. FINAL AGREEMENT, AFTER MINOR HAGGLING, IS SLIGHTLY MORE THAN WAS STRICTLY NECESSARY TO BRIDGE FINANCING GAP SHOWN IN IMF BOARD PAPER EBS/88/173. ARGENTINA AND BRAZIL, BOLIVIA'S LARGEST CREDITORS, DECLINED INVITATIONS TO ATTEND, BUT BOLIVIA IS BOUND BY THIS AGREEMENT TO SEEK FROM THEM

TERMS AT LEAST AS GENEROUS AS THESE.

4. ROMERO, MINISTER FOR PLANNING, LEADER OF BOLIVIAN DELEGATION, SAID THE DEAL WOULD RESOLVE BOLIVIA'S IMMEDIATE CASH-FLOW PROBLEM, BUT REGRETTED PARIS CLUB'S RELUCTANCE TO ADOPT HIS LONGER-TERM PROPOSALS.

5. SECRETARIAT ISSUED SHORT PRESS STATEMENT AFTERWARDS CONTAINING NO DETAILS APART FROM REPAYMENT DATES.

6. TEXTS FOLLOW BY BAG FROM FCO TO LA PAZ.

FERGUSSON

YYYY

DISTRIBUTION 129

MAIN 128

.MONETARY
ERD [-]

SAMD

ADDITIONAL 1

MR WICKS NO 10 DOWNING ST

NNNN

dti

the department for Enterprise

229/12
214/12

The Rt. Hon. Lord Young of Graffham
Secretary of State for Trade and Industry

Jonathan Taylor Esq
Private Secretary to the
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1P 3AG

CH/EXCHEQUER
REC. -6 DEC 1988 ✓ 6/12
ACTION FST
COPIES TO

Department of Trade and Industry

1-19 Victoria Street
London SW1H 0ET

Switchboard
01-215 7877

Telex 8811074/5 DTHQ G
Fax 01-222 2629

Direct line 215 5423
Our ref PS1BWE
Your ref
Date 5 December 1988

Dear Jonathan,

I took a call from Tristan Garel-Jones MP this morning. He has recently visited Mexico where, apparently, the new Minister for Communications and Transport - Andres Caso Lombardo - had recently taken office.

The British Ambassador in Mexico City had told Mr Garel-Jones that this particular Minister was probably the most important member of the Government and that several British contracts were dependant upon his signature.

Mr Garel-Jones told me that the Mexican Government was just about to embark on a privatisation programme starting with their telecommunications industry. The Mexican Government, and Mr Lombardo in particular, would appreciate advice on:-

the golden share and how it operates;

other devices to control foreign participation;

any other assistance that HMG could provide given our experience of privatisations.

Mr Garel-Jones is also in contact with the Foreign Secretary's Office on his visit in general and has asked that we provide "a few sheets of paper" on the privatisation points above for Mr Lombardo, via the Foreign Office, headed something along the lines of "Specially prepared at the request of HMA, Mexico City" as soon as possible. Given the general nature of this request, I think that it is more a matter for HM Treasury to take on. Mr Garel-Jones would appreciate a prompt reaction and, of course, a copy of anything we send to Mexico sent to him in the Whip's Office.

I am copying this letter to Lyn Parker in the Foreign Secretary's office and to Anna Walker here who may have some comments to input to Treasury officials who will be taking this on; could you please let me know who this will be?

Yours Sincerely,

Gareth Jones

GARETH JONES
Private Secretary

Jan.m.6 cc as before

CONFIDENTIAL

Mr Lankester

I strongly agree with your para 6. If there is to be any "political" approach to the Brazilians, it should come from the US – as their "best friend" among the industrialised countries.

N.C.U. 17.1

From: T P Lankester
Date: 17 JANUARY 1989

I agree with Mr Evans.

MR MOUNTFIELD

cc
Mr Wicks
Mr J Taylor
Mr Evans
Mr Bottrill

BRAZIL

Anthony Loehnis telephoned this morning to say that the Advisory Committee for Brazil has now met to consider their response to the new Brazilian package, which includes proposals to suspend the debt equity programme and the free lending facility under the 1988 Rescheduling Agreement. The Brazilians want to suspend both of these in order to help curb domestic monetary expansion.

2. The Advisory Committee have reluctantly gone along with these proposals at least for the time being.

3. But they have also heard the Brazilians propose not to pay the $500 million due to the banks today on the grounds that payment would make the overall package more difficult for the Brazilian people to stomach the measures that Sarney and Nobrega have introduced.

4. The Advisory Committee, not surprisingly, are very unhappy about this and believe that any delay will seriously put back the mending of fences between the Brazilians and the creditors last year. Midland, who sit on the Committee, have told Loehnis that the Committee would very much like governments to make known their displeasure to Nobrega, saying that it would be very much in Brazil's interest, and in the interest of the overall creditor relationship, for Brazil to pay the $500 million today. Loehnis asked if the Chancellor, or failing that, Nigel Wicks or myself, would be prepared to speak to Nobrega.

5. I said he should first find out what the Americans are doing. Loehnis will do this, and then we can take stock.

6. My own hunch is that neither the Chancellor nor Mr Wicks nor myself should get involved. If anyone is to speak to the Brazilians, it should be the Governor even if this means his having to speak to Nobrega (Loehnis says that the Brazilian Central Bank Governor is not worth talking to).

T P LANKESTER

P.S. Loehnis has now come back to say that "things are moving more slowly". The Americans have not yet decided whether to intervene. He will come back to us.

aef2.cj/bottrill/minute/mexico

CONFIDENTIAL

FROM: A R H BOTTRILL
DATE: 20 February 1989

CHANCELLOR

cc Chief Secretary
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Wicks
Mr Lankester
Mr Mountfield
Mr H P Evans
Mr H G Walsh
Mr Kilpatrick
Mrs Thomson
Mr Tarkowski

Ch

Tel. 072 provides an account of the Mexicans' less-than-successful talk with Brady. For a more illuminating report, see the CIA (sic) report in the green folder.
21/2

VISIT OF MEXICAN FINANCE MINISTER

I attach a brief for your meeting with Dr Aspe on Wednesday. It reflects discussions with officials of other Departments. Dr Aspe will be accompanied by Mancera, Director General of the Bank of Mexico. They are to see the Governor of the Bank of England after leaving you. The Mexicans saw the US Treasury Secretary, the IMF Managing Director and the IBRD President in Washington on 6-9 February. They have also visited Paris, and are travelling on to Switzerland.

A Bottrill

A R H BOTTRILL

MEETING WITH DR PEDRO ASPE, MEXICAN FINANCE MINISTER, WEDNESDAY 23 FEBRUARY

Objective

To encourage Mexico to agree a new IMF adjustment programme; warn Dr Aspe against pursuing external financing options which would shift the burden towards official creditors; and suggest both Mexico and its creditors avoid dangerous brinkmanship.

Line to take

a. Glad to see you - grateful for your letter and early notice.

b. Acknowledge substantial efforts already made by Mexico to tackle its economic problems - with generous support from both official and private creditors.

c. Problems remain big. Welcome reduction in inflation achieved in 1988 but concerned at widening in current balance of payments deficit. This has been exacerbated by capital flight - although glad to see this partly reversed in January. Priority must be to keep this capital returning.

d. Key to domestic stabilisation and retaining confidence of creditors is sustained adjustment effort. Need full support of IMF. Glad you are now talking to them.

e. Cannot anticipate UK attitude. Wait for proposals from IMF Managing Director. Exchange rate policy crucial for non-oil balance of payments improvement and avoidance of further capital flight.

f. Fund approval necessary ahead of IBRD policy loans. Concerned at size of World Bank exposure to Mexico. No softening of IBRD conditionality.

g. As you have presented it in your letter, debt is largely a matter for commercial banks which account for 70 per cent of Mexico's external debt.

h. Menu up to banks. We will not apply any pressure but welcome voluntarily negotiated debt reduction. Sorry you have abandoned debt-equity swaps. Not convinced by your reasons.

i. Banks will not respond well to threats eg or moratoria. Nor will governments. Important to avoid brinkmanship.

j. Equally, government cannot accept any solution involving transfer of risk from private to public sector. Official creditors' share of Mexico's debt has doubled from 15 per cent in 1982 to almost 30 per cent in 1988.

k. Paris Club: Question whether a new rescheduling in Mexico's interest. Agencies, including ECGD, currently providing new credit. These put at risk if Paris Club is asked to capitalise interest. Even more so if cut-off date moved. Post cut-off date credits were given on the understanding that they would not be rescheduled. Expect there will also be great reluctance among agencies to a MYRA. In general suggest proposed contribution of IFIs is more than enough to meet official sector's share of burden.

l. Debt strategy : Don't expect major changes to the approach which is likely to remain case by case, with emphasis on strong adjustment policies and market-based solutions for external financing options.

Background

behind.

2. In his letter to you of 17 February Dr Aspe sets out a target growth rate of at least 4½ per cent a year for the Mexican economy and suggests that net transfers should be reduced from 6 per cent of GDP a year to 1½-2 per cent. He argues that banks

should reschedule $12½ billion of repayments becoming due over the period 1989 to 1994; the Paris Club should reschedule principal and part of interest as part of a MYRA, shift the cut-off date from 1985 to 1988, and continue to provide new credits; the World Bank should speed negotiations on $1½ billion of policy loans. In return for such help, Mexico 'does not rule out' entering into an agreement with the IMF. The Mexican authorities appear to be in a hurry to gain concessions from creditors - but it is not clear to what extent this is dictated by their internal political situation or by cash flow worries. The latter are not acute at present but could become more pressing if capital flight recommenced or if negotiations with creditors were prolonged.

Economic developments

3. Mexico's GDP which grew by about 6 per cent a year during the 1970s, has on average shown no further increase since 1982. The combination of this and population growth of about 2½ per cent a year has meant a sizeable fall in real incomes per head. Mexico's adjustment to its first round of debt problems in the period 1982 to 1985 was impressive with the budget deficit cut from 17 per cent of GDP to 9 per cent, the external current deficit lowered from $6 billion to zero and inflation reduced from 100 per cent to below 60 per cent.

4. The steep fall in oil prices in late-1985 and early-1986 however, increased the budget deficit again, returned the current account to deficit and was accompanied by soaring inflation. Mexico's adjustment was less successful although it completed its IMF Standby Arrangement with the help of waivers last April. Pre-electoral considerations ruled out maintenance of the austerity measures in spite of the fact that year-on-year inflation was running at 170 per cent. Instead, the Mexican authorities chose to attempt to control inflation directly by selected price and wage freezes and the maintenance of an artificially high peso exchange rate against the US dollar throughout the rest of 1988. These formed the key elements in their Economic Stabilisation Programme.

5. The programme has been relatively successful in reducing inflation which is now running at about 3 per cent a month but the lack of adequate reinforcement from fiscal measures has transferred the pressures to the external account. No official figures for the current account outturn for 1988 have been published but it seems likely to have shown a deficit of $3-4 billion, reflecting lower oil prices and a surge of at least 40 per cent in imports as a result of liberalisation, speculation and a rise of more than 25 per cent in the real exchange rate. This, combined with periodic bouts of capital flight around the mid-year election and again in the autumn, reduce Mexico's reserves from $12½ billion at end-1987 to about $7 billion at end-1988. A bridge loan of $3½ billion made available by the US in October but was not drawn - possibly because the US set tough conditions.

6. Mexican policies to tackle the situation both domestically and externally are not yet clear. Dr Aspe's 1989 Budget announcement in mid-December is apparently designed to reduce the PSBR to about 6½ per cent of GDP but we do not know to what extent this depends on his success in reducing domestic interest rates and securing concessions on external debt servicing. ESP has been replaced by a Pact for Economic Stabilisation and Growth (PECE) to run until July. This includes a daily devaluation of one peso to the dollar - equivalent to about 1.3 per cent a month. Public sector prices are to be increased, except for sensitive items such as petrol. Increases in private sector prices are also to be allowed to reflect at least partly the rise in costs during 1988. The minimum wage, however, has also been increase by 8 per cent.

7. The measures have been criticised by the opposition domestically as being a continuation of austerity but they are unlikely to cut the current deficit significantly and without further action it may remain around $5 billion in 1989. The Mexicans are reported to be seeking about $7 billion in external financing and have started to approach creditors - namely the IMF, World Bank and the United States. Their tone has apparently been minatory, mirroring Salinas' election threat "If we don't grow, we don't pay".

Relations with the IMF and IBRD

8. The Mexicans are due to repay the Fund approximately $0.9 billion this year and about $3½ billion over the next four years. They are seeking an EFF as part of a four-year programme to reduce Mexico's net repayments to the Fund. Dr Aspe was in Washington earlier this month to talk about a programme with Fund staff. The present inadequate rate of peso depreciation is likely to be an important point with the Fund Staff. Perhaps the Mexicans could be persuaded to increase the daily rate of depreciation. The Fund Staff will presumably also want firm budgetary and monetary framework to allow a return to price liberalisation. An IMF team is currently in Mexico.

9. The Mexicans are also due to repay the IBRD and other multilateral development banks about $1 billion a year and are seeking new loans to secure a net inward transfer. Loans likely to be approved by the IBRD by mid-1989 already total about $1.3 billion, including a fast-disbursing agriculture sector loan ($300 million), and slower disbursing steel ($400 million), fertiliser ($265 million) and housing ($300 million) loans. In addition, Mexico is seeking three $500 million policy sector loans for industry, the finance and trade sector and public enterprises. These latter should in our view not be put to the IBRD Board until Mexico agrees an IMF programme.

10. The overall net contribution of the IFIs could be substantial in 1989 - perhaps as much as $1-1½½ billion from the IMF and the IBRD combined. Mexico's outstanding credit from the Fund, however, stands at 306 per cent of quota and the IBRD's exposure to Mexico is more than 8 per cent of its total portfolio.

Relations with bilateral official creditors

11. The United States is the key here both as the likely organiser of any future bridging operation and because of its heavy bilateral credits - partly through the Commodity Credit Corporation (CCC). The Bush Administration has blown hot and cold

towards Mexico with Baker and Bush apparently concerned to help but Brady taking a tougher line. We have not reached the stage of a multilateral bridging operation to replace the US bridge since Mexico is currently making payments to both Paris Club creditors and commercial banks - but delays in negotiating an IMF programme or a resumption of capital flight could face Mexico with a short-term liquidity crisis later in the year.

12. For the moment, however, the Mexican request appears to be for a multi-year rescheduling in the Paris Club, including at least a portion of interest and involving a shift in the cut-off date from 1985 to 1988. Our first line of defence should be that a Paris Club rescheduling would be counter productive for Mexico since debt to governments is relatively small at $14 billion out of Mexico's total debt of $100 billion. Export credit agencies, including ECGD which has $1.3 billion of exposure, are currently providing new cover which would be suspended if Mexico rescheduled. The Paris Club does not typically do multi-year rescheduling, particularly if interest capitalisation would be equivalent to new money packages over several years. A shift in the cut-off date would be enormously damaging to Mexico's credibility and a most undesirable precedent for other debtors.

13. We shall want to warn the IMF Staff that any assumptions about Paris Club rescheduling should be discussed with creditors <u>in advance</u> of the finalisation of any IMF programme.

14. The Japanese are reported to have discussed a substantial bilateral credit of $1 billion or more but we have no details.

<u>Relations with the London Club</u>

15. Banks hold almost 70 per cent or $70 billion of Mexico's debt, of which about $8 billion is owed to UK-registered banks. About $6 billion of banks' claims are short-term. More than $40 billion of medium-term claims - representing debt falling due between 1982 and 1990 - was rescheduled on extended terms in 1987 allowing Mexico seven years' grace and 20 years to repay. Of the rest, the bulk represents the $15 billion or so of new money

packages agreed by banks in 1983, 1984 and 1987. Mexico is due to repay banks only very small amounts of unrestructured debt this year and next, but the first significant repayments of the new money packages become due - amounting to $0.6 billion in 1989 and $2-2½ billion a year in subsequent years.

16. The problem for banks, therefore, is that they will be faced not only with finding new money to ensure that Mexico has the resources to pay their interest but also with rescheduling the repayments due under the previous new money packages. The Mexicans are asking banks to restructure $12½ billion due between 1989 and 1994. They are apparently offering a menu including new money and/or interest capitalisation; debt reduction or interest reduction; but <u>no</u> debt/equity swaps.

17. We do not yet know the banks' preferences. New money or interest capitalisation will need to form an important part of the package since these are the only options which meet Mexico's cash flow needs. The results of last year's debt reduction when $3.7 billion of debt was swapped by banks at an average discount of about 30 per cent were disappointing. Banks were reluctant to provide discounts greater than the level of their provisions. The fact that the zero coupon US Treasury bonds used as collateral by the Mexicans guaranteed only the principal has made banks seek some form of interest guarantee eg a three-year rolling guarantee from the IBRD. This, however, would need to count against the World Bank's exposure and capital. The extent of any leverage would depend on the discount banks were prepared to accept on account of the interest guarantee. If this widened to 50 per cent (in line with the secondary market price) then $10 billion of net debt reduction could be secured for about $3 billion of additional World Bank exposure (assuming the guarantee was renewed and not called) and a saving of about $1 billion a year in Mexican interest payments. But the experience of the 1988 Mexican scheme was that the net present value of the collateral was reflected in the exchange discount, but no more: there was no additional leverage. We should want to look very carefully at the implications for the allocation of the resource burden of such schemes. For the present, it is perhaps most important to explore the Mexicans' ideas while giving no commitments on any public sector intervention.

aef2.cj/bottrill/minute/brazil.2

CONFIDENTIAL

FROM: A R H BOTTRILL
DATE: 21 March 1989

CHANCELLOR

cc Sir P Middleton
Mr Wicks
Mr Lankester
Mr H P Evans
Mr Mountfield
Mr H G Walsh
Mrs Thomson
Mr Segal

VISIT OF MAILSON DA NOBREGA

I attach a brief for your meeting tomorrow with the Brazilian Finance Minister, Mailson da Nobrega. He will also be seeing the Governor and some of the major clearing banks. The references to the Brady Plan have been drafted ahead of your meeting on International Issues at which this will be discussed.

ABottrill

A R H BOTTRILL

MEETING WITH MAILSON DA NOBREGA, BRAZILIAN FINANCE MINISTER, 22 MARCH, 1989

Objective

To encourage Mailson to agree measures to put Brazil's IMF programme back on track. To dampen expectations on the Brady plan.

Points to make

Brazilian economy

(1) Acknowledge steps in Summer Plan to avert hyper-inflation. But express concern at failure to win necessary congressional support for fiscal tightening.

(2) Congratulate authorities on tighter monetary policy since January. Urge steadfastness. Agree that suspension of indexation is needed to make policy credible but roots of high inflation lie in irresponsible financial policies.

(3) Firm budgetary policies needed also to create the environment for relaxing price freeze which risks causing distortions to the economy.

(4) UK will judge IMF programme on its merits. Important that programme contains credible strategy to see Brazil through difficult election period. Grateful for Mailson's views on election prospects.

(5) [If asked about social strains. Only Brazilian government can judge how much austerity the electorate will stand, but it is often more resilient than expected. Tragic riots in Venezuela seem to have resulted from government's bad handling as much as adjustment measures.]

(6) [If asked about UK's attitude to delay in IBRD Board discussion of the Power Sector II Loan. IBRD Staff have an obligation to satisfy themselves as to whether proposed

construction of a third nuclear power station is the most efficient use of resources.]

(7) [If asked about ECGD cover. Agreement to large medium-term commitments depends on successful conclusion of current bilateral negotiations on debt rescheduling and satisfactory progress with IMF negotiation. Will be concentrated on projects which benefit Brazil's balance of payments ie not defence sales.]

(8) [If environmental issues are raised: Politically important issue for Western electorates but link between debt and environmental issues tenuous.]

Brady Plan

(9) Continued economic adjustment in debtor countries is essential to lay the basis for sound growth. Important to stimulate domestic savings and return of flight capital.

(10) Role of IMF and IBRD in encouraging debtors to adopt sound policies should continue.

(11) Debt reduction largely a matter for debtors and banks to negotiate on basis of broad menu. Share reservations of others about IFI guarantees. Any involvement of IFIs should not involve undue transfer of risk to official creditors. Debt/equity conversions have a useful part to play where they can be accomplished without undermining domestic monetary control.

(12) Paris Club ready to continue to reschedule debts where necessary in support of firm IMF-approved programmes but also concerned that public sector (ie IFIs and Paris Club) should not be asked to increase its share of risk. Paris Club, therefore, unlikely to concede debt reduction.

Economic background

2. Strong export growth and improved terms of trade allowed Brazil to achieve a $19 billion trade surplus in 1988 and an

estimated $4½ billion current surplus. Domestic demand, however, fell and GDP showed no growth. The programme agreed with the IMF in July rapidly went off track as Brazil missed the September fiscal target. Inflation accelerated in the latter months of the year to reach 30 per cent in December - an annual rate of about 1000 per cent.

3. Against this background, President Sarney announced a new heterodox Summer Plan in January. This froze prices at their mid-January level which was itself inflated by a series of hefty public sector price increases in the preceding weeks. Wages were to be de-indexed but the Government subsequently had to concede increases in March, April and May to offset the large price rises around the turn of the year. Inflation fell to a monthly rate of about 3 per cent in February, but the Government now faces the difficult task of relaxing the freeze without unleashing inflation.

4. Its ability to do this will depend on its ability to achieve firm control of monetary and fiscal policy. The de-indexation of many financial assets has been accompanied by high real interest rates. The budgetary measures in the Summer Plan, however, which were designed to reduce the operational (ie inflation-adjusted) deficit to zero in 1989, have been rejected by Congress. In particular, the Government has not been able to press ahead with its plans to close five ministries, sack 60,000 civil servants and speed up privatisation. It will be important to have Mailson's assessment of his chances of achieving budgetary control since this will be a touchstone for the IMF Staff who are currently reviewing Brazil's programme.

5. The balance of payments seems bound to deteriorate during 1989. The decision to fix the dollar/cruzado rate in January will progressively undermine Brazil's competitiveness and pressures for extra spending ahead of the November presidential election are both likely to reduce the trade surplus. Brazilian forecasts put this at $14 billion which would probably imply a swing into current account deficit again.

6. This will put pressure on Brazil to secure its external finance for the rest of the year. External reserves were probably around $5 billion at the end of 1988 and there may have been some modest increase after the Summer Plan was announced to perhaps $6-6½ billion but Mailson has said that if reserves fall too low, Brazil will suspend debt service payments. The key is progress with the IMF negotiations which will unlock both IBRD and commercial bank loans.

Relations with IMF/IBRD

7. We do not know whether the IMF Staff will be able to recommend reactivation of last year's Standby Arrangement. If the current review ends in deadlock then agreement will become more difficult as the election approaches.

8. The IBRD is now set to abandon its Power Sector II Loan for $0.5 billion since World Bank Staff have not been convinced of the economic case for expanding Brazil's nuclear power programme. Instead, the IBRD is contemplating three other loans for energy-environmental policy, electricity transmission and electricity distribution. These would total about $1-1.1 billion of which two thirds might be disbursed this year.

Relations with commercial banks

9. Brazil failed to make a $400 million interest payment to banks on 15 March. It is waiting for disbursement of the second $0.6 billion tranche of the banks' new money package agreed last year. This, however, was tied to the stalled Power Sector Loan. The banks have agreed to tie it to other IBRD loans in the pipeline but are insisting on a letter from the IMF Managing Director saying that Brazil 'is making progress towards achieving to goals established in its economic programme.' Conditionality is stricter for the banks third $0.6 billion disbursement since the Brazilians will have to fulfil the conditions for further IMF drawings to be authorised.

Relations with the Paris Club

10. Governments agreed to reschedule 100 per cent of principal and 70 per cent of interest falling due between August 1988 and March 1990 at the Paris Club last July. The inclusion of interests was exceptionally generous for a middle income debtor of Brazil's standing. ECGD officials are currently in Brasilia negotiating the bilateral details.

ECGD cover

11. ECGD was the first agency to resume medium-term cover once the IMF programme became effective, but Brazil's failure to adhere to the Fund programme has led ECGD not to give firm commitments for contracts of more than £5 million. Ministers have just agreed not to provide cover for a defence export to Brazil. (NB: The Brazilians are unaware of this). We shall review the situation once the bilateral is signed but full cover is unlikely to be resumed until the IMF programme is back on track. ECGD has exposure of some £1.2 billion.

Brady Plan

12. Mailson has been in Europe for the IADB meeting where the Brady Plan has been much discussed - although most participants like ourselves are awaiting details. Our objective at this stage is to encourage debtors to persevere with economic reforms, discourage exaggerated expectations of large scale IFI involvement in debt reduction schemes, which would shift the burden unduly to the public sector, and stress that the main negotiations must be between debtor countries and commercial banks.

13. The Brady Plan encourages debt/equity swaps, but the Brazilians like the Mexicans have been concerned about the monetary implications and have suspended swaps. We believe that where public sector assets are being swapped for public external debt or where private assets are being swapped for private foreign debt, these monetary effects are not relevant. Where public

sector debt, however, is being swapped for domestic currency to facilitate the purchase of private sector assets, then the resulting increase in private liquidity should be sterilised by bond sales. The Brazilians are in any case reported to be ready to resume debt/equity swaps shortly. They should also be encouraged, however, to relax controls on inward direct investment and sign the MIGA convention.

Personality notes

14. Mailson - Minister of Finance since January 1988. Born 1942. Employee of Bank of Brazil 1963. Economics graduate 1974. Post graduate, City University, London, 1985. Economic Adviser to Ministry of Industry and Commerce 1977-79. Economic Co-ordinator, Ministry of Finance 1979-83. Secretary-General, Ministry of Finance 1983-85. Executive Director of European Brazilian Bank, London, 1985-87. Married. Four children. Speaks English.

15. Mailson will be accompanied by Sergio Amaral, Brazil's chief debt negotiator; Celso Antonio de Sonza e Silva, the Brazilian Ambassador; Arnim Love, Director of the Central Bank and Rosa Dalcin, press officer.

10.4/d2 **CONFIDENTIAL**

FROM: H G WALSH (IF1)
DATE: 14 APRIL 1989
EXT: 4680

CHANCELLOR

cc: Economic Secretary
Sir P Middleton
Mr Wicks
Mr Lankester
Mr Evans
Mr Mountfield
Mr Bottrill
Mr Lazar
Mr Kilpatrick
Mr Tyrie

Mr Cassell - UKDEL

Thanks. Not good. We ~~must~~ do all we can to get [illegible] pass the criteria satisfactorily. (Some [illegible] the US agree to).

MEXICO

You asked for a note on the agreement between Mexico and IMF management on a 3-year Extended Financing Facility (EFF) to extend for the next 3 years. It will probably be the first programme to incorporate Brady debt reduction and it is also proposed that the programme should be approved with an unfilled financing gap while the banks negotiate debt reduction and/or new money. The programme is due to come to the IMF Board in late May or early June. A copy of the Letter of Intent is attached.

Access

2. Access under the EFF proposed is for $1.2 billion per annum or equal to access of around 80 per cent of quota. This is higher than average for all programmes, about an average level of access for an EFF judging by experience since 1980. Mexico's total access, already 380 per cent of quota, will rise under an EFF to 426 per cent at the end of the programme. This is very near the 440 per cent cumulative access limit.

Commercial Banks

3. Negotiations with the banks begin next Wednesday and will no doubt take some time. The banks, which hold 70 per cent of the debt, will be anxious not to set any expensive precedents for themselves and this means that some of the more ambitious

WALSH → CH/Ex 14/4

objectives of the Mexicans on debt reduction may be difficult to fulfil. Given our concerns about burden sharing, it will be important in these circumstances to ensure that arrears arising because of any residual unfilled financing gap should fall to the banks.

Economic Policies and Prospects

4. The Mexican programme envisages some tightening of fiscal policy, with the operational budget deficit falling from 3 per cent of GDP last year to 2½ per cent in 1989. The nominal PSBR is forecast to fall from 13 per cent to 7 per cent. The recent strengthening of oil prices will have helped the outlook for revenues. The authorities are envisaging some reduction in the present high real interest rates, credit for which is taken in a saving for the PSBR. The exchange rate is to be allowed to continue to depreciate by one peso a day to the US dollar until July, but no step devaluation seems to be envisaged.

5. The authorities consider that this combination will allow a modest resumption of growth to 1½ per cent in 1989 while inflation continues to fall to 18 per cent by December. The current account, however, is expected to show a deficit of about \$4.8 billion compared to \$3 billion in 1988.

6. The main immediate question about the programme is whether the peso exchange rate can be sustained on its present course. The maintenance of a high exchange rate policy has already led to a 25 per cent loss of competitiveness since the middle of last year. The combination of this - with the projected lower interest rates and a continuing large current deficit - could put the exchange rate under pressure. The Fund staff do not appear to have decided whether a faster depreciation is necessary. Mexico does not have the reserves to protect the peso.

7. A lower exchange rate, while necessary to help the balance of payments adjust and stem capital flight, would of course jeopardise the inflation objective. This is likely to come under strain in any case after the ending of the present price and wage

controls in July. We have no details yet as to how the Mexicans are going to handle this.

8. The size of the projected current deficit, coupled with the need to rebuild Mexico's current depleted $6 billion level of reserves, raises the question as to whether sufficient external finance is likely to be available. Direct investment has contributed strongly to Mexico's external finance in recent years but a continuation of this will depend on the Mexicans' readiness to allow further debt/equity swaps. The IMF is also assuming a modest reflow of flight capital, but this could be difficult to achieve against a background of falling interest rates especially if sentiment about the peso worsens. The IMF would provide a small, and other multilaterals a more substantial, contribution to net finance. We do not know the shape of the request to the Paris Club, but Mexico needs substantial new credits to refinance repayments of pre-1983 official debt, and these could be jeopardied if the required rescheduling is too much.

9. The balance of payments projections are based on a Mexican oil mix price of $12 per barrel, equivalent to $16 per barrel of West Texas Intermediate. The latter can be compared with the present price of $20. The programme targets will be variable depending on the oil price, with a range of plus or minus $2 per barrel above or below the base assumptions or an equivalent effect from interest rate fluctuations - a LIBOR of 10.5 per cent has been assumed.

Debt Reduction

10. The novel feature of the programme is of course debt reduction, and around 30 per cent of the IMF funding is notionally identified to be set aside for this purpose. There is no information on details, but apparently there is no provision for possible support for interest rate reduction at this stage. This will need consideration in principle in the Fund and Bank Boards first, including the vexed question of additionality and whether support for interest reduction scores for access limits. We have seen press reports that both the Mexicans and the banks may favour some interest reduction on the menu.

11. The programme falls well short of our objectives for IMF programmes with debt reduction:-

i. Mexico is not a signatory of MIGA.

ii. Mexico retains some restrictions on direct investment.

iii. It is not clear whether Mexico intends to continue with a debt/equity programme.

iv. A 30 per cent set aside is more than the 25 per cent set aside for debt reduction mentioned by the Americans at the G7 discussions etc. You implied that 25 per cent was too much, and no figure was agreed.

v. There is as yet no indication of any protection for Paris Club in terms of preferred creditor status if the programme proceeds with a financing gap.

vi. It is possible that exchange restrictions will have to be approved under Article VIII to allow for the building up of arrears to the banks and preventing the enforcement of loan contracts in those countries where, unlike the UK, "exchange contracts" are interpreted by the Courts to include loan agreements.

vii. The Mexicans have given vague promises of continuing liberalisation, but has also presented the IMF programme as involving no extra reform compared to their own plans.

12. We have indicated to UKDEL that we regard strong own efforts to obtain private finance as a very important part of any programme for Mexico. We also regard it as important that the Paris Club should only be asked to make an equitable contribution towards the package, and that - if we can get others to agree - full and current servicing of the Paris Club should be made a condition of the programme continuing.

13. We will report further when we have more information; and will ask Mr Cassell to keep closely in touch with the Germans, Dutch and other doubters in order to try and agree on a common line with as many of the items in paragraph 11 as possible.

H.W.

H G WALSH

155223
MDLIAN 3266

A note on para 10 pls.

CONFIDENTIAL
FM MEXICO CITY
TO ROUTINE FCO
TELNO 170
OF 141855Z APRIL 89
INFO ROUTINE IMF/IBRD WASHINGTON, BANK OF ENGLAND, HM TREASURY
INFO ROUTINE ECGD, DTI
INFO SAVING CARACAS

MEXICO : DEBT

1. CRAWFORD AND MILLGATE (BANK OF ENGLAND) AND NASON (MINISTER) CALLED ON GURRIA ON 12 APRIL (BEFORE YOUR TELNO 101 ARRIVED).

2. GURRIA WAS CLEARLY PLEASED THAT THE LETTER OF INTENT TO THE IMF HAD BEEN ACCEPTABLE TO THE IMF MANAGEMENT AND HAD BEEN SIGNED ON 11 APRIL. HE EMPHASISED THAT THE IMF HAD ACCEPTED ALL CURRENT MEXICAN POLICIES INCLUDING EXCHANGE RATE POLICY SUBJECT TO THE PROVISO THAT THERE WOULD BE A REVIEW IF CTMPARATIVE INFLATION RATES DIVERGED BEYOND A CERTAIN POINT. YOU WILL BE AWARE OF IMF VIEWS ABOUT THE PROGRAMME FROM THE INFORMAL MEETING OF THE IMF BOARD ON 11 APRIL.

3. GURRIA SAID THAT THE THREE-YEAR EFF WILL BE FOR 80% OF QUOTA EACH YEAR AND THAT TMERE IS AN INFORMAL UNDERSTANDING WITH THE IMF THAT ABOUT ONE-THIRD OF THIS MAY BE USED FOR DEBT REDUCTION. FURTHERMORE,

THE PART EAR-MARKED FOR DEBT REDUCTION IS NOT TO BE INCLUDED IN THE CALCULATION OF RESOURCES AVAILABLE TO FILL THE FINANCING GAP OF DOLLARS 7 BILLION P.A. IN 1989-91.

4. NEGOTIATIONS WITH THE IBRD FOR STRUCTURAL ADJUSTMENT LOANS (SALS)

TOTALLING DOLLARS 1.5 BILLION CONTINUE. ABOUT 30% OF FUTURE SALS (BUT NOT OF PROJECT LOANS) IS ALSO TO BE DEVOTED TO DEBT REDUCTION OR DEBT-SERVICE REDUCTION, AND WOULD NOT BE INCLUDED IN THE CALCULATION OF RESOURCES AVAILABLE TO FILL THE FINANCING GAP.

5. GREAT EXPECTATIONS HAVE BEEN AROUSED BY JAPAN'S INTENTION TO CO-FINANCE IMF/IBRD DEBT REDUCTION, ALTHOUGH GARRIA SAID ONLY DOLLARS 4.5 BILLION IS TO BE AVAILABLE GLOBALLY INSTEAD OF THE DOLLARS 8 BILLION EXPECTED. NO MEXICAN AGREEMENT HAS YET BEEN STRUCK WITH JAPAN ALTHOUGH MEXICO HOPES TO OBTAIN A LARGE PROPORTION OF THE GLOBAL SUM. THE JAPANESE HAVE ALSO INSISTED THAT THEIR DEBT

REDUCTION CO-FINANCING BE EXCLUDED FROM THE FINANCING GAP CALCULATIONS.

6. WITH THE EFF TO BE APPROVED BY THE IMF BOARD ON 22 MAY, MEXICO INTENDS TO SEEK A PARIS CLUB MYRA AS SOON AS POSSIBLE. THEY WISH TO SHIFT THE CUT-OFF DATE TO END 1988 BECAUSE, IF THEY DO NOT, THEY WILL HAVE TO REPAY DOLLARS 1 BILLION TO THE COMMODITY CREDIT COOPERATION (CCC). GURRIA THOUGHT THE SHIFT WOULD NOT MATTER MUCH TO OTHER EXPORT CREDIT INSURERS WHO HAD PROVIDED LITTLE NEX COVER SINCE 1985. CRAWFORD SAID HE THOUGHT A SHIFT IN THE CUT-OFF DATE WOULD BE BADLY RECEIVED AND WOULD INCREASE THE RISK OF COVER BEING SUSPENDED. GURRIA TOOK NOTE AND SAID HE MIGHT THEREFORE HAVE TO SEEK A SPECIAL DEAL WITH CCC.

7. TURNING AGAIN TO DEBT/DEBT SERVICE REDUCTION AND THE ROLE OF THE IMF/IBRD, GURRIA NOTED THAT THERE WERE UNRESOLVED ISSUES. HE COMMENTED THAT THE CHANCELLOR, STOLTENBERG AND RUDING ''GAVE A LOT OF GRIEF'' AT THE IMF/ IBRD SPRING MEETING AND WERE AT ONE END OF THE SPECTRUM. FRANCE AND THE US WERE AT THE OTHER END, WITH JAPAN SOMEWHERE IN THE MIDDLE. CRAWFORD COMMENTED THAT THE UK WAS CONCERNED, AND WITH GOOD REASON, ABOUT THE POSSIBLE IMPACT OF THE NEW DEBT SCHEME ON THE IBRD'S CREDIT RATING (GURRIA ADMITTED THAT MOODY'S HAD RECENTLY PRODUCED A DISCOURAGING ASSESSMENT) AND ABOUT THE TRANSFER OF RISK FROM THE BANKS TO THE OFFICIAL SECTOR. BUT HMG HAD GIVEN ITS SUPPORT TO THE CONCEPT OF DEBT REDUCTION.

8. GURRIA SAID THAT HE KNEW THERE WERE G7 DIFFERENCES ABOUT FRONT-LOADING, GUARANTEES, ADDITIONALITY ETC. THERE SEEMED TO BE A LEGAL PROBLEM FOR THE IMF AS TO WHETHER IT COULD GIVE GUARANTEES WHICH MIGHT HAVE TO REMAIN IN PLACE FOR 20 YEARS OR WHETHER IT COULD ONLY LEND FOR INVESTMENT (BY WHICH HE SEEMS TO HAVE MEANT TO FINANCE BUY-BACKS OR PERHAPS THE PURCHASE OF ZERO COUPON BONDS. ANOTHER ISSUE WAS WHETHER IMF/IBRD/JAPANESE DISBURSEMENTS COULD BE FRONT LOADED. THIS WAS ESSENTIAL. MEXICO DID NOT BELIEVE THAT DRIP-FEEDING OF DEBT REDUCTION WOULD WORK IN A MARKET SENSE. BANKS WOULD ALL WANT TO WAIT TO THE LAST MOMENT. RELIEF FOR MEXICO WOULD BE TOO SLOW. HE THOUGHT HIS PREVIOUS IDEA FOR SHORT-TERM GUARANTEES BY FRIENDLY COUNTRIES MIGHT BE RESURRECTED. SUCH GUARANTEES WOULD BE TAKEN OUT AS IMF/IBRD/ JAPANESE RESOURCES FOR THIS PURPOSE WERE RELEASED. FRIENDLY GOVERNMENT'S GUARANTEES COULD ADDITIONALLY BE SECURED, AGAIN AS HE HAD PREVIOUSLY SUGGESTED, BY A MEXICAN COMMITMENT TO REPAY IN GOODS IF THE GUARANTEES WERE IMPLEMENTED AND COULD NOT BE REPAID IN ANY OTHER WAY.

9.WITH REGARD TO THE BANKS, MEXICO WILL MEET THE ADVISORY COMMITTEE, NOW EXPANDED TO INCLUDE MIDLAND AND SUMITOMO ON 19 APRIL IN NEW YORK. THREE IMMEDIATE DECISIONS WILL BE SOUGHT:
(I) TO EXTEND FROM JUNE 1989 TO DECEMBER 1992 THE BANKS' COMMITMENT TO PROVIDE INTERBANK LINES. MEXICO WOULD ENDEAVOUR TO MAKE THESE APPEAR NORMAL FACILITIES BY INCREASING THE FREQUENCY OF CLEAN PERIODS,
IE, WOULD REPAY AS LINES MATURED AND SEEEK RENEWAL ONLY AFTER A FEW DAYS. INTERBANK LINES WOULD CONTINUE TO BE PART OF THE EXPOSURE BASE.
(II) TRADE LINES ARE NOT TO BECRESTRUCTURED BUT MEXICO WOULD EXPECT BANKS TO CONTINUE TO PROVIDE THEM. THEY WOULD BE EXCLUDED FROM THE EXPOSURE BASE.
(III) BANKS TO AGREE TO RESTRUCTURE THE US DOLLAR 12.5 BN OF MATURITIES DUE IN 1989-94 ON THE 1983 AND 1984 NEW MONEY.

OTHER ISSUES FOR THE MEETING ARE TO BEGIN WORK ON DEBT REDUCTION PRINCIPLES, ESPECIALLY ON EQUIVALENCE, PERHAPS ESTABLISHING A WORKING SUB-COMMITTEE WITH THE ADVISORY COMMITTEE: AND TO CONSIDER HOW TO DEAL WITH MEXICO'S CASH FLOW SITUATION (SAVED IN Q1 BY CAPITAL REPATRIATION) GIVEN THAT IMF RESOURCES WILL NOT BE AVAILABLE UNTIL LATE MAY AT EARLIEST AND THAT EVEN IF THE BANKS STRIKE A DEAL WITH MEXICO IN JUNE (VERY OPTIMISTIC) IT WOULD NOT BE EFFECTIVE UNTIL MANY MONTHS LATER. HE THOUGHT THAT G7 GOVERNMENTS WOULD IN ANY CASE NOT ENDORSE IMF-IBRD PARTICIPATION IN DEBT SERVICE REDUCTION UNTIL THE MEETING IN PARIS ON 14 JULY: FRANCE WOULD WANT TO MARK THE 200TH ANNIVERSARY OF THE REVOLUTION IN SOME NOTABLE WAY.

10. BANKS WOULD ALSO BE PRESENTED WITH THREE OPTIONS:
A) A 50% REDUCTION IN PRINCIPAL.
B) A CUT IN THE INTEREST RATE OF 4% WHICH MEXICO BELIEVED WAS THE EQUIVALENT OF A). GURRIA ESPECTED BANKS TO PREFER THIS OPTION.
C) A MULTI-YEAR COMMITMENT TO PROVIDE NEW MONEY FOR 6 YEARS, ALTHOUGH MEXICO CALCULATED THAT TO BE EQUIVALENT TO A) THE COMMITMENT SHOULD BE FOR 9 YEARS. NEW MONEY WOULD IN EFFECT CAPITALISE INTEREST PAYABLE.
THE NBANKS WOULD HAVE TO CHOOSE A), B) OR C) OR A COMBINATION OF OPTIONS. THE SCHEME WOULD NOT BE VOLUNTARY EXCEPT AS TO THIS CHOICE. ASKED HOW THE BANKS COULD BE OBLIGED TO PARTICIPATE, GURRIA INDICATED THAT HE EXPECTED ENOUGH BANKS TO DO SO AND THAT THEY WOULD EXERT PEER PRESSURE ON OTHER BANKS. BUT MEXICO WAS ALSO CONSIDERING PUTTING THE BANKS INTO A NEW AGREEMENT (HE WAS AWARE OF PREVIOUS UNSUCCESSFUL EXAMINATION OF THIS IDEA) WHICH WOULD LEAVE NON-PARTICIPATING BANKS IN THE OLD AGREEMENTS WHICH WOULD BE TREATED

EVEN LESS FAVOURABLY. FOR MEXICO C) WAS THE LEAST PREFERRED OPTION (AND BUIRA OF BANK OF MEXICO EARLIER TOLD CRAWFORD THAT NEW MONEY SHOULD IDEALLY BE THE SMALLEST ELEMENT) BUT THERE WAS NO PREFERENCE BETWEEN A) AND B). GURRIA WAS AWARE THAT THE US ILLUSTRATIVE FIGURES ON A) AND B) WERE DISTORTED, BUT MULFORD THOUGHT B) GAVE TOO MUCH AWAY TO THE BANKS. THE MEXICANS WERE TRYING TO EDUCATE HIM ABOUT EQUIVALENCE.

11. GURRIA BELIEVED THAT THE BRADY PLAN GAVE TOO SHALLOW AN ENHANCEMENT TO B), A ONE YEAR INTEREST GUARANTEE, COMPARED WITH A) WHICH HE SAID GIVES THE SAME INTEREST GUARANTEE PLUS A GUARANTEE OFPRINCIPAL. HE THOUGHT BANKS WOULD GIVE NO VALUE TO THE ROLLING NATURE OF THE GUARANTEE.

12. IN ANSWER TO QUESTIONS, GURRIA SAID THE INTEREST PAYABLE UNDER C) WAS NEGOTIABLE, BUT IT WOULD NOT BE BELOW MARKET RATES, BY WHICH HE PRESUMABLY MEANT NOT BELOW COST OF FUNDS. MEXICO WOULD NOT FAVOUR ANY UP-SIDE PROVISION ALTHOUGH HE ADMITTED HE EXPECTED THE BANKS TO PRESS FOR IT. MEXICO WOULD BE MORE AMENABLE TO AN ARRANGE-MENT TO MAKE EARLIER REPAYMENT OF CAPITAL OR OF LATE YEARS' INTEREST IF THE ECONOMIC SITUATION ALLOWS. BUT IDEALLY, GREAT UP-FRONT ENHANCE-
MENT WOULD AVOID PRESSURE FROM BANKS FOR UP-SIDE PROVISIONS.

13. FINALLY, DESPITE HIS COMPLAINTS ABOUT EXPECTED DELAYS BY THE BANKS, GURRIA SAID MEXICO WAS NOT PLANNING INTEREST SUSPENSION AS A MEANS OF FOCUSSING THE BANKS' ATTENTION ON THE NEED FOR QUICK DECISIONS. MEXICO HAD NO INTENTION OF BEING AGGRESSIVE OR CONFRONT-ATIONAL (BUIRA GAVE A DIFFERENT MESSAGE) BUT THEY MIGHT OF COURSE BE FORCED INTO SUSPENSION OR THE ADVISORY COMMITTEE MIGHT FEEL IT WOULD HELP.

MORGAN

YYYY

DISTRIBUTION 182

MAIN 181

.MONETARY
ERD
SAMD

WAD
UND
LEGAL ADVISERS

155223
MDLIAN 3266

MCAD NAD
FID

SAVING 1

CARACAS

NNNN

155262
MDHIAN 0846

Have we considered @ X
Do applied + Mexico? [illegible]?

CONFIDENTIAL
FM UKDEL IMF/IBRD WASHINGTON
TO DESKBY 170900Z FCO
TELNO 112
OF 142300Z APRIL 89

IMF: DEBT - OUTLINE OF WORK PROGRAM

1. THE FUND BOARD MET TODAY IN INFORMAL SESSION TO HEAR WHITTOME (ETR) AND FRENKEL (RESEARCH) OUTLINE THE CONTENTS OF THE THREE FORTHCOMING STAFF PAPERS ON ''ISSUES RELATING TO DEBT''. ERB (DMD) SAID THAT THESE PAPERS WOULD BE CIRCULATED NEXT WEEK. IT WAS AGREED THAT THE BOARD WOULD MEET TO DISCUSS THEM (AGAIN IN INFORMAL SESSION) ON 5 AND 10 MAY. THE PAPERS WILL COVER THE FOLLOWING ISSUES:

(I) A GENERAL ''SCENE-SETTING'' PAPER.
(!) (II) FUND SUPPORT FOR DEBT-REDUCTION OPERATIONS (DROPS).
(III) FINANCING ASSURANCES.

SCENE-SETTING

2. FRENKEL SAID THAT THE FIRST PAPER WOULD PROVIDE A BACKGROUND TO THE OTHER TWO AND WOULD DEAL WITH THE OBJECTIVES OF THE DEBT STRATEGY AND THE CONTRIBUTION DROPS COULD MAKE.

3. THE STAFF TOOK THE CENTRAL OBJECTIVES OF THE DEBT STRATEGY TO BE TO ENGINEER A RETURN TO ''NORMAL ECONOMIC GROWTH RATES'' IN THE DEBTOR COUNTRIES AND TO RE-ESTABLISH THESE COUNTRIES' CREDITWORTHINESS. THE STAFF PAPER WOULD ASSESS THE CONTRIBUTION SPECIFIC DEBT REDUCTION OR DEBT SERVICE REDUCTION SCHEMES COULD MAKE TO SECURING THESE OBJECTIVES. THE MODE OF ANALYSIS WOULD BE TO EXAMINE DIFFERENT TYPES OF OPERATION WITHIN A MEDIUM-TERM FRAMEWORK, AND IN PARTICULAR TO REVIEW HOW THESE SCHEMES MIGHT IMPROVE GROWTH AND POLICY PERFORMANCE OVER THE MEDIUM-TERM. WHILE RECOGNISING THE WEAKNESSES OF THE ''MEDIUM-TERM SCENARIO APPROACH'', FRENKEL STRESSED THAT THIS WAS THE ONLY WAY TO ANALYSE THE CONTRIBUTION DROPS COULD MAKE TO THE ACHIEVEMENT OF MEDIUM-TERM VIABILITY.

4. FRENKEL SAID THAT THE PAPER WOULD ALSO DISCUSS THE ''ELIGIBILITY QUESTION''. UNIFORM QUANTITATIVE ELIGIBILITY CRITERIA WERE UNLIKELY TO BE APPROPRIATE - HOWEVER, SOME CRITERIA WOULD BE NECESSARY. (COUNTRIES WOULD NEED TO BE FOLLOWING A STRONG FUND PROGRAM, IT WOULD NEED TO BE DEMONSTRATED THAT DEBT REDUCTION WOULD BE ''BENEFICIAL'', AND

INDEED THAT THE FINANCING OF DEBT REDUCTION SCHEMES WAS AN EFFICIENT USE OF SCARCE RESOURCES - E.G. MORE EFFICIENT THAN DEVOTING RESOURCES TO INCREASING DOMESTIC INVESTMENT.)

5. FRENKEL SAID THAT THE SCENE-SETTING PAPER WOULD ALSO LOOK AT THE AMOUNTS OF MONEY THAT MIGHT POTENTIALLY BE DEVOTED TO DROPS. THIS IN TURN WOULD REST ON AN ANALYSIS OF WHAT THE DIFFERENT SCHEMES WOULD IMPLY FOR COUNTRIES' DEBT SERVICE PAYMENTS AND (IN THE SHORT-TERM) FOR THEIR CASH-FLOW POSITIONS (I.E. THE PAPER WOULD TRY TO ANALYSE DEBTOR COUNTRIES' DEMAND FOR THE DIFFERENT SORTS OF DEBT REDUCTION SCHEME). THE AMOUNT OF MONEY INVOLVED WOULD ALSO REST UPON THE WILLINGNESS OF BANKS TO PARTICIPATE - AT CURRENT AND PROSPECTIVE SECONDARY DEBT MARKET PRICES - IN (VOLUNTARY) DEBT OR DEBT SERVICE REDUCTION SCHEMES.

X

6. CONCLUDING, FRENKEL SAID THAT GUIDANCE WOULD BE SOUGHT FROM THE BOARD ON THREE MAIN ISSUES:

(I) WHAT BROAD CRITERIA SHOULD DETERMINE ELIGIBILITY FOR FINANCIAL SUPPORT TO FACILITATE DROPS?

(II) HOW APPROPRIATE IS THE MEDIUM-TERM SCENARIO FRAMEWORK FOR ASSESSING THE POTENTIAL IMPACT OF DROPS?

(III) TO WHAT EXTENT DO DIFFERENT SCHEMES ACHIEVE ''LEVERAGE''?

7. WHITTOME MADE TWO BRIEF COMMENTS AFTER FRENKEL'S PRESENTATION:

(I) ''UNIFORMITY OF TREATMENT'' WAS NOT INFRINGED BY THE FUND'S CHANNELING SUPPORT TO COUNTRIES WITH ''SPECIAL PROBLEMS''. THE MAIN POINT WAS, HOWEVER, THAT IN HELPING THESE ''SPECIAL PROBLEM'' COUNTRIES THE FUND SHOULD MAKE SURE THAT THE FINANCING AVAILABLE TO OTHER COUNTRIES WOULD IN NO WAY BE REDUCED. THIS SUGGESTED THAT ALL THE SUPPORT FOR THE PROBLEM COUNTRIES SHOULD BE ''ADDITIONAL''. (NB: THIS WOULD SEEM TO PUT THE STAFF ON A COLLISION COURSE WITH THE US WHO WERE ADAMENT YESTERDAY THAT THERE SHOULD BE NO ADDITIONALITY EXCEPT FOR INTEREST SUPPORT.)

(II) MEDIUM-TERM SCENARIO ANALYSIS WOULD BE USEFUL AS A GUIDE BUT WOULD BE USELESS AS A QUANTITATIVE INDICATOR OF THE OPTIMAL LEVEL OF DEBT REDUCTION OR DEBT SERVICE REDUCTION.

FUND SUPPORT FOR DROPS

8. WHITTOME EXPLAINED THAT THE SECOND STAFF PAPER WOULD DEAL WITH THE FUND'S POTENTIAL INVOLVEMENT IN DROPS. WHITTOME SAID THAT THE PAPER WOULD RAISE A HOST OF DETAILED QUESTIONS:

?

(I) HOW WOULD CONDITIONALITY 'BE ENSURED'? THIS WAS EASY - DROPS WOULD BE ASSOCIATED WITH STRONG FUND PROGRAMS.

(II) WHICH WOULD BE THE APPROPRIATE ''PARALLEL'' FUND PROGRAM - AN EFF/A SUCCESSION OF SBAS/ONE SBA? A ONE-YEAR SBA MIGHT BE TOO SHORT, PARTICULARLY UNTIL THE NEW DROPS SCHEMES GOT OFF THE GROUND. DISCUSSIONS WITH THE BANKS OVER WAIVERS WOULD BE LENGTHY AND DIFFICULT AND COULD TAKE LONGER THAN ONE YEAR. WHAT WOULD HAPPEN TO THE 'SET ASIDE MONEY' IF THE SBA EXPIRED BEFORE NEGOTIATIONS WERE COMPLETED?

(III) WOULD WAIVERS NEED TO BE GENERAL OR COULD THEY BE PARTIAL? HOW COULD THE FUND ENSURE THAT THE WAIVERS NEGOTIATED WOULD BE 'SUFFICIENT'? WOULD THE GRANTING OF WAIVERS BE MADE CONDITIONAL ON AGREEMENT TO A FUND PROGRAM?

(IV) COULD ESAF MONEY BE USED TO SUPPORT DROPS? (WHITTOME MADE IT CLEAR THAT THE STAFF PAPER WOULD NOT FOCUS ON THIS ISSUE.)

(V) WOULD 'SET ASIDE MONEY' BE FRONT-LOADED, PHASED OR BACK-LOADED? THIS WOULD BE AN IMPORTANT QUESTION GIVEN THAT MARKET DISCOUNTS MIGHT BE EXPECTED TO RISE DURING THE COURSE OF A (SUCCESSFUL) FUND PROGRAM.

(VI) WOULD THE BOARD NEED TO REVIEW THE TERMS OF THE DEBT BUYBACK/EXCHANGE? WOULD FUND SUPPORT DEPEND ON THE ''ADEQUACY'' OF THE AGREED DEBT REDUCTION (I.E. THE SIZE OF THE IMPLIED DISCOUNT)?

(VII) AS FAR AS ''ASSET ENHANCEMENT'' WAS CONCERNED, IT WAS CLEAR THAT THE FUND COULD NOT PROVIDE ''GUARANTEES''. HOWEVER, COLLATERAL ACCOUNTS WERE PERMISSIBLE. SUCH ACCOUNTS RAISED MANY QUESTIONS (LIQUIDITY, ACCESS, CHARGES). THERE WAS ALSO THE WIDER QUESTION OF 'LEVERAGE'. AND WHAT HAPPENED IF A COUNTRY WENT INTO ARREARS OR A FUND PROGRAM WENT OFF TRACK? ?? WOULD THERE BE MUCH MILEAGE IN 'POOLING' (I.E. ONE ACCOUNT BACKING SEVERAL COUNTRIES' INTEREST LIABILITIES)?

FINANCING ASSURANCES

9. SUMMARISING THE THIRD PAPER, WHITTOME SAID THAT IT WAS CLEAR THAT THE ''CRITICAL MASS'' POLICY HAD NOT WORKED AS INTENDED. IN THE PERIOD 1982-87, IN ONLY 50 PER CENT OF THE CASES IN WHICH THE CRITICAL MASS POLICY SHOULD HAVE APPLIED, WAS IT APPLIED. MOREOVER, OVER TIME THE REQUIREMENT FOR 100 PER CENT CRITICAL MASS HAD BEEN WEAKENED. THE BOARD HAD ALSO

SATISFIED ITSELF WITH WEAKER FINANCING ASSURANCES (E.G. 3 MONTH MONEY).

10. THE STAFF'S CONCLUSION WAS THAT THE EXISTING POLICY HAD NOT BEEN EFFECTIVE FOR A RANGE OF SMALL AND MEDIUM-SIZED COUNTRIES - THE BANKS HAD SIMPLY NOT BEEN PREPARED TO PUT UP THE NECESSARY FINANCING. THE POLICY HAD MERELY SERVED TO PREVENT THE FUND FROM HELPING THESE MEMBER COUNTRIES AT CRITICAL MOMENTS.

11. THE STAFF PAPER WOULD ADDRESS SEVERAL ISSUES:

(I) WOULD THE FUND STOP AT THE FIRST DISBURSEMENT? OR, IF THE 'UNDERFINANCED PROGRAM' WERE GOING WELL, WOULD THE FUND CONTINUE TO DISBURSE?

(II) HOW COULD THE FUND'S MONEY BEST BE SAFEGUARDED? HOW COULD 'DISORDERLY' ACCUMULATION OF ARREARS BE MADE MORE ORDERLY? HOW COULD A REASONABLE SHARING OF THE BURDEN AMONG CREDITORS BE ENSURED?

DIRECTORS' COMMENTS

12. A FEW GENERAL POINTS WERE MADE BY DIRECTORS:

(I) JALAN (INDIA) STRESSED THAT ELIGIBILITY SHOULD BE BASED ON OBJECTIVE CRITERIA. AND THIS SHOULD HAVE NOTHING TO DO WITH ''DEBT DISCOUNTS''. ISMAEL (LNDONESIA, ETC.) SAID THAT SOMETHING WOULD NEED TO BE DONE FOR COUNTRIES THAT WERE NEITHER ELIGIBLE FOR ESAF/SAF/TORONTO TERMS AND NOR HAD DEBT THAT WAS TRADING AT A DISCOUNT. GHASIMI (IRAN, ETC.) ASKED HOW MUCH MONEY THE FUND COULD DEVOTE TO SUPPORTING DROPS WITHOUT REDUCING THE AMOUNT OF FINANCING AVAILABLE TO OTHER COUNTRIES.

(II) WARNER (US) WAS PLEASED BY THE DEGREE OF DETAIL ENVISAGED. HE THOUGHT THIS BODED WELL FOR THE 'EARLY MATURITY' OF THE PROPOSALS. HE QUESTIONED WHETHER SET ASIDE MONEY WOULD BE EARMARKED SPECIFICALLY FOR DEBT REDUCTION AND CAUTIONED AGAINST OVER-RESTRICTIVENESS (WHITTOME SAID THAT THE STAFF PAPER WOULD EXAMINE THE OPTIONS - ONE ALTERNATIVE WOULD BE TO HAND OVER THE FUNDS TO A COUNTRY TO USE AS THE LATTER SAW BEST (THE MARKET APPROACH). ANOTHER OPTION WOULD BE TO CONDITION DISBURSEMENT ON THE AGREEMENT OF A WAIVER.)

(III) WARNER ALSO SAID THAT HE THOUGHT A ''RE-ITERATIVE'' APPROACH WOULD BE APPROPRIATE. THUS WHILE SOME OF THE PRINCIPLES OF THE NEW SCHEMES COULD BE DETERMINED IN ADVANCE, OTHERS WOULD EVOLVE AS PARTICULAR COUNTRY-SPECIFIC SCHEMES WERE DESIGNED (WHITTOME AGREED).

155262
MDHIAN 0846

(IV) WARNER ASKED WHETHER CAPITAL FLIGHT WOULD BE DISCUSSED IN THESE PAPERS. WHITTOME SAID THAT THE SECOND PAPER WOULD COVER THIS ISSUE.

(V) YAMAZAKI (JAPAN), WARNER AND FILARDO (MEXICO, ETC.) THOUGHT THAT THE PAPERS SHOULD ALSO ANALYSE THE USEFULNESS OF DEBT/EQUITY SWAPS. FILARDO NOTED THAT THERE WERE SOME PROBLEMS WITH DEBT/EQUITY CONVERSION PROGRAMS (WHICH PRIMARILY BENEFITTED THE BANKS). NEVERTHELESS, IT MIGHT BE POSSIBLE TO DESIGN PROGRAMS SUCH THAT ANY ''OVERPERFORMANCE'' (IN THE FORM OF UNEXPECTEDLY HIGH RESERVES) COULD TRIGGER CONVERSION OF DEBT INTO EQUITY. FRENKEL SAID THAT THE PAPERS WOULD TOUCH ON THIS.

13. FCO PLEASE ADVANCE TO LANKESTER, EVANS AND WALSH (HMT), CROCKETT AND WARE (BOE), AND RICHARDSON (ERD).

CASSELL

YYYY

DISTRIBUTION 134

MAIN 134

.MONETARY ERD

NNNN

17.4/m3

CONFIDENTIAL

FROM: H G WALSH (IF1)
DATE: 19 April 1989
EXT: 4680

CHANCELLOR

Thanks. A good note. I note X: possible change not any of developments!

cc: Mr Wicks
Mr Lankester
Mr Evans
Mr Mountfield
Mr Bottrill
Mr Kilpatrick

Mr Cassell - UKDEL

NALSH → CH/EX 19/4

MEXICO

You asked for comments on the latest information that we have about the Mexican deal. (Mr Taylor's note of 18 April).

2. FCO telno 170 broadly confirms other information that we have about the discussions so far between the Mexicans and the banks. The new proposals, while they are similar to the US ideas that have been put forward at G7D by Mulford, are different in some respects. In particular they are a series of menu options - proposals by Mexico - which are intended to be of roughly equivalent value to enable each individual bank to choose one option only if it so wishes.

The Options

3. The options are as follows:-

Principal Reduction

i. A 50 per cent reduction in principal. This would reduce debt to the banks of $68 billion to $34 billion and the annual interest saving on this would be - at an assumed interest rate of 10 per cent - about $3.4 billion per year. (No value has been placed on the reduction in principal itself. Principal could be expected to be indefinitely rolled over in the absence of debt reduction. But a reduction in principal outstanding is clearly a small "plus" compared to straight interest reduction and would indicate that the annual interest savings from interest reduction should be slightly higher than those from principal reduction to make the two equivalent).

Interest Rate Cut

ii. A cut in the interest rate on loans either of 4 per cent or to 4 per cent. This involves both a reduction in interest rate and a change from a floating rate to fixed rate format. If the cut is by 4 per cent the annual debt service reduction would be $2.8 billion, and if the reduction is to 4 per cent, the annual debt service reduction would be $4.2 billion, or

New Money

iii. The new money component of the package might be equal to about 80 per cent of interest payment receivables or $5.6 billion a year for 6 years.

All this is shown in the table below. (We believe (ii)(b) is what Mexico is actually seeking).

Mexico: Debt (Service) Reduction/New Money Options

$bn

1989			DSR (per year)		
Mexican Debt to Commercial Banks	Interest Due to Banks	Debt Reduction (½ Principal)	(i)	(ii)	(iii)
68	7	34	(a) 3.4	(a) 2.8	5.6
				(b) 4.2	

(i) Estimated annual debt service reduction (effects on interest only):
Principal cut by half

(ii) Estimated annual debt service reduction:
(a) Interest rate cut by 4 per cent
(b) Interest rate cut to 4 per cent
(both for 30 years)

(iii) Annual new money for 6 years.

Collateral

4. It has been proposed that both options (i) and (ii) would be secured by 30-year US Treasury zero coupon bonds, with a 2-year rolling interest rolling guarantee. The Mexicans want "a Western Government" to secure 1 year of interest payments - a reference to the United States or possibly Japan - and a multilateral institution (IFI) the second year of the rolling guarantee. The details of the guarantees have not yet been worked out, and it may be that the somewhat less objectionable option of a World Bank loan placed in an escrowed account could be used rather than a straight guarantee for the IFI element. The basic shape of options (i) and (ii) are very similar to the 1988 Aztec bond scheme with an added interest support element.

Assessment

5. The discounts on options (i) and (ii) look high in relation to the collateralisation offered. We agree with the Mexican assessment that a 1-year interest guarantee would be much too shallow to achieve the interest rate reductions sought. A 2-year rolling interest guarantee plus a principal guarantee at 30 years will reduce interest rates by perhaps 2½-3 per cent a year, not 4 or 6 per cent. But the Mexicans may be working on a different concept of a rolling interest guarantee than we are, and we await discussions in the IFIs on exactly what is meant by this.

6. On your second question, we think there is at least some chance that the amount of IFI money devoted to debt reduction will be related to the willingness of banks to participate in voluntary debt or debt service reduction schemes. Secretary Brady - under pressure from the US Congress - is thinking along the same lines. (See attached clipping from Tuesday's Wall St Journal). The extent to which this linkage is made will of course be entirely dependent on the discussions in the IMF and World Bank Boards and we shall certainly work for such a relationship.

7. It seems very unlikely that the majority of the US banks will be very interested in the principal reduction that the US Treasury prefers and is pressing for, but they may be more interested in providing some interest rate reduction if this can be adequately collateralised. There is no doubt that the willingness of the banks to participate is the key factor in whether the Brady scheme can have even a partial success. The outlook for their voluntary participation on an adequate scale is not particularly bright.

8. The US Treasury is changing the rules of the game: trying to influence the banks to provide debt reduction, rather than merely giving them support, and going beyond purely voluntary debt reduction to cajoling the banks into accepting large discounts. The debtors themselves may threaten or actually introduce moratoria if US Treasury efforts are not enough to achieve this. This means that the banks are likely to be put under enormous pressure to co-operate, especially given their unpopularity in the US Congress (where they have their own deregulation objectives).

H.W.

H G WALSH

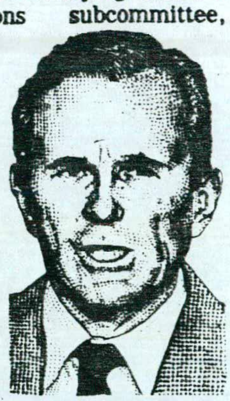
Brady Says Loan to Mexico Could Be Cut

By PETER TRUELL

Staff Reporter of THE WALL STREET JOURNAL

WASHINGTON – U.S. Treasury Secretary Nicholas Brady said a pending $3.6 billion loan to Mexico from the International Monetary Fund will be slashed by about $1 billion unless the country negotiates debt reductions with its commercial banks.

Mr. Brady, who was testifying before a House appropriations subcommittee, seemed anxious to reassure Congress that the IMF and the World Bank will restrain lending to heavily indebted developing countries unless commercial bank creditors take losses on their credits to these borrowers. Some lawmakers are threatening to hold up the U.S.'s annual appropriation for various international development banks unless they're assured that new loans by the IMF and the World Bank aren't used simply to bail out commercial banks.



Nicholas Brady

Mexico begins talks with its main commercial bank creditors tomorrow in New York and has presented them with a proposal that offers both debt reduction and renewed lending options. The country is the leading candidate for Mr. Brady's new debt strategy, which emphasizes debt reduction over new lending.

Mr. Brady seemed eager to damp expectations for his proposal. "Let's not make the first transaction so big it scares everybody," he said. The Treasury secretary said it is encouraging that some debtor countries are coming up with plans to try to take advantage of the U.S. debt-reduction initiative. But in some cases, these proposals "are too grandiose, too big and too favorable to their own cause," he said.

Debt-for-equity swap plans and arrangements for the return to debtor counties of capital that has gone overseas are important parts of the new debt strategy, Mr. Brady said.

If debtor countries "don't have debt-equity swap programs going forward, we tell them they should have," he said.