Mexico & Commercial Bank Creditors Reach Debt Reduction Agreement In Principle: Summary Of Developments

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July 13: US officials said the Bush administration was preparing to provide a bridge loan of $1 billion to $2 billion to Mexico. The loan was contingent on an agreement between Mexico and foreign commercial bank creditors. Unidentified officials told the New York Times that other countries and possibly commercial banks may also contribute to the bridge loan. The Bush administration hoped to present a tangible sign of progress on its debt initiative, known as the Brady Plan, at the July 14-16 G-7 economic summit in Paris. This sign would have been a complete or nearly complete debt reduction agreement between Mexico and its foreign commercial bank creditors. G-7 member-nations are Japan, West Germany, France, Britain, Italy, Canada, and the US. In addition to G-7 leaders, French President Francois Mitterrand invited more than 20 other heads of state, many from major debtor nations, to participate in Bastille Day festivities. The presidents of Mexico, Brazil, Venezuela and Uruguay called for a summit meeting of debtor and creditor nations. The French government endorsed the proposal. The US opposes such discussions, based on Washington's argument that debt problems must be resolved on a country-by-country basis. July 14: At the Paris G-7 economic summit, President Bush's advisers were toasting a tentative pact between Mexico and US bankers. Major features of the tentative agreement consist of three major options for creditor banks. (1) Write off 35% of principal, in exchange for bonds on the reduced amount at an interest rate slightly less than the current market interest rate. The International Monetary Fund and the World Bank would lend Mexico money to guarantee parts of the remaining principal and interest. (2) Maintain current face value of loans, while lowering interest rates to a fixed 6.25%. (3) New loans over the next three to four years. In 1989, Mexico is scheduled to pay nearly $10 billion in debt service. The Mexican government has said service payments would leave the country about $4 billion short of foreign exchange requirements. Some US bankers disagree, arguing that because Mexico has underestimated oil revenues, it will fall $1.5 billion short. Jeffrey Sachs, Harvard economics professor and adviser to Latin American governments, said there had been "an inordinate rush to get an agreement, any agreement, before the summit." Shafiqul Islam, senior fellow at the Council on Foreign Relations, told the New York Times that he believed the banks and Mexico were "still far apart" on major issues. He said the agreement is partly a "public relations thing to build confidence that the talks haven't collapsed completely." Initially, the banks sought to limit the first option to money loaned before 1982 ($38 billion). The banks have since agreed to include all $54 billion. Some banks still wish to limit the length of the agreement for the second option to prevent bearing interest rate risk for 30 years. As of July 14, amounts and terms on new loans have not been agreed upon. Citibank chief William Rhodes, head of the 15-bank committee representing Mexico's commercial bank creditors, and Mexican Deputy Finance Minister Jose Angel Gurria said the accord would give Mexico a total of $3 billion in "benefits" in 1989, comprised of new loans and debt service reduction. Mexico had originally asked for a 55% reduction in its foreign debt. Rudi Dornbusch, professor at the Massachusetts Institute of Technology and adviser to the Mexican government, said, "The Mexicans made surprising concessions. I don't see how they can
afford them." In addition, critics say the agreement is flawed because Mexico cannot make its own choices about whether to get debt relief or new loans. This decision is left to each individual bank. According to Riordan Roett, professor at Johns Hopkins and expert on Brazil: "Brady and the US government want others to pick up the cost of a policy problem. Latin American debt is a foreign policy question that the Bush administration, like the Reagan administration, refuses to accept as a foreign policy question. The banks are willing to share responsibility, but they want partners." Bankers argue that the Bush administration could guarantee portions of the debt or interest if the banks write off portions of their loans. Guarantees would help lower interest rates on the remaining debt. Bankers also want accelerated tax benefits for debt writeoffs. A recent Internal Revenue Service ruling limited the tax advantages of taking losses on writedowns in principal. Most US banks have set aside reserves to cover losses they expect to incur on Latin American loans. Banks have set aside reserves averaging 30% of the face value of loans to the region. While some banks expect to write off as much as 35% of the face value of their loans, they can deduct the writeoffs from income and obtain a tax benefit. After taxes, the highest writeoff option would cost the banks 23% of the face value of the loans which would be covered completely by the reserve funds. While these operations would have no effect on net income, the use of reserves would reduce bank capital. Compared to seven years ago, loans to Latin America represent a much smaller percentage of bank capital. Mexican debt is currently selling for about 40 cents on the dollar on the secondary debt market, compared to 20 cents for Argentine debt, and 30 cents for Brazilian debt. Bush and President Carlos Salinas de Gortari failed, however, to conclude a debt reduction agreement. July 18: US Rep. John LaFalce (D-NY) said the Paris summit may have produced a recognition by both the private banks and the Bush administration that Brady's plan cannot work without more direct government intervention. LaFalce supports the establishment of a new international agency to take the lead on deciding how to divide losses on "bad" Third World loans. "They realize that the bank advisory committees can't facilitate it," LaFalce said. To apply pressure on private banks, LaFalce and other congresspersons have introduced legislation that would effectively reduce bank profits if they continue resisting substantial voluntary reductions in developing nations' debt. July 19: US Treasury Secretary Nicholas Brady told the Joint Economic Committee of Congress he expected an agreement "reasonably soon" between commercial banks and Mexico, and that G-7 nations supported his debt reduction strategy. He claimed that the G-7 endorsement would put pressure on commercial banks to be more flexible in negotiating agreements with debtor nations. An unidentified banking source in New York told Notimex that the agreement under discussion would include a retroactive clause to go into effect in 1989. The month, said the source, had not yet been defined. The banks, said the source, would likely insist on July 1, while Mexico will to establish a retroactivity start-date in April, or when the negotiations commenced. This week, Mexico managed to persuade the bankers to drop a clause linked to the reduced fixed interest rate option. Under the "step-up" clause, once economic growth is resumed, interest rates would automatically increase to market levels. According to Notimex, the most important issue causing delays is the banks' insistence on a "recovery" clause linked to the first option of reducing debt face value by 35% in exchange for 30-year bonds at the remaining principal value. The clause is also linked to economic recovery, or oil prices. Once economic recovery is achieved, Mexico would turn over to the banks savings accumulated as result of the reduction agreement. According to oil market analysts, such as Harvard University's William Hogan, petroleum prices will steadily increase in the 1990s. The price per barrel of crude, they say, could reach $50. July 20: Notimex reported that financial guarantees are another source of uncertainty for the banks causing delay in finalizing an agreement with Mexico. Mexico has received a total of $7 billion from the World Bank, the IMF, and Japan to
use as guarantees in its debt reduction programs. Commercial banks insist that these monies be made available immediately, while the institutions have opted for disbursement in defined stages. July 21: Negotiations in New York between Mexican government representatives and the committee representing the country's commercial bank creditors were suspended. Participants agreed to reconvene on July 22 in Washington to resume the talks at the "highest level." July 23: Unidentified sources told Notimex on Sunday afternoon that "substantial progress" had occurred and that an agreement was imminent. The banks, said the sources, had reportedly agreed to drop the recapture clause linked to the first option (see above). Later, Mexican government sources announced that an agreement in principle had been signed by the two sides. Notimex said the agreement calls for a 35% reduction in principal on $54 billion owed to private banks, interest rate reduction to about 6.25% on remaining debt, and loans of about $3 billion per year for the next four years. Notimex said the package will have the financial backing of Japan and Spain, and that the US would provide a bridge loan of about $2 billion to tide the nation over for the next six months. An unidentified source close to the talks told Notimex, "With this accord we have achieved our goal of reducing from 6 to 2% (of GDP) our net transfers abroad." Participants in the talks held at the Federal Reserve building in Washington included IMF director Michel Camdessus, World Bank president Barber Conable, Inter-American Development Bank president Enrique Iglesias, US Federal Reserve chairperson Alan Greenspan, and US Treasury Secretary Nicholas Brady. The final phase of the negotiations will focus on financial guarantees. On Sunday evening in a nationwide broadcast, President Salinas de Gortari described the agreement as historic. "Now Mexico can leave the crisis behind," he said. Concluding, he called on the nation to join him in singing the national anthem and the TV programs cut to a shot of the Mexican flag. A Finance Ministry statement issued shortly before midnight described the deal as "an agreement in principle." The extent of commitment of Mexico's more than 500 commercial bank creditors is not clear. In addition to describing the banks' three "menu options," the ministry's statement also reported on an apparent revision of the "recovery" clause linked to the first option. The clause states that after 1996, if oil prices "remain substantially higher in real terms," the terms of the agreement will be reduced. In brief, Mexico would have to start paying more principal and/or more interest than the reduced amounts indicated in the accord. The ministry statement said the accord contained a contingency mechanism under which Mexico would receive more financial aid if oil prices fall below a certain, unspecified level. [Mexico has based its 1989 budget on an average oil price of $10 a barrel, a figure the creditor banks say is too low since the price has been several dollars higher for most of this year.] The statement said the third or new loan option available to creditor banks covered a four-year period and allowed banks to provide fresh money worth the equivalent of 25% of the nominal value of outstanding loans. It gave no figure but banking sources cited by Copley said this could be worth $3 billion a year of new loans for the next four years. (Basic data from New York Times, 07/14/89; Washington Post, 07/14/89, 07/15/89; AP, 07/19/89, 07/23/89; Notimex, 07/19-21/89, 07/23/89; Copley News Service, 07/24/89)