VI Mexico's External Debt Policies, 1982–90

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Since the outbreak of the 1982 "debt crisis," external debt-management policies have played a critical role in the Mexican authorities' efforts to restore sustained economic growth in the context of internal and external financial stability. The authorities, recognizing the heightened awareness of the adverse impact of growing public sector indebtedness on private sector confidence and economic growth, placed increased emphasis on the need to lower debt-servicing obligations by reducing contractual claims rather than rescheduling of payments falling due. The primary focus was on reaching agreements with bank creditors to restore access to voluntary international capital market financing. This reflected the importance of bank debt in Mexico's total indebtedness and the greater preparedness of Mexico's official creditors to provide new financing. The authorities' efforts toward a comprehensive bank debt restructuring included the signing on February 4, 1990 of a far-reaching financing agreement affecting some $48 billion of Mexico's estimated total indebtedness of $95 billion at the end of 1989. The agreement incorporated an innovative "menu" of financing options featuring principal reduction, interest rate reduction, and a new money option. It also included waivers for future market-based debt-reduction operations, as well as a "value recovery facility," linking incremental debt-servicing payments to better-than-anticipated developments in Mexico's oil export prices.

Appropriate debt restructuring has had a dramatic impact on Mexico's economy, together with the sustained implementation of a comprehensive medium-term economic adjustment and reform program. In addition to reduced debt-servicing obligations, the package contributed to a sharp improvement in private sector perceptions of Mexican transfer risk. Diminished concerns about Mexico's external indebtedness were reflected in a sudden and substantial fall in real domestic interest rates, a surge in domestic share prices, a recovery in secondary market prices for Mexican external bank claims, and a reduction in interest rates on foreign bond issues. These developments were associated with large private capital inflows—in the form of foreign direct investment and the repatriation of flight capital—and the restoration of Mexico's access to voluntary international capital market financing.

This section analyzes the evolution of Mexico's debt-restructuring approach from the outbreak of the 1982 debt-servicing problems up to the recent restoration of access to voluntary financing. It discusses the key elements of the approach, the manner in which they were implemented, and how they developed into comprehensive debt and debt-service reduction operations. This provides the basis for an analysis of the country's return to voluntary capital market financing—an issue addressed in greater detail in the next section. This section is organized as follows: The first part outlines the background to the 1982 crisis and the authorities' initial approach, including an analysis of the elements that led to the growing consensus, both at home and abroad, on the need to address the debt problem through debt-reduction operations rather than repeated rescheduling and new money exercises. The second describes the authorities' debt-reduction approach, focusing in particular on the structure of the bank debt-reduction package finalized in 1990 and the associated debt-equity program. The last part analyzes the 1990 package's direct and indirect impact on the Mexican economy. It also outlines some of the implications for debt-management policies in what has been labeled by some as the era of "life after debt."

Developments in Mexican debt issues have had effects that go even beyond their contribution to the restoration of the country's medium-term viability and the rationalization of creditors' balance sheets. In effect, Mexico's bank packages are often viewed as having created precedents for more generalized adaptations in debt-restructuring terms. At the same time, Mexico has been among the first developing countries to benefit from international initiatives concerning commercial bank debt restructurings, such as the Baker Plan and Brady Initiative. Moreover, it was among the first countries with recent debt-servicing problems to restore access to voluntary financing from international loan, equity, and bond markets. For these reasons, the present analysis of Mexico's
Debt-management policies is conducted within a broader framework emphasizing the two-way interactions between developments in Mexico and the evolution of the “international debt strategy.”


Emergence of Debt-Servicing Problems

In August 1982, Mexico announced to its commercial bank creditors that it was unable to meet fully its scheduled debt-service payments. It requested a three-month moratorium on principal payments and the formation of a bank “advisory group” to negotiate the restructuring of its bank claims. The action is often regarded as marking the outbreak of the “international debt crisis,” since it was followed by similar developments in many other developing countries. This, in turn, was reflected in a sharp increase in debt-rescheduling agreements, with the average number of agreements a year increasing from 4 in 1978–81 to 18 in 1983–84 for bank debt, and from 4 to 15 in the case of Paris Club debt.1

Although the debt problems of Mexico and several other developing countries came to prominence in 1982, their causes reflected developments over a number of years. The emergence of severe debt-servicing difficulties was due to the implementation of inappropriate domestic policies (particularly overexpansionary fiscal and monetary stances and maintenance of an overvalued exchange rate), unfavorable exogenous developments (including adverse terms of trade and international interest rate developments, sluggish demand in industrial country trading partners, and growing protectionist tendencies abroad) and a sharp cutback in the availability of private external financing. The combined effect of these factors was a reduction in debtor countries’ debt-servicing capacity at a time of increasing debt-service payments obligations.

In Mexico’s case, pursuing overly expansionary domestic demand-management policies resulted in a sharp deterioration in the fiscal balance. This was accompanied by a sharp appreciation of the real effective exchange rate, an acceleration in inflation, and a marked deterioration in the current account deficit in 1981, despite the sevenfold increase in petroleum receipts.2

The country’s worsening current account position was financed in large part through increased external borrowing, especially by the public sector. As a result, external debt grew from under $30 billion at the end of 1977 to $75 billion at the end of 1981; in 1981 alone, the country’s external indebtedness grew by almost 50 percent (Chart 11). The situation was aggravated by the deterioration in the structure of debt, with the share of short-term claims (with maturity of less than one year) in total debt increasing from 13 percent to 30 percent at the end of 1978 to 30 percent at the end of 1981. Accordingly, the Mexican economy was extremely vulnerable to the major adverse exogenous developments that occurred in 1981–82, including the sharp increase in international interest rates.

Mobilizing nonconcerted external financing sufficient to cover the balance of payments requirements became more difficult during 1982 as concern mounted in finan-

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1 Details on commercial bank and Paris Club debt reschedulings are contained in the International Monetary Fund’s annual reviews of international capital markets and multilateral official debt reschedulings, respectively.

2 The current account deficit increased from $2.3 billion (equivalent to 3.1 percent of GDP) in 1978 to $13.9 billion (5.8 percent) in 1981. The deficit had averaged $2.1 billion in the 1970–77 period (3.0 percent of GDP). Discussions on economic developments during this period are contained in Cunby and Obstfeld (1983), Soils and Zedillo (1984), and Zedillo (1985a and 1985b).
cial markets regarding Mexico’s deteriorating economic situation. The arrangement in midyear of what turned out to be the final voluntary bank syndication of $2.5 billion proved protracted—with only 75 banks accepting out of the 650 invited—despite the attractive pricing of the loan. Analysts have observed that by July 1982, “it became clear that the only debt-management expedient left was to continue rolling over short-term credits—at any price and at any maturity.”

New bond issues fell to $1.6 billion from $2.3 billion in 1981, while access to new short-term commercial bank credit lines was significantly curtailed. Yields on existing international bond issues rose sharply reflecting heightened risk perceptions among international investors. At the same time, domestic residents’ loss of confidence in peso-denominated assets caused a sharp growth in currency substitution (with the share of dollar deposits in total deposits increasing from less than 20 percent in the late 1970s to over 40 percent in 1981–82) and substantial private capital outflows (with capital flight estimated in the $17–23 billion range for 1980–82). Thus, despite a sharp contraction of imports and an improvement in the current account balance (by 2 percentage points of GDP), Mexico resorted to a substantial drawdown in reserves during 1982; by the end of the year, reserves stood at the historically low level of 2.9 months of imports.

Mexico’s debt-servicing problems were recognized to have adverse implications not only for the country’s growth and development prospects but also for the financial integrity of the international banking system. For example, by 1982, the capital of U.S. banks covered only 50 percent of external claims on developing countries, with Mexico accounting for a significant portion of these claims. The nine largest U.S. money center banks had an exposure to Mexico (i.e., claims adjusted for guarantees and other risk transfers) of $13 billion at the end of December 1982; this was equivalent to 45 percent of their total capital and accounted for 15 percent of their exposure to all developing countries. The systemic implications of developing countries’ debt difficulties led to a recognition of the need to approach the problem within a comparably systemic “international debt strategy.” Based on increased coor-

dination among debtors, creditors, and international financial institutions, the strategy sought to strike an appropriate balance between financing and adjustment, while ensuring equitable burden sharing among creditors. Under the strategy, which was applied on a case-by-case basis, debtors were urged to adopt adjustment programs that would restore financial viability, and official bilateral and commercial bank creditors were urged to provide liquidity support through principal reschedulings and new money facilities. The Fund and the World Bank were given a central role in assisting in the formulation and implementation of debtors’ adjustment policies and mobilizing external assistance in support of these policies. 

### Period of Repeated Debt Reschedulings

After intense negotiations, the Mexican authorities succeeded in rescheduling debt-servicing obligations to commercial banks, in the context of an adjustment program aimed at macroeconomic stabilization. The bank agreement, which was made effective in March 1983, included (1) the rescheduling over eight years (including four-year grace periods) of $19 billion of obligations (reflecting 100 percent of eligible principal falling due over the period August 23, 1982–December 1984); (2) the concerted rollover through the end of 1986 of $5 billion of short-term interbank obligations; and (3) $5 billion in new money through a medium-term (six years, including three years’ grace period) international syndicated credit. Thus, in total, the package was to provide Mexico gross cash flow relief of some $30 billion over the period 1983–86. In an attempt to introduce a degree of “fairness” among the 500-plus participating banks, an individual bank’s new money contribution was based on its outstanding exposure to Mexico as of August 1982. Moreover, the inclusion of short-term obligations ensured that several late lenders were not “bailed out.”

Pending the satisfactory conclusion of the bank financing package, Mexico received substantial bridge financing from official sources. These included advance payments for sales of petroleum and $4 billion of official bridge loans, of which $925 million each from the Bank for International Settlements (BIS) and the U.S. authorities (Treasury and Federal Reserve Board) and swaps with Spain and France for $450 million. In addition, Mexico signed a rescheduling with the Paris Club in June 1983 covering $1 billion of obligations to 15 industrial country creditors.

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5. A discussion of currency substitution in Mexico is contained in Ortiz (1983).
10. The new money facility carried spreads of 2.25–2.5 percentage points over the London interbank offered rate (LIBOR), while the spreads on the rescheduled debt amounted to 1.25–1.5 percentage points.
11. The rescheduling of Mexican private debt is not addressed in this paper.
The terms of the Mexican financing package (coverage, interest rate, and maturity structure) created precedents for subsequent debt reschedulings for other heavily indebted developing countries. It also established procedures for mobilizing concerted financing from various creditors; for example, in the approach taken by the international financial institutions as they sought to ensure the effectiveness of their role as catalysts for financial assistance from official bilateral and commercial bank creditors. The December 4, 1982 telex sent by the Mexican Secretary of Finance to bank creditors stated that the Managing Director of the International Monetary Fund would not recommend to the Executive Board approval of an arrangement in support of the Mexican program “without assurances from both official sources and commercial banks that adequate financing was in place... and the principles of a realistic restructuring scheme would be favorably considered by the community.”

This approach was formalized through the subsequent implementation of the “critical mass” procedure. Under this procedure, the entry into effect of a Fund arrangement was made conditional on sufficient formal commitments for bank support (usually for at least 90 percent of the programmed new money). In addition to providing assurances that the program would be adequately financed, the procedure assisted in limiting free-rider problems—the latter associated with withdrawals of banks that would place an “undue” financing burden on the remaining participating banks.

Despite the implementation, although with some slippages, of substantial corrective measures, Mexico faced recurrent problems in meeting contractual debt-service obligations. Accordingly, the 1983 commercial bank rescheduling was followed by similar but more comprehensive agreements in 1984 and 1985. Throughout this period, as well as in later years, Mexico remained current on its interest obligations to banks. As in 1983, the 1984–85 agreements centered on the reduction of payments to banks through principal reschedulings and on de facto interest refinancing through concerted new money facilities. Thus, in April 1984, Mexico secured a new money facility of $4 billion; this was followed by the March 1985 multyear rescheduling covering some $30 billion of principal obligations corresponding to previously rescheduled debt, payments falling due in 1987–90, and obligations on the 1983 syndicated credit. The agreement also committed Mexico to introducing a debt-equity conversion program. This package foreshadowed several of the elements of later restructurings, including the gradual move toward stock-of-debt operations and allowance for banks to “exit” at a discount through debt-equity swaps.

The debt-equity program was initiated in April 1986, allowing the exchange of eligible credits for capital stock. New authorizations under the program were suspended in November 1987 in response to, inter alia, concerns about the program’s inflationary pressures, doubts about the additionality of the related foreign investments, and public perceptions that Mexican capital was being sold at “unduly low prices.” During 1986–90, external bank claims of some $3.8 billion were exchanged under the program for equity valued at $3.2 billion, involving a weighted average discount of 17 percent (Chart 12).

Mexico’s external accounts improved as a result of the implementation of adjustment efforts. By 1985, the current account had moved into surplus (amounting to $1.3 billion, equivalent to 0.7 percent of GDP, mainly due to a 45 percent reduction in nominal import values since 1981) and gross international reserves (excluding gold and balances under payments agreements) had recovered to 4.3 months of imports. The sustainability of this improvement, however, was increasingly questioned. Given the extent and nature of the initial economic and financial imbalances, the adjustment efforts were accompanied by an initial deceleration of economic growth. Despite the repeated debt restructurings, debt-service payments averaged around 35 percent of receipts from exports of goods and services, with the bulk of payments representing interest obligations. Moreover, the economy remained vulnerable to adverse exogenous shocks at a time when access to concerted bank loan facilities became increasingly difficult as a result of weakening creditor cohesion and associated free-rider problems. This compounded the impact of the near total absence of voluntary external bond financing.

These types of concerns were instrumental in the decision to strengthen the international debt strategy through a plan put forward in October 1985 by U.S. Treasury Secretary Baker (the “Baker Plan”). The plan maintained a case-by-case approach and called for (1) the implementation by debtor countries of strong growth-oriented adjustment policies; (2) increased structural adjustment-

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15 These dates correspond to the finalization of agreements with all banks, rather than the initial agreements with the steering committee of bank creditors.
16 The 1984 new money facility carried better terms than that of 1983, including a 10-year maturity, 5½ years’ grace period, and spreads of 1½–1½ percentage points over LIBOR.
17 The modalities of the program were set out in Comisión Nacional de Inversiones Extranjeras (1986).
18 In its 1986 Annual Report, the Bank of Mexico warned that “This scheme can have inflationary effects in that it has recourse to the issuance of currency to finance the repurchase of foreign debt. To avoid these effects it is necessary for the Government to finance its reacquisition of its debt through the placement of securities [which has] the disadvantage of exerting upward pressure on the internal cost of credit and displacing private users of capital.” Some of the costs and benefits of debt-equity swaps in general are discussed in United Nations Center on Transnational Corporations (1990).
19 The tightening of economic and financial policies is discussed in Gil Diaz (1987) and Dornbusch (1988).
20 After declining to $1.6 billion in 1982, Mexican international bond issues averaged only $72 million a year in the next five years, with three of these years characterized by no new issues.
Debt-Management Policies in 1982-87

The agreement contained the traditional new money and principal rescheduling elements, as well as growth and investment contingency financing facilities. Specifically, it included (1) a new money facility of $5 billion; (2) $1 billion in cofinancing with the World Bank; (3) $2 billion in growth contingency and contingent investment support facilities; and (4) the rescheduling of $45 billion of principal claims. The agreement also carried significantly more favorable terms, including maturities of up to 20 years (including seven-year grace periods) on the rescheduled portion and a uniform spread of 13/16 of 1 percentage point over LIBOR.

As regards official bilateral debt, Paris Club creditors granted a multi-year rescheduling agreement in September 1986 covering $2 billion of non-previously rescheduled obligations falling due between September 1986 and March 1988. Mexico had also received exceptional support in the form of a $1.6 billion bridge financing from industrial country governments and other Latin American countries.

Secondary Market for Bank Claims

The protracted nature of bank restructuring exercises and the introduction of officially sanctioned debt-equity conversions contributed to a marked growth in the importance of the secondary market for bank claims on developing countries. Although there are no comprehensive data on the size of the market in its early stages, partial indicators point to a steady growth throughout the second half of the 1980s. Annual turnover is estimated to have increased from less than $5 billion in 1985-86 to $30-40 billion in 1987-88, with Mexican paper accounting for a significant proportion of this trading. The bulk of the transactions reflected banks swapping assets as a means of reallocating their loan portfolios, purchases of claims for use in debt conversions, and retirement by the corporate sector of own-debt at a discount.

Secondary market prices exhibited considerable volatility during these years around a declining trend. As illustrated in Chart 13, the secondary market price for bank claims on Mexico declined from 63 cents on the dollar (discount of 37 percent) in early 1986 to around 40 cents on the dollar (60 percent discount) at the end of 1988. This decline reflected Mexico-specific factors (including the suspension of the debt-equity program) and, perhaps more important in this period, general market influences. Most significant among the latter was the announcement

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21 Agreement on the "critical mass" for the new money facility was reached in late 1986.
22 Additional information on the package is contained in Wertman (1986) and Gardner (1986).
23 Disbursements from the facility included $545 million from the United States, $400 million from 12 European countries, and $355 million from Argentina, Brazil, Colombia, and Uruguay.
broadly met, despite generally more protracted negotiations and uncertainties about their outcome, especially in the area of new money mobilization. Questions increased, however, both in Mexico and in other highly indebted countries, as to the prospects for medium-term external viability. The relaxation in short-term liquidity constraints was accompanied by a growth in contractual debt obligations, contributing to a further deterioration in market sentiments regarding the creditworthiness of borrowing countries and the eventual restoration of access to voluntary foreign financing.

There were thus growing concerns regarding the impact of new money and principal reschedulings on highly indebted countries' growth potential—that is, the so-called debt overhang concerns. Although these were expressed in various ways, the fundamental issue involved the implications of growing indebtedness for private sector investment activities. Specifically, as the stock of contractual debt surpasses agents' perceptions of the debtor country's capacity to service it, foreign and domestic assessments of country risk deteriorate significantly. Thus, even in the context of sustained domestic adjustment efforts, questions arise about the authorities' ability to meet debt-service payments without, inter alia, further increases in effective taxation. The latter lowers the expected return on domestic investment activities, thereby discouraging inflows of foreign direct investment resources and encouraging capital flight and diversion of resources to consumption. In an attempt to counter the associated credit rationing, domestic borrowers are forced to offer relatively high rates of return to foreign and domestic savers to compensate for the increased risk premiums. In some cases, such rates may impose costs that are in excess of the expected return on the debt-financed activities or prove insufficient to relax the credit rationing. These adverse effects cannot be addressed through rescheduling of debt-service payments but, rather, require dealing with the overall stock of indebtedness through operations to reduce debt and debt service.

The increasing emphasis on operations to reduce debt and debt service was accompanied by growing evidence of banks' willingness to dispose of developing country claims, often at substantial discounts. This reflected banks' willingness to dispose of developing country claims, often at substantial discounts. This reflected banks' growing ability to "exit"—partly owing to the gradual

Concerns About Excessive Indebtedness

As noted earlier, the main objective of the financing packages during the 1982–87 period was to provide developing countries with the short-term cash flow support needed to facilitate the restoration of balance of payments viability. The objective of liquidity support was

—partly owing to the gradual

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strengthening of their capital base—as well as greater incentives to do so as a result of more stringent regulatory provisioning requirements on developing country exposure and prospects of seemingly endless episodes of concerted new money packages based on existing bank exposure. The erosion of cohesion within the banking community intensified, and seriously impeded the coordination needed to formulate and implement concerted new money packages. These developments were part of a larger phenomenon of portfolio rationalization and reconsideration of asset structures by international commercial banks. In these circumstances, increased attention was directed to the use of a “menu” that includes a range of several financing options to reconcile banks’ differing circumstances.

Operations to Reduce Debt and Debt Service

Mexico appeared to meet many of the “stylized facts” associated with the above-cited concerns about a high stock of external debt. The economy’s external indebtedness had grown from some $75 billion (45 percent of GDP) at the end of 1981 to $108 billion (76 percent of GDP) by the end of 1987. As a result, and despite a sustained growth in nonpetroleum exports, the debt service ratio (before rescheduling) rose in the mid-1980s, fluctuating in the 60–80 percent rate in 1985–87; interest obligations amounted to around one fourth of receipts from exports of goods and services during this period (Chart 14). This compared to debt-service and interest-service ratios of around 16 percent and 6 percent, respectively, for developing countries without recent debt-servicing problems. Moreover, as shown in Chart 15, Mexico’s debt-service ratio after restructuring during this period remained above the average for the group of developing countries with recent debt-servicing problems, with the margin increasing through the mid-1980s.

The continued deterioration in Mexico’s debt situation was accompanied by increasing uncertainties about timely and adequate new financing from banks. A growing number of bank creditors (particularly smaller ones) resisted further increases in exposure associated with concerted new money exercises. The associated concerns about the country’s financial prospects contributed to capital flight, including in the form of a sharp rise in deposits held outside Mexico by Mexican residents.

In these circumstances, the authorities sought ways of gaining debt relief through a reduction of claims at discounts from face value. Although the international climate was not conducive to a comprehensive debt-reduction package, there was scope for some partial operations. In the context of a voluntary market-based approach, this required a bank agreement to waive clauses governing the prepayment of principal and the sharing of payments among creditors grouped together through syndications.

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27 In the case of U.S. banks, for example, the ratio of capital to external claims on developing countries increased from 49 percent at the end of 1982 to 119 percent at the end of 1987.
30 The 1987 new money package, for example, was delayed substantially by reluctance on the part of U.S. regional banks to participate.
31 For example, the Fund’s International Financial Statistics (IFS) reported stock of Mexican residents’ deposits in U.S. banks increased from $7.2 billion at the end of 1981 to $14.5 billion at the end of 1986 (IMF (1988)).
and rescheduling agreements. Moreover, to the extent that debt reduction involved collateralized debt exchanges, it was also necessary to obtain a waiver of the negative pledge clause.\footnote{The sharing clause commits creditors that are party to an agreement to share on a proportional basis any payments received from the debtor. The negative pledge clause commits the debtor not to create for new debt a lien on any present or future assets or revenues without offering to share that security with existing creditors on an equal basis.}

**Aztec Debt Exchange**

In late December 1987, the Mexican authorities and Morgan Guaranty announced a debt-conversion operation involving the voluntary exchange of bank claims for newly issued 20-year bullet repayment bonds; the principal on these bonds was fully guaranteed by U.S. Treasury zero-coupon bonds. The new Aztec bonds (also referred to in the literature as the Mexico-Morgan bonds) carried a spread of 1½ over LIBOR, twice that on the rescheduled debt.\footnote{Additional information on the exchange is contained in Folkerts-Landau and Rodriguez (1989).}

The bonds were allocated through an auction completed in February 1988, with 139 banks tendering 320 bids for a total value of $6.7 billion of bank claims. The authorities accepted bids from 95 banks for a total face value of $3.7 billion in claims—substantially below their goal of $10 billion. The claims were exchanged for $2.6 billion in new bonds. The new bonds—which were reportedly acquired primarily by Japanese banks, followed by U.S. (mainly regional) and Canadian banks—were collateralized through the Mexican purchase of $0.5 billion of U.S. Treasury zero-coupon bonds.

While welcoming the results of the debt exchange, the Mexican authorities emphasized the need to expand the scope of debt and debt-service reduction beyond the small-scale operations that had been undertaken to date. For example, in setting out the economic objectives for his administration, President Salinas emphasized a reduction in the “historical” stock of debt, lowering the net external resource transfer, and securing multiyear agreements with creditors in order to reduce the uncertainty caused by recurrent debt negotiations.\footnote{Aspe Armella (1990).}

Similarly, in a 1988 presentation to other Mexican officials, Angel Gurría, Mexico’s debt negotiator, noted that “every step would be taken to explore market-based, voluntary debt alternatives. If they should fail, the international community must offer a solution or else face unilateral action.”\footnote{Hacienda’s “Política de Deuda y Financiamiento Externo,” quoted in Dornbusch (1988).}

**Comprehensive Debt-Reduction Operations**

The Aztec debt exchange had an impact that went well beyond its modest net debt-reduction effects. It represented the first officially sanctioned, market-based, bank debt-reduction exercise for a large middle-income developing country debtor.\footnote{In November 1987, Bolivia finalized waivers from its commercial bank creditors to buy back its debt at a discount. During the first quarter of 1988, banks tendered about half of the outstanding principal claims, the bulk of which were bought back at a discount of 89 percent. The buy-back was financed by official grants to Bolivia administered and disbursed through a “voluntary contribution account” held at the IMF.} It confirmed the gradual movement toward debt- and debt-service reduction operations based on a voluntary market-based approach, and the associated recognition that some write-down of contractual debt to banks was inevitable in some cases. After a number of proposals for official initiatives—emanating from academic, banking, and official circles—industry...
trial country support for comprehensive commercial bank debt-reduction operations in highly indebted developing countries coalesced around the proposals put forward in March 1989 by U.S. Treasury Secretary Brady.\(^{38}\)

The Brady proposals stressed four key elements: (1) the adoption of medium-term reform programs in debtor countries, with special emphasis on measures to encourage investment and capital repatriation; (2) a stronger emphasis on instruments that reduce debt and debt service as a complement to new lending; (3) the use of international financial institution resources to facilitate debt- and debt-service reduction operations; and (4) continued creditor government support through Paris Club reschedulings, support of international financial institutions, ongoing export finance, and a review of constraints to debt operations imposed by the regulatory, tax, and accounting regimes.\(^{39}\)

**The Bank Package to Reduce Debt and Debt Service**

The above-mentioned proposals established the framework for the July 1989 preliminary agreement on the restructuring of $48 billion of Mexico's bank debt through a menu incorporating principal and interest reduction instruments. In April of that year, Mexico initiated discussions with its bank creditors on a comprehensive package to reduce debt and debt service. Such a package was to support the implementation of the authorities' medium-term economic program, including important structural reform efforts (in the areas of production, trade, investment, and financial services) and prudent fiscal, monetary, and pricing policies.\(^{40}\)

Preliminary agreement on the broad elements of the package was reached with the advisory committee of banks on July 23 and the "term sheet" for the agreement was finalized on September 13 and subsequently marketed to over 500 banks. With positive responses from almost all bank creditors, the financing package was signed on February 4, 1990. The exchange of instruments under the agreement took place on March 29, 1990, or almost one year after the initiation of the negotiations.

In dealing with the bulk of Mexico's medium- and long-term indebtedness to banks, the financing package offered creditors a menu with three options.\(^{41}\) The first option involved the exchange of claims for 30-year bullet discount bonds (at 65 percent of face value) carrying a "market interest rate" (spread of \(\%\) over LIBOR) and collateralization of all principal obligations and 18 months of interest on a rolling basis. The second option involved the exchange of claims for 30-year bullet reduced interest par bonds (fixed interest rate of 6\%\) percent), with the same collateralization structure. Taking account of the residual Mexican risk in these new instruments, their implicit pricing was broadly consistent with secondary market prices for bank claims prevailing at the time of the initial agreement on the package. The third option involved a net increase in bank exposure through a new money facility for 1989-92 amounting to 25 percent of eligible exposure, carrying a spread of \(\%\) of 1 percentage point over LIBOR and repayable over 15 years (including 7 years' grace). The financing package also granted Mexico the necessary waivers to conduct additional market-based debt- and debt-service reduction operations in the future.

A total of $4.4 billion of claims was allocated to the new money option, implying bank loan disbursements of $1.1 billion over the three-year period, well below initial expectations. By contrast, the banks' response to the debt and debt-service reduction instruments was larger than expected. Banks accounting for $20.6 billion chose the discount bond option, while $22.5 billion of claims was allocated to the reduced interest par bonds. These bond instruments involved setting up collateral for a total of $7.1 billion, based on the net present value of the associated guarantees. The collaterals took the form of U.S. Treasury zero-coupon bonds (at a yield of 7.925 percent) for the principal guarantee and the establishment of an interest guarantee account at the Federal Reserve Bank of New York. The collateral was financed through loans from the IMF (total of SDR 1.3 billion—$1.7 billion at the end of January 1990 exchange rate—available over three years), the World Bank ($2.0 billion disbursed up front), and Mexico's own resources ($1.3 billion). In addition, the Japanese Export-Import Bank provided an incremental $2.1 billion of import financing over three years, thereby freeing an equal amount for funding the debt and debt-service reduction operations. Since not all of these resources were disbursed to Mexico up front, the authorities arranged for bridge financing from the banks of $1.2 billion.

\(^{38}\) See remarks by Secretary Brady to the Brookings Institution and the Bretton Woods Committee Conference on Third World Debt, reproduced in Department of Treasury (1990). The move on commercial indebtedness was preceded by adaptations in Paris Club rescheduling practices for low-income countries (known as the "Toronto Initiative") involving, inter alia, options to reduce debt and debt service for maturities falling due.

\(^{39}\) As summarized in U.S. Under-Secretary of the Treasury Mulford's 1990 statement to the House of Representatives' Subcommittee on International Development, Finance, Trade, and Monetary Policy, House Committee on Banking, Finance and Urban Affairs. See also Mulford (1989).

\(^{40}\) The main elements of the 1989-92 program, supported by a three-year Fund arrangement under the extended Fund facility and World Bank financing, are described in Kalter and Khor (1990).

\(^{41}\) Main features of the financing package are discussed in El-Erian (1990).
The new debt and debt-service reduction bonds (also commonly referred to as “Brady” bonds) carry a “value recovery” facility providing for incremental payments to banks should the real price for Mexican oil exports exceed $14 a barrel. These payments would start in 1996 and amount to 30 percent of the “windfall” oil revenue, subject to an annual limit of 3 percent of the banks’ eligible claims at the time of the agreement. In establishing the terms for this recapture clause, a delicate balance had to be struck between providing a more direct linkage between Mexico’s debt servicing capacity and its obligations (thereby allowing for a reduction in contractual noncontingent payments obligations) and avoiding excessive marginal taxation of incremental export receipts.

The Mexican authorities sought to introduce symmetrical downside financing contingencies in the event of unanticipated adverse exogenous events. This attempt did not succeed, however, reflecting banks’ general reluctance at that time to agree to increases in their exposure. (Banks also refused to include downside contingency financing in the subsequent financing agreements with Venezuela and Uruguay.)

Debt-Equity Program

Under the terms of the financing package, Mexico committed itself to resume the debt-equity program for a minimum amount of conversions of $3.5 billion (face value of debt) over a three-year period. The modalities for this program, announced in March 1990, specified, inter alia, (1) the range of eligible debt (that restructured under the 1990 package plus new money commitments); (2) modalities for conversion (auction mechanism, with successful bidders required to deposit, within ten days of the auction, claims in an amount of 5 percent of the swap rights awarded and having 18 months to acquire the remaining rights); and (3) the sectoral distribution of the allowable equity participation (infrastructure projects and privatization purchases—the latter subject to a ceiling of 50 percent of sales).

In formulating these modalities, the authorities sought to limit the negative consequences perceived to have been associated with the earlier debt-equity program. As noted earlier, these included potential adverse domestic liquidity implications, the scope for hidden subsidies, and unfavorable effects on future investment flows. To this end, the aggregate limit on conversions was derived consistent with the potential under the financing program for sterilization through issuance of domestic debt or for reduced total budgetary outlays, or for both. Moreover, the associated domestic liquidity creation was spread over a number of years. The announcement of strict adherence to the aggregate limit (and the relatively rapid allocation of swap rights within this limit—see below) reflected concerns among officials that an open-ended program would delay future untied private foreign direct investment inflows. At the same time, the authorities sought to ensure the additionality of the external resources and the positive externalities associated with the debt-equity operations through the specification of the allowable sectoral allocation. Finally, the adoption of an auction system with relatively few barriers to entry reflected the authorities’ desire for transparent and competitive pricing.

Impact of Debt Reduction

Magnitude of Debt Reduction

The discount bond option extinguished $7.1 billion of Mexican bank debt. At the same time, the par bond option reduced the contractual interest rate on $22.5 billion of claims, equivalent to an additional reduction of $7.9 billion in principal (based on then-prevailing interest rate conditions). Thus, in total, the bond instruments involved a gross effective principal reduction of $15.0 billion, representing some 16 percent of Mexico’s outstanding debt at the end of 1989.41

As regards the debt-equity program, auctions were held in July and October 1990. In the July auction, the authorities offered to convert $1 billion of claims (original face value) using a “marginal pricing” system. They accepted 27 of the 359 offers tendered, with the lowest successful discount amounting to 52.05 percent. In the second auction, the authorities reserved the right to increase the offered amount above the initially-specified limit of $1.5 billion. This limit was reached at a marginal discount of 53.15 percent. In view of the favorable offers, and to avoid the direct and indirect costs of holding an additional auction, the authorities proceeded to accept bids up to the global limit of $2.5 billion. This was achieved at a discount of 52.0 percent.

In total therefore, the authorities accepted to convert $3.5 billion of claims into equity at an average discount of 52.01 percent. The overwhelming majority of the successful bids involved par and discount bonds (as opposed to new money claims). If successful bids are fully exercised, the book value reduction in the post-package debt stock (i.e., after taking account of the discount bond

41 As noted earlier, the reduction in contractual claims required Mexico to provide partial collateralization (present value of $7.1 billion) for the debt and debt-service reduction bonds. This was associated with the acquisition of a “contingent foreign asset” (in the form of the zero-coupon bonds and cash balances at the Federal Reserve Bank of New York) that may be used in meeting final interest and principal payments on the bonds, provided Mexico remains current until then.
adjustments) would amount to $2.6 billion. As a result, the total gross effective debt reduction associated with the package would amount to some $17 1/2 billion (some 19 percent of external debt at the end of 1989).

Since the operations were market based (i.e., priced consistent with conditions on the secondary market for bank claims), they involved, on average, no change in banks' expected stream of receipts even though the contractual value of their obligations was reduced. Should Mexico meet fully its debt-service payments—and abstracting from the additional costs/benefits associated with provisioning requirements, tax allowances, and other institutional factors—the stream of receipts (measured in ex post net present value terms) would be larger, ceteris paribus, for holders of the debt and debt-service-reduction bonds as compared with creditors who exited fully through the debt/equity route. At the same time, however, the total yield for the bond holders would be below that for creditors who opted for larger Mexican risk exposure through the new money option. Finally, the relative yield ranking within the debt and debt-service-reduction bonds will depend, ceteris paribus, on developments in international interest rates. Thus, given that the bonds were broadly equivalent in net present value terms at the time of the initial agreement, LIBOR rates well below 9 percent would involve higher relative yields for holders of the par bonds.44

Cash Flow Impact of Debt Reduction

The direct impact of the package on Mexico's balance of payments will be felt through the savings in interest obligations. On the basis of international interest rates prevailing in 1990—which were much higher than at present—the gross saving amounts to some $1 1/2 billion annually on account of the bond exchanges and some $1/4 billion on account of the debt/equity conversions. After taking into account the financing costs of the collateral (including forgone interest receipts due to the use of Mexico's own reserves), the total annual net savings in contractual interest obligations amount to about $1 billion, equivalent to 0.6 percent of GDP (of which $1/4 billion (0.5 percent) on account of the bond exchanges).45 The beneficial cash flow impact of the package will increase over time as a result of the lower interest payments that Mexico will have to make as external financing requirements are met through the continued impact of the debt and debt-service reduction elements rather than new money. The package also reduced Mexico's vulnerability to unfavorable movements in international interest rates. Specifically, in excess of one fourth of Mexico's remaining debt is now subject to a fixed interest rate.

The financing package also involved the effective rescheduling of amortization obligations falling due, thus significantly changing the contractual maturity profile of bank indebtedness. Under the debt and debt-service reduction bonds, principal payments of $43 billion were deferred to a single payment due in 2020. Principal repayments on the remaining eligible claims were rescheduled over 15 years, including 7 years' grace. Unlike the reduction in interest payments, however, it may be assumed that the refinancing of principal obligations would have been granted under the previous rescheduling approach—albeit involving a series of debt negotiations.

Addressing Concerns About Excessive Indebtedness

More important than the direct cash flow impact is the change in the private sector's perceptions of Mexico's creditworthiness and economic prospects, brought about by the package. In the context of sustained implementation of sound economic and financial policies, the fall in Mexico's contractual debt obligations and the associated reduction in uncertainties about the need and outcome of periodic debt renegotiations contributed to a turnaround in private sector sentiment. This, in turn, facilitated the country's restoration of access to voluntary financing from international capital markets and enhanced its ability to attract foreign direct investment and repatriated flight capital.

A number of financial indicators illustrate the turnaround in private sector perceptions of Mexican risk. Domestic real interest rates declined by 20 percentage points (to around 10 percent a year, measured in ex post terms) immediately after the announcement of the preliminary agreement on the bank package—a decline was subsequently sustained. Domestic share prices rose sharply and the secondary market price for Mexican bank claims generally improved. By the end of November 1991, the ratio of the secondary market price of Mexican bank claims (calculated on the basis of the stripped yield for Mexican risk)46 to the weighted average of the other countries constituting the "Baker 15" group of heavily indebted developing countries had risen by around 40

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44 A comprehensive discussion of the distribution of the benefits of the package between Mexico and its commercial bank creditors is contained in van Wijnbergen (1990).

45 This factor has been reflected in secondary market price developments since the issuance of the bonds, with the par bonds appreciating at a faster rate than the discount bonds.

46 These calculations do not take into account profit and dividend transfers associated with the new participation obtained through debt/equity swaps.

47 The derivation of the Mexican price is based, inter alia, on adjusting (or "stripping") the reported discount and par bond market prices for the value of the principal and interest collateral, as well as a notional estimate of the value recovery feature.
percent as compared with its level before the announce-
ment of the package (see Chart 13). 44

Perhaps the most dramatic manifestation of the change
in perceptions of Mexican risk is provided by the extent
and speed with which the country has been able to restore
access to voluntary capital market financing—an issue that
is documented in more detail in the following section.
The implementation by Mexico of appropriate econom-
ic policies and the comprehensive debt restructurings
consistent with medium-term viability were precondi-
tions for access to such financing. The process was also
facilitated by the use of techniques addressing investors' con-
cern about transfer and credit risks—including the
use of credit enhancements in the initial phases of mar-
ket re-entry. 49

Mexican international bond issues rose from an esti-
imated $0.6 billion in 1989 to over $2 billion in 1990.
Preliminary data for the first three quarters of 1991 indi-
cate that a somewhat larger amount was raised during
this period. This greater volume of bond issues was placed
among a widening group of investors in industrial coun-
tries (primarily the United States, Germany, Spain, and
Switzerland), as well as reportedly mobilizing Mexican
resident capital held abroad—the latter appears to have
been particularly important in the initial phases of the
market re-entry process. 50

The relaxation in credit rationing on international bond
markets was accompanied by a sharp improvement in
terms. By the second half of 1991, average yield spread
at issue fell to around half the level prevailing in 1990. 51
Similar developments occurred with regard to secondary
market yields for Mexican bonds. Moreover, maturity
terms lengthened substantially. Finally, as documented in
the following section, the market re-entry process was
not limited to international bonds. Mexico also mobi-
lized voluntary financing through, inter alia, placements
of equities, Euro-commercial paper, and Euro-certifi-
cates of deposit. 52

Policy Implications

Mexico's return to more normal capital market financ-
ing has been a difficult and protracted process. It is
generally believed that the attainment of the authorities' objectives of sustained economic growth and financial
stability will require the maintenance and strengthening
of normal financial relations with domestic and external
creditors. As recognized by the authorities, it is there-
fore critical that the country consolidate the progress
achieved so far. 53 Two important elements may be iden-
tified in this regard: (1) the maintenance of sound eco-


Credit Enhancements

The use of collateralization and other credit enhance-
techniques in the initial re-entry issues strength-
ened Mexican entities' ability to overcome high levels of
market risk aversion. Thus, through appropriate design of
debt instruments, Mexican borrowers have been able to
minimize investors' exposure to credit and transfer risks. 54
At the same time, however, as recognized by the author-
ies, the continued use of such techniques may involve
potentially significant costs and should be carefully
monitored.

Collateralization techniques should be used only by
entities that have already strengthened their underlying
financial position. In effect, unless the borrowers' funda-
mentals are sound—with respect to both actual and
prospective creditworthiness and the transfer risk associ-
ated with the country's economic and financial condi-
tions—credit enhancements will not lastingly improve
market perceptions of risk. Even in circumstances where
fundamentals are sound, the benefits of credit enhance-
ments should be assessed in terms of their overall impact
on liquidity management. By pledging existing assets or
future receipts, borrowers may lose financial flexibility in


48 If Chile and Venezuela are excluded from the denominator on
the basis that they have also major appropriate restructuring oper-
tions, the relative increase in the Mexican price is more pronounced.
49 An analysis of these issues is contained in El-Erian (1991). An
overview discussion of the restoration of some Latin American coun-
tries' access to voluntary capital market financing is provided in El-Erian
50 Calculated relative to "risk-free" industrial country sovereign
issue of same currency and maturities.
51 It may be noted that Mexico's recent return to voluntary financ-
ing is not an unprecedented phenomenon. After defaulting in the early
part of the twentieth century, Mexico's entire debt was renegotiated in
1942-46, including through a reduction in contractual principal. By
1960, Mexico had redeemed the affected obligations (see Green (1976)).
This was followed by a restoration of access to voluntary internation-
al markets leading the New York Times to observe: "Mexico is closing
a checkered page in financial history, a story of default and rebirth that
goes to the misty era of international promise that preceded World
War I ... The 46 years between the defaulting of the external bonds in
1914 and the granting of the (new voluntary $100 million) loan will go
down as marking the financial coming-of-age of the Latin republic ... .
With most of the old bonds sacked out of the market by the redemption
last week, most of this lingering public evidence of Mexico's long
struggle to live down the old debt default has been wiped out for good" (New York Times, July 2, 1960, quoted in Dombusch (1988)).
52 For example, some of the early bond placements by Telmex pro-
vided the investor with protection in the form of a claim on future pay-
ments from AT&T on account of international communications.
Accordingly, investors' exposure to Telmex credit risk and Mexican
country transfer risk was effectively transformed into an exposure to
AT&T credit risk and U.S. transfer risk. Other forms of collateral have
included bank deposits, electricity accounts, and credit card receivables.
the future, with potentially adverse implications in the event of short-term liquidity problems. Accordingly, it is important that the use of credit enhancements be based on an intertemporal maximization process. This would need to take account of, inter alia, the immediate gains in terms of lower financing costs, the correlation between the borrowers’ expected stream of receipts and expenditures, and possible costs owing to the deterioration in the relative status of creditors with unsecured claims. Indeed, under certain circumstances, wide-scale resort to credit enhancements could impair rather than improve certain borrowers’ prospects for sustaining their return to voluntary capital market financing. Moreover, this could have contagion effects for other entities accessing the market, thereby increasing their borrowing costs and raising public policy issues.

An application of the above considerations to Mexico would suggest that, with the authorities’ sustained implementation of economic and financial policies to reduce market perceptions of transfer risk, the recent significant reduction in the use of collateralization by established Mexican entities should continue. The immediate costs in terms of borrowers accepting less favorable interest rate and fee structures is offset by the gains accruing from avoiding the potentially escalating costs of credit enhancements. At the same time, care should be taken to ensure that the uses of credit enhancements are not generalized to include firms that are yet to strengthen their financial positions. Given potential adverse externality effects for other Mexican borrowers and possible market information failures, a case could be made for continued government involvement, particularly in the initial stages of market re-entry. This could include the monitoring of borrowing amounts and terms and the provision of information to actual and prospective borrowers to assist in evaluating the potential net costs of credit enhancements.

Risk-Management Techniques

In the earlier discussion of the origins of Mexico’s debt problems, the section alluded to the impact of adverse developments in international oil prices and interest rates. As demonstrated by conventional standard deviation-based volatility measures, the Mexican economy has also been exposed to considerable fluctuations in these key exogenous variables since the emergence of the debt crisis. The maintenance of relatively “open positions” in such circumstances allows for the volatility in exogenous variables to be quickly translated into the country’s international obligations and receipts. Moreover, estimations of simple correlation coefficients for this period indicate that adverse developments in one of the variables were not offset, on average, by favorable developments in the other.

In recognition of the above, Mexico has taken steps recently to reduce its vulnerability to exogenous shocks. As noted earlier, the 1990 bank package has enabled the central government to lower its interest rate risk through agreement on a fixed below-market rate on an important portion of its outstanding indebtedness. The authorities have also reduced the country’s exposure to international oil price movements through sustained export diversification. Nevertheless, adverse exogenous developments would have a significant impact on the country’s prospects. Accordingly, as recognized by the authorities, further steps in these areas would be beneficial and would contribute to an improvement in country transfer risk.

It may be noted that between December 1990 and the end of February 1991, the Mexican authorities sold futures contracts in the oil market covering about three months of crude oil exports. The pricing of these operations is reported to have been above the central budget assumption of $17 a barrel, leading a Finance Ministry official to state that “it is extremely important for us that investors know that, no matter what happens to the price of oil, the economic program is on for 1991. Regardless of what happens, we’ve got $17 a barrel.”

The reduction in country transfer risk has also facilitated nongovernment borrowers’ access to market-based risk management instruments. This should allow, inter alia, for Mexican corporate issuers of variable interest rate notes to improve their management of interest rate risk through the use of forward, swap, or contingent contracts. For certain borrowers, such activities could be complemented by commodity hedging operations, particularly through future market transactions. This would be particularly relevant for exporters of commodities


54 Specifically, the correlation coefficient for changes in monthly U.S. dollar-denominated international oil prices and LIBOR interest rates amounts to 0.02; it falls to minus 0.2 when account is taken of the average lag between LIBOR interest rate changes and actual interest payments.

55 The share of oil receipts in total exports (including in-bond transactions) has declined from an average of over 70 percent in 1980-82 to an estimated 30 percent in 1988-90.

56 For example, computed on the basis of 1990 oil exports, a 10 percent decline in oil prices would be associated with a $1 billion loss in export receipts on an annual basis. On the same basis, a 1 percentage point rise in LIBOR would involve incremental interest obligations of some $0.7 billion.

57 Moffett and Truell (1991). At the same time, the authorities have set up a contingency fund in which the windfall oil and privatization receipts are deposited.

58 Several of these instruments involve the borrower making future payments under certain conditions (e.g., in the case of a swap where the borrower agrees with its counterparty to exchange a string of certain types of payments obligations for other types of payments obligations).

59 Additional information is contained in Mathieson and others (1989).
(e.g., the copper companies) or manufacturing enterprises that rely heavily on imports of certain commodities (e.g., glass producers). Increased commodity price and interest rate hedging is an appropriate goal within a framework that takes account of their market costs and their administrative requirements.

**Conclusion**

The section has examined the evolution of Mexico’s bank debt restructurings since the outbreak of debt servicing problems in 1982. It analyzed the development of the approach to debt away from one based on liquidity/cash flow concerns toward one placing greater emphasis on the need to address the adverse impact of a growing stock of indebtedness on private sector investment and growth. When implemented in the context of a comprehensive economic adjustment program, the adaptations in debt policies played a critical role in facilitating Mexico’s return to voluntary capital market financing—the latter constituting a fundamental component of the economy’s progress toward medium-term viability.

Mexico’s 1990 financing package with commercial banks was important in improving market perceptions of Mexico’s country transfer risk. Thus, although its direct, immediate financial impact was relatively limited, indications show that, together with the sustained implementation of sound policies, it reduced concerns about Mexico’s indebtedness. This was reflected, inter alia, in a sharp reduction in domestic real interest rates and a fall in secondary market yields on external loan and bond claims on Mexico. The associated restoration of access to voluntary capital market financing was accompanied by a steady improvement in market terms, including a sharp fall in the risk premiums paid by Mexican borrowers. Large repatriation of flight capital and increased foreign direct investment inflows reinforced the beneficial impact on the economy’s private investment and growth performance.

As recognized by the authorities, the consolidation of Mexico’s return to voluntary credit markets requires, inter alia, the maintenance of sound economic and financial policies and responsive debt-management policies. As regards the latter, this section has noted the importance of careful monitoring of the risks inherent in re-entrants’ reliance on credit enhancements. The section also noted the merit of Mexican borrowers making greater use of financial risk-management techniques to reduce further their exposure to adverse exogenous price developments. As was the case for Mexico’s debt-management policies in the past, these actions are likely to have effects that go well beyond the country’s economic and financial prospects. Thus, it is probable that Mexico will continue to influence the approach of other developing countries to debt management, particularly through “demonstration effects.”


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