THREE BRADY DEALS DESCRIBED

1. The Renegotiation of Mexico's External Debt

Pedro Aspe Armella

1. Background

When President Salinas gave his inaugural speech on December 1, 1988, the Mexican economy faced a state of prolonged recession, high levels of inflation and a serious deterioration of standards of living for the population. One of the main causes of this situation was the net external transfer of resources, due to an excessively high external debt. In effect, between 1983 and 1988 these transfers averaged 6 per cent of GDP and, in the latter year, the total stock of debt reached \$100.384 bn; that is, 57 per cent of what the country produced in that year.

In view of the situation, the President instructed the Ministry of Finance to immediately open negotiations with the international financial community with the following four objectives in mind:

1. reduce the historical stock of debt;
2. reduce the flow of net external resource transfers;
3. obtain a multi-annual agreement in order to reduce the uncertainty caused by recurrent negotiations; and
4. reduce the stock of debt in real terms and its proportion to GDP.

Consequently, in December 1988 talks were initiated with Mexico's various external creditors in order to fulfil the Presidential instructions. The negotiations took place in two stages. The first was with the international financial institutions and the Paris Club, where two objectives were set out: firstly, to reduce to zero or to slightly positive levels net external transfers with these institutions by contracting new resources on a multi-annual basis; secondly, to count on their technical and political support for the Mexican thesis that only by eliminating the debt overhang could we resume economic growth. In the second stage, with the commercial banks, the goal was to diminish resource transfers through reduction of debt and its service.

2. Agreements with Official and International Financial Institutions

Among the agreements subsequently reached, the one with the International Monetary Fund will mean resources totalling \$4.135 bn over three years, extendible to a fourth at Mexico's option.

The Main Points of the IMF Agreement of (May 26, 1989) are:

1. Recognition that external financing requirements are derived from growth objectives;
2. Acknowledgement that the debt overhang is an obstacle to sustained growth with price stability;
3. Reduction of net external transfers to a level consistent with Mexico's growth objectives established in the National Development Plan;
4. Financial support for debt reduction operations;
5. Financing totalling US\$4,135 mn over a period of 3 years, which eliminates uncertainty and therefore allows productive investment to be reactivated.

Concurrently, the World Bank agreed to provide resources for investment amounting to \$1.96 bn in 1989 and an average of \$2 bn per year for the period 1990-92 to support structural change and modernisation in key sectors of the economy.

Both institutions supported Mexico's position with respect to the necessity of reducing the debt burden as a precondition for recovering growth and, in a decision without precedent, accepted that part of the resources they would extend to Mexico, plus the provision of an additional one-time sum, would be used to support debt reduction operations with commercial banks.

An accord was reached with the Paris Club under which principal and interest payments originally falling due between June 1989 and May 1992, totalling \$2.6 bn, were restructured. Access to financing for at least \$2 bn per year until 1994 was also confirmed to cover imports from the member countries.

Paris Club Agreement (May 30, 1989):

1. Restructuring of US\$2,600 mn of principal and interest payments over 10 years with six of grace, on the following basis:
   - A) Between June 1, 1989 and March 31, 1990 100 per cent of principal and 100 per cent of interest payments;
   - B) Between April 1, 1990 and March 31, 1991 100 per cent of principal and 90 per cent of interest payments;
   - C) Between April 1, 1991 and May 25, 1992

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100 per cent of principal and 80 per cent of interest payments.

2. Credit coverage of at least US$2.0 bn per year to finance Mexican imports from the Paris Club countries.

In the meantime, in an act of great solidarity, the Government of Japan through the Export-Import Bank, offered financial support to Mexico of $2.5 bn, also to be utilised in the debt reduction package with commercial banks.

3. Agreement with the Commercial Banks

Talks were begun in April with the Bank Advisory Committee for Mexico in order to make known to them our economic programme and our objectives in terms of relief from the debt burden. After more than three months of intense negotiations, an agreement in principle was reached on July 23, 1989. The characteristics of the Agreement were made known to Congress and to public opinion through the media and through the Term Sheet.

The fundamentals of the Agreement consist of three options among which the nearly 500 creditor banks represented by the Committee can choose. Under the first option, banks exchange existing debt for new bonds at a 35 per cent reduction; under the second, the exchange is for bonds with the same principal amount but bearing a rate of interest fixed at 6.25 per cent — or its equivalent in other currencies. In both cases, the final maturity of the debt was extended from 20 years with seven of grace to a single payment in 30 years, thus eliminating the pressure caused on the economy by annual amortisations. The third option consists of providing new loans over the period 1989-92 in an amount equal to 25 per cent of a bank's existing loans not committed to either of the first two options.

The special funds from the World Bank ($2.06 bn), the IMF ($1.644 bn), the Government of Japan ($2.05 bn), plus a direct commitment by Mexico ($1.296 bn), which total $7 bn, will be destined to guarantee the payment of the principal of the new bonds as well as 18 months of interest, thus improving the credit quality of the bonds. With a part of these funds, Mexico will purchase zero coupon bonds from the US Treasury (and from other countries) that will constitute an asset of our country and which, reinvested at a rate of 7.925 per cent per year for 30 years, will grow to an amount sufficient to fully cover the principal payments on the new bonds at the end of period. The rest of the funds, which, again, also constitute an asset of Mexico, will be destined to the guarantee of interest payments. Consequently, these resources do not imply an additional net cost nor do they represent net indebtedness, since they generate interest in favour of Mexico roughly equal to their expense by virtue of being invested.

At the start of the discussions with the commercial banks, the stock of debt that was subject to negotiation (eligible debt) amounted to approximately $52.6 bn. During 1989, various operations were carried out which reduced this total to $48.5 bn, namely:

a) cancellations of public sector debt which certain public sector institutions received in payment for the sale of government-owned enterprises being divested;

b) debt-for-equity conversions (swaps) authorised before November 1987;

c) net amortisations by the public sector during 1989; and

d) movements of exchange rates with respect to the dollar. The foregoing elements all contributed to the reduction in the stock of debt.

The distribution selected by the banks regarding the $48.5 bn of eligible debt was as follows:

a) 41 per cent of the total will be subject to principal reduction;

b) 47 per cent to interest rate reduction; and

c) the remaining 12 per cent will be base for new money.

The banks' choices have the following consequences: first, the exchange of debt for bonds bearing a 35 per cent discount will lead to a reduction in nominal debt of approximately $7 bn. Second, about $22.5 bn of debt will be subject to a fixed rate of 6.25 per cent instead of the 9 to 10 per cent that Mexico has been paying. This is equivalent, economically, to a further reduction in the nominal stock of debt of around $7.75 bn. Expressed in another manner, the interest payments made at a rate below current rates are the same as those resulting from reducing the debt by $7.75 bn and paying market rates. Thirdly, with regard to new money, the banks' choices mean that Mexico will receive around $1.5 bn of additional credits between 1990 and 1992.

4. Effects of the Various Agreements with External Creditors

As a result of the various agreements with Mexico's external creditors and once the Financing Package is instrumented, the total nominal external debt on March 31, 1990 is estimated to be $93.599 bn. Now, if from this figure are excluded a) approximately $7.75 bn of implicit principal reduction derived from the reduction in interest rates described above and b) the credits destined for guarantees on the new bonds (by virtue of the fact that they are offset by a like amount of financial assets that are the property of Mexico), the total net adjusted economic stock of external debt will have been reduced to an equivalent of $79.889 bn at

the interest rate levels prevailing prior to this Agreement. This means that the stock will have been reduced by $20.495 bn with respect to that outstanding in December of 1988, when the current Administration took office, and $27.581 bn when compared to the outstanding in 1987 ($107.470 bn), which was the highest in Mexico's history.

With regard to the public sector, the economic stock of debt in March 1990 will have been reduced by almost $21.4 bn with respect to that outstanding in December 1988.

The reduction in net external resource transfers resulting solely from the Agreement with the commercial banks will be $4.071 bn each year on average over the period 1990-94. This figure is composed of the following elements:

a) annual average interest savings of $1.629 bn due to principal and interest reduction;

b) new loans averaging $288 mn per year; and

c) the deferal of $2.154 bn of principal amortisations per year falling due in this period.

With respect to this last point, it is important to emphasise that another benefit stemming from the Agreement with the commercial banks is the dramatic change in the profile of principal amortisations of public sector debt. Mexico had $2.154 bn on average in principal amortisations falling due each year between 1990 and 1994 and $3.5 bn on average between 1995 and 2006. Now, the total amount of principal payments on the new bonds of around $35 bn, after the reductions resulting from this exercise, have now been deferred to a single payment in 30 years and, as mentioned previously, will be liquidated at maturity through the investment in zero coupon bonds today.

If to the sums above are added the benefits in terms of external transfers from Mexico's negotiations with the International Monetary Fund, the World Bank, the Inter-American Development Bank and the Paris Club, we have as a global result of Mexico's agreements with all of its external creditors that net external resource transfers are reduced to around 2 per cent of GDP on average between 1989 and 1994. Thus, those resources which previously were channelled abroad will now be used to stimulate productive investment.

As a consequence of the agreements obtained with the international financial institutions and with the Paris Club, Mexico has assured itself of funds on an annual basis until 1992, with an average amortisation period of 10 years with five of grace, which will permit Mexico to have greater flexibility in its balance of payments. With commercial banks, apart from new loans totalling $1.5 bn between 1990 and 1992, the amortisation of principal on the restructured debt has been deferred to 2019 and, as mentioned above, is guaranteed through the acquisition by Mexico of zero coupon bonds.

At the end of March 1990, the estimated net economic total stock of debt will represent only 40 per cent of GDP, which compares very favourably with 60 per cent in December 1987 and 57 per cent at the end of 1988.

Another important element of the Agreement is the flexibility provided to Mexico to undertake more debt-reducing transactions in the future, including direct buy-backs. Additionally, the package envisages, following Mexico's criteria, debt-for-equity conversions exclusively for privatisation of public enterprises and infrastructure projects totalling $3.5 bn over three and a half years, which will further reduce external debt by the same amount.

5. Perspectives for the Mexican Economy

The benefits derived from the Agreement are not limited to the direct impact on the balance of payments. Indirect effects of great significance are also expected and have already begun to be observed. Among these we can point to the bolstered confidence of economic agents. This has led to a gradual decline, on average, of real domestic interest rates which, combined with the permanent austerity of the public finances and the continued effort towards structural change and economic modernisation, will lead to a reduction of the public sector financial deficit to levels of around 2 per cent of GDP. This reduction of the deficit is consistent with a reduction of inflation to international levels and with an improvement of our external commercial accounts.

All of this should generate an increase in productive investment, both internal and foreign, as well as capital repatriation, which reached over $2.5 bn in 1989.

At the same time, it will be necessary to encourage domestic savings and facilitate the financial intermediation process in order to increase investment to levels consistent with reaching our objective of 6 per cent GDP growth rates by the end of this Administration. The Agreement, by freeing resources, will translate into the creation of new sources of employment and the gradual recovery of the purchasing power of workers, while allowing increased public spending in basic services such as education, health, social security and infrastructure.

Mexico faces a great opportunity to regain the path towards growth and stability. The groundwork has been laid for consolidating the recovery and strengthening the economy, thus allowing all sectors of the population to benefit from growth. We are also committed to maintaining strict fiscal discipline, to persevere with and deepen our efforts of structural change, of modernisation of the economy and of the Reform of the State, while learning from our own

recent history that we should act with prudence and not incur again such excessive deficit spending or external indebtedness.

Table 1

Sources of Variations in the Total Foreign Debt Outstanding
(millions of dollars)

	Total	*Public Sector*	*Private Sector*	*Banks*[4]	*Bank of Mexico*
Outstanding at 31/12/1988	100384	81003	6498	8097	4786
— Net Borrowing	-877	-323	-1720	863	303
— Variations due to Exchange Rates[1]	-1872	-2061	0	0	189
— Cancellations[2]	-1830	-1830	0	0	0
— Swaps[3]	-730	-730	0	0	0
Estimated Outstanding at 31/12/1989	95075	76059	4778	8960	5278
— Net Borrowing	1231	0	0	-229	1460
— Principal Reduction from Debt Package	-6820	-6820	0	0	0
— New Money	576	576	0	0	0
— Bilaterals	1511	1511	0	0	0
— World Bank/IADB	2169	2169	0	0	0
— Bonds and Other	-143	-143	0	0	0
Estimated Outstanding at 31/03/1990	93599	73352	4778	8731	6738
— Implicit Principal Reduction Derived from Interest Rate Reduction	-7750	-7750	0	0	0
— Guarantees[5]	-5960	-5960	0	0	0
Estimated Outstanding at 31/03/1990[6]	79889	59642	4778	8731	6738

[1] This refers to the impact on the stock of debt of movements in currency rates vis a vis the dollar. Since approximately 25 per cent of the external debt is denominated in currencies other than the dollar, an appreciation of the latter causes the stock of non-dollar debt to fall when expressed in dollars. This volatility will practically disappear since a by-product of the Financing Package is that 90 per cent of the new debt will be denominated in dollars.

[2] These operations are a consequence of reconciling the positions of Nacional Financiera and Banco Nacional de Comercio Exterior as both debtors and creditors with respect to the public sector.

[3] These refer to operations approved before November 1987, where public sector debt is exchanged for equity investments.

[4] This includes interbank lines extended to Mexican banks by foreign banks before 1982. They are mostly short term and are renewed during the year. Also included are credits obtained from the CCC (Commodity Credit Corporation).

[5] The total amount of guarantees is $7,000 mn. However, only $5,960 mn are registered as assets since the remaining $1,040 mn are in the form of a standby credit facility with commercial banks, which will be gradually taken out by resources from the IMF and Exim Bank of Japan.

[6] This figure includes $7,750 mn of the principal reduction-equivalent of debt subject to below-market fixed rates. It also excludes $5,960 mn of funds constituting guarantees, as follows: World Bank $2,060 mn, Exim-Bank of Japan $1,400 mn, and International Reserves $1,300 mn, they are excluded because these resources earn interests in favour of Mexico similar to their contractual cost.

Benefits from the Renegotiation with Commercial Banks

I. Direct Benefits

- External debt is reduced by US$14,670 bn:
  - $6,820 through principal reduction
  - $7,760 through implicit principal reduction due to a lower interest rate.
- Annual interest payments are reduced by US$1,629 mn on average between 1990 and 1994.
- US$1,440 mn of new money to be received between 1990 and 1992.
- Annual principal payments of US$2,154 mn over the period 1990-94 are deferred to 30 years.
- The debt will be paid for at maturity through the acquisition of zero coupon bonds.
- Annual net external transfers are reduced by US$4,071 mn on average between 1990 and 1994.

II. Indirect Benefits

- Increase in domestic savings.
- Reduction of real domestic interest rates.
- Increase in investment.
- Capital repatriation.
- Strengthening of confidence.

Table 2 **Cash Flow Savings from the 1989-92 Financing Package**

Terms		Terms	
1. Principal Discount	35.00%	1. New Money Participation	12.00%
2. Reduced Rate	6.25%	Principal Reduction Participation	41.00%
3. New Money		Rate Reduction Participation	47.00%
1989	7.00%		
1990	6.00%		
1991	6.00%	2. Base ($ mn)	48044[1]
1992	6.00%		
		Assumptions:	
		3. Libor 1990-94	9.000%
		4. Spread over Par Bonds, Outstanding New Money and New Money commitments of 1989-92 Financing Package	.0825% (13/16%)

(in millions of dollars)	*1990*[2]	*1991*	*1992*	*1993*	*1994*	*Average 1990-94*
Interest savings from principal reduction	1014.8	676.5	676.5	676.5	676.5	744.2
Interest savings from rate reduction	1206.7	804.4	804.4	804.4	804.4	884.9
New money cash flows	749.5	345.9	345.9	0.0	0.0	288.3
Savings from restructuring of amortisations[3]	2545.0	1873.0	2431.0	2430.0	1492.0	2154.2
Total Cash Flow Savings	5515.9	3699.9	4257.9	3910.9	2972.9	4071.5

[1] The difference between $48,044 and $48,483 mn of eligible base debt is due to a portion of the base debt which is guaranteed by the World Bank and is not subject to the restructuring options.

[2] This includes retroactive savings from July 1, 1989, applicable in 1990.

[3] This includes the deferment of amortisations originally falling due in this period to 2019.