Mexico, 1982: Paving the Way with Exceptions

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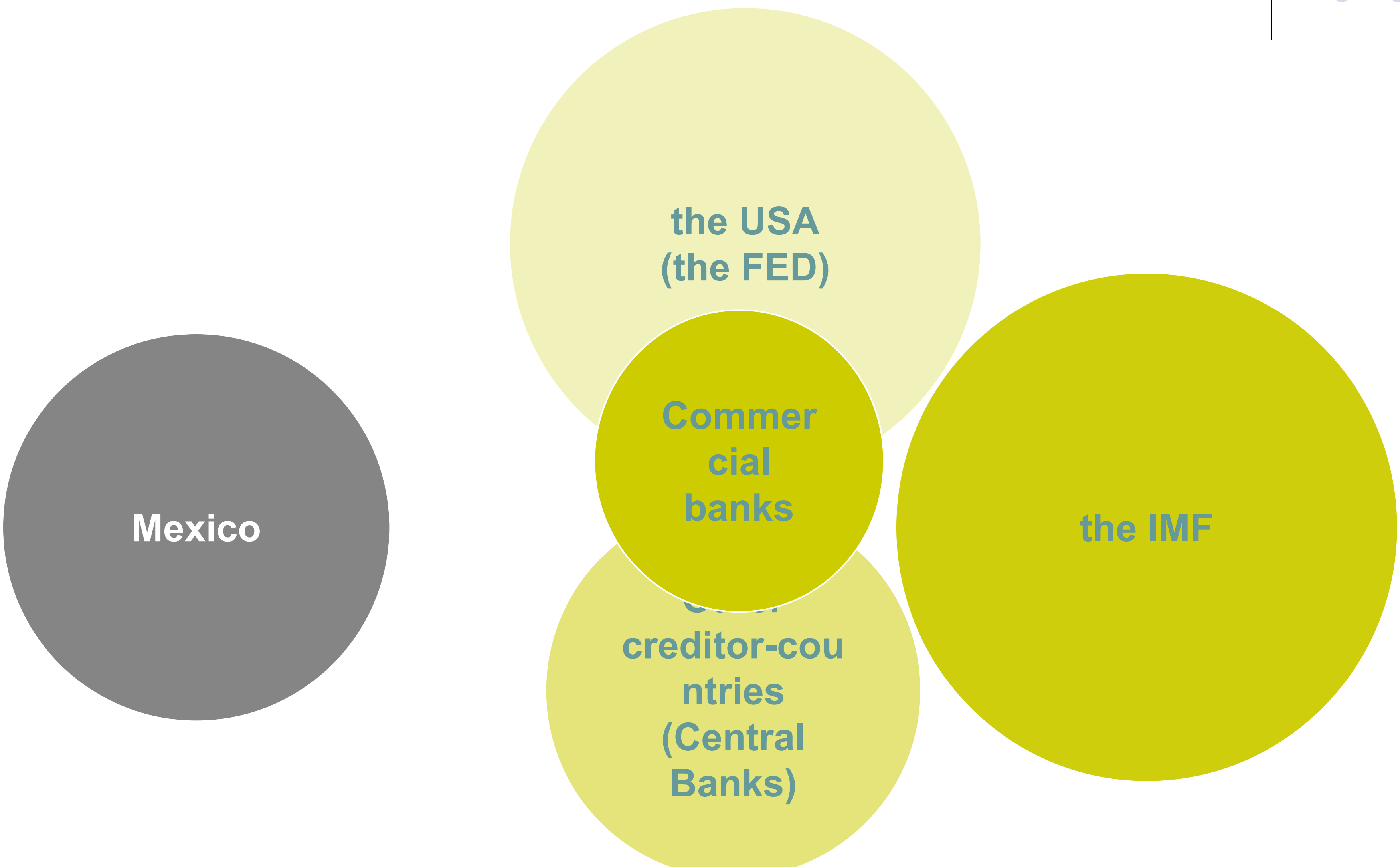
Major players



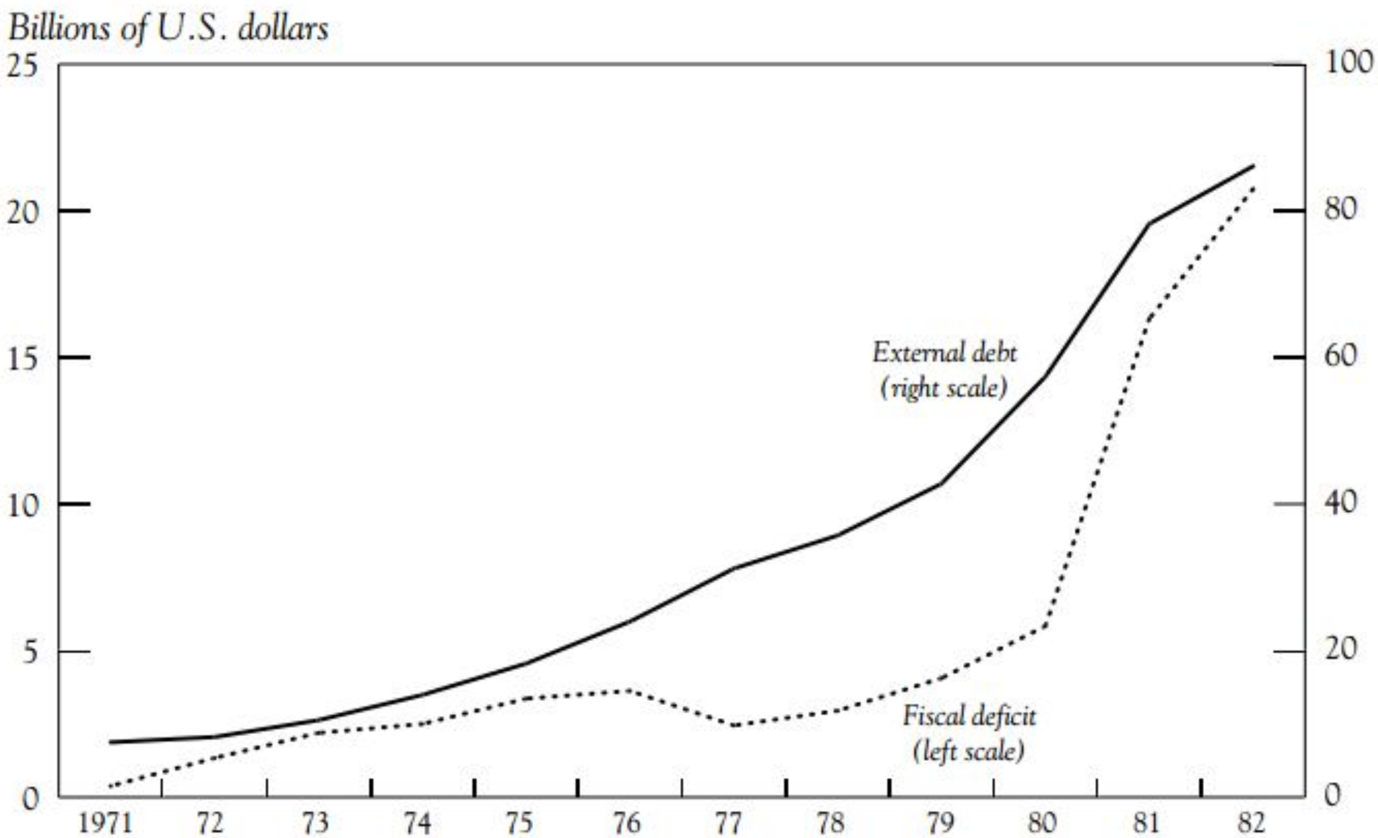
Mexico’s internal situation

- Heavy government spendings on social welfare programs and the development of the petroleum industry in the mid- to late-1970s → budget deficit
- Budget deficit were financed with commercial banks loans
- Heavy reliance on imports
  - “We need to import about 30 percent of our total consumption” (Jesus Silva Herzog)
- Mexico's dependence on open U.S. trade
  - 52% of Mexican exports went to the U.S.
- Petroleum revenues form the major part of GDP
- Pre-election period: new president in December, 1982
- Capital flight → Currency devaluation → Inflation

External situation

- The banking system was understress by 1982:
  - Fraudulent banking practices flourished
  - Many banks went bankrupt
  - Some countries were under threat of default (Poland, Argentina)
- Rising real interest rates
  - Loans contracted on variable interest rates in the 1970s now entailed heavy interest costs
- Recession in the USA and then Europe
  - Reduction of demand for petroleum products in Mexico’s principal export markets
- Oil price shoks
  - Decrease of export revenues

Mexico: Fiscal Deficit and External Debt, 1971–82



Sources: IMF, *IFS*; and World Bank, *World Development Indicators*.

The USA-Mexico Interconnection

Mexican difficulties of any type are of great concern to the USA

- 1,760-mile border (> 2 832 km)
- In 1982 -Mexico was the third largest trading partner of the USA
  - sold more oil to the United States than Saudi Arabia
  - purchased U.S. grain in quantities second only to Japan.
  - The United States provided two-thirds of Mexico's imports.
  - 1981-1982 the U.S. trade balance with Mexico => from a $4 billion surplus to a $4 billion deficit.
- US transactions with Mexico in the financial sector were substantial
  - U.S. commercial banks held an estimated 30% of Mexico's external debt
  - the debt was equivalent to 46% of the capital of the seventeen largest U.S. banks.
  - swap line with the U.S. Federal Reserve system—a testimony to the exceptional importance of Mexico to the U.S. economy.
  - the outflow of Mexican capital to the United States was significant.
  - In 1982, it was estimated that Mexicans had deposits in U.S. banks worth $14 billion, and that they owned an additional $30 billion of U.S. real estate.

The Washington Weekend August 13-15, 1982

- The Mexican Finance Minister, Jesus Silva Herzog, came to the United States and warned of the impending danger of Mexican bankruptcy and a domino effect on the banks
  - Mexico risked bankruptcy by the end of the weekend if no solution was reached
- **The objective** of the Mexican and U.S. governments was to arrange for **interim financing** to prevent a Mexican default until Mexico could reach agreement both with the IMF on an economic program and with its private creditors on a longer-term financial package.

The U.S. Federal Reserve Board

- After the IMF's blessing Silva Herzog moved to the U.S. Federal Reserve Board to meet Volcker
- Volcker took **three actions** to facilitate resolution of Mexico's crisis.
  - 1) **estimated** that Mexico would **need $2 billion** to avoid catastrophe on Monday morning, and suggested that the Mexican finance minister solicit this funding **from the U.S. Treasury**.
  - 2) having acknowledged Mexico's **need for some private bank** debt relief Volcker urged Silva Herzog to arrange immediately with the **private banks** for a meeting **at the New York Federal Reserve**.
  - 3) Volcker advised Silva Herzog **to seek medium-term bridge** loans from the **central banks of Europe and Japan**, so that Mexico could continue functioning while the IMF and private bank agreements were being arranged.
    - To arrange this funding, Volcker suggested a session **at the BIS in Basel**, Switzerland.

The U.S. Treasury Department

- The set of negotiations that involved not only the Treasury but the U.S. Departments of Agriculture, State, Energy, and Defense and the Office of Management and Budget (OMB)
- Secretary Regan & deputy secretary R. T. McNamar
- Silva Herzog and his team had both **to convince U.S. Treasury** leaders of the severity of Mexico's crisis and **make lengthy, detailed presentations** to apprise them of the latest Mexican economic developments.
- Volcker and Silva Herzog's earlier **$2 billion estimate** of Mexico's immediate requirements **was verified**.

The first billion

- The first billion was easily procured through **the Department of Agriculture.**
- Mexico was a large importer of food, and the United States, a surplus producer, had aided Mexico before with credits for food purchases.
- **Surplus** U.S. grain and other products **were available**
- The secretary of agriculture, John Brock had arranged through the Commodity Credit Corporation to extend **more than $1 billion** of guarantees to U.S. exporters for sales of agricultural commodities to Mexico.

The second billion

- The second billion, by contrast, was raised only after extensive U.S. maneuvering and a significant amount of conflict between U.S. and Mexican negotiators.
- From the outset, the Americans and Mexicans had agreed that the most practical way to arrange emergency financing for Mexico was through some sort of **exchange of U.S. money for Mexican oil.**
- The problem, however, was determining **where** in the U.S. government this money could be obtained on short notice.
  - the Social Security Fund
  - Exchange Stabilization Fund (ESF)
  - the Department of Energy => the Strategic Petroleum Reserve (SPR).

The second billion

Proposals

1) about **$28** per barrel (selling on the world market for $32 per barrel) – **rejected**
2) the agreement take the form of an interest-bearing loan, with Mexican oil as repayment.
3) an offer for a $1 billion loan, which Mexico would repay over a fifteen-month period with $1.3 billion worth of oil shipments (**35%** percent interest rate) – rejected (not pay more than **20**)
4) a front-end negotiating fee in the range of **$100** million – **rejected**
5) a **$50** million negotiating fee – **rejected** - ***accepted***

The terms of the final agreement translated to an effective oil price of $27.40 per barrel (>30% in interest charges)

The BIS Loan

- Representatives from the central banks of **Belgium** and **Germany** expressed doubts about Lopez Portillo's ultimate willingness to accept IMF conditions in exchange for financial assistance.
- The **French** representatives were equally reluctant, and the Europeans felt in general that Mexico was essentially an "American problem."
- Under pressure from the **U.S. Fed and Bank of England** representatives, the Europeans agreed to provide **50%** of a $1.5 billion bridge loan to Mexico.
- The United States would supply the other **50%**.
- At the end of the session, Spain, as a gesture of support for its former colony, volunteered an additional **$175 million**. The United States matched that amount as well, bringing the total BIS loan to **$1.85 billion.**

The IMF’s interests

- The threat of the possible international financial crisis
  - a Mexican default → the banks' solvency collapse
- The crisis of the IMF as an institutition maintaining the world financial stability
- → **Immidiate financial assistance to Mexico**

The IMF’s behavior in negotiations

- Immidiate actions
  - On the Washington Weekend WW the IMF insisted that Mexico would have to immediately begin work toward developing an economic adjustment program
- Reluctunce to change initial conditions
  - Pre-election period in Mexico → appointment of a new director of Mexico's CentralBank, an opponent of the IMF's programs
- Diversification of risks
  - The U.S. government and the IMF also pressured commercial banks to participate in a loan to Mexico

The IMF Outcomes

- In December the IMF approved the adjustment program it had negotiated with Mexico.
- High adjustment by Mexico
  - (1) to reduce the budget deficit from 16.5% of GDP in 1982 to 8.5% in 1983, 5.5% in 1984, 3.5% in 1985, and near 0% in 1986;
  - (2) to phase out the triple exchange rate system and allow interest rates to rise;
  - (3) to increase the trade surplus to $8-10 billion;
  - (4) to reduce inflation;
  - (5) to cut the current account deficit.34
- Some concessions from the banks
  - The banks, forced by the creditor governments and the IMF, also made real concessions to Mexico in the form of loans they were otherwise reluctant to make.

Commercial banks’ interests

- About 1,400 commercial creditors
- The large money-center banks stronger incentives to continue lending
  - Large loans highly reliant on servicing from Mexico
  - European banks less enthusiastic about providing Mexico with new loans
  - The 10 largest American banks had a total exposure in Mexico of about $14 billion for both public and and private lending
- Smaller banks reduction their losses
- Mexican default would have bankrupted many lenders
- Creditor governments showed no inclination to use force to help banks recover their money
- Banks often reschedule loans in the hope of recouping their investments or simply cutting their losses

First Agreement with the Commercial Banks (August, 1982)

- meeting between Mexico and the chairmen of four major New York banks coordinating committee
- meeting with representatives of 115 commercial banks 14 of the largest bank creditors, based in 8 different countries on 3 continents, adopted the proposal to establish an advisory committee to negotiate new loan agreements
- IMF didn’t have enough resources to cover the borrowers’ financing requirements the Fund needed the help from banks

Commitment from Commercial Banks: November–December 1982

- raise exposure to Mexico by $5 billion, or the IMF program would not add up
- continue to roll over existing short-term credits
- agreement with the Mexican authorities on a rescheduling of intermediate and long-term debt
- “clean up” $1.5 billion in private sector interest arrears that would be outstanding by the end of 1982

Commercial banks’ outcomes

- Agreement between the Advisory Committee of Commercial Banks and IMF on the financing required to support the Fund program
- Agreement on the financing proposal between the Advisory Committee and the Mexican authorities

Financial Assistance to Mexico, August–December 1982

Source	Type	Date	Amount (Millions of U.S. dollars)[a]
United States			
Federal Reserve swap lines	90-day credit	August 4	700
	BIS-linked, short-term	August 28	325
Strategic petroleum reserve	advance payment for imports	August 24	1,000
Department of Agriculture	credit guarantees	August 15	1,000
Treasury (Exchange Stabilization Fund)	line of credit:	August 15	
	commitment		1,000
	drawn	(repaid August 24)	(825)
	BIS-linked credit	August 28	600
Bank for International Settlements[b]	short-term credit	August 28	925
Other bilateral (France, Israel, Spain)	swap lines	August	550
IMF	first credit tranche (immediate)	December 23	220
	extended arrangement (three-year commitment)		3,750
	initial drawing		(110)
World Bank			
Inter-American Development Bank			
Commercial banks	medium-term concerted lending	December 23	5,000

[a]IMF assistance denominated in SDRs; amounts converted to dollars at market exchange rate.
[b]Non-U.S. G-10 central banks, plus those of Switzerland and Spain.

Summary

- High adjustment by Mexico:
  - To IMF → considerable stabilization package
  - To USA → consessions on future relations
- USA and IMF as a lever of influence on commercial banks

Mexico's bargaining power	Influence
Size of a country/debt	Strong influence on USA and IMF (and commercial banks indirectly)
Strategic significance	Strong influence on USA
Nonconditional resources	Medium influence on the USA
Internal bargaining space	Week influence on the IMF

Thank you!