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Mexican-IMF Agreement: The Risks of Spillover



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An Intelligence Assessment

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October 1986*

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Mexican-IMF Agreement: The Risks of Spillover



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An Intelligence Assessment

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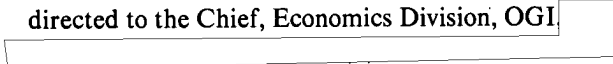
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**Mexican-IMF Agreement:
The Risks of Spillover**

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Key Judgments

*Information available
as of 12 September 1986
was used in this report.*

On 22 July 1986, Mexico and the International Monetary Fund announced a ground-breaking agreement to deal with Mexico's debt problems. The agreement assumes more than \$12 billion in new funding, allows for annual real GDP growth of at least 3 percent through 1987, and shields Mexico from the effects of further oil-price declines. This accord appears to have diffused a volatile situation

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Nevertheless, the precedents established in the accord could create new risks for the management of the LDC debt situation.

[Redacted]

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In our view, the major risks will be those stemming from the spillover effect of this Mexican agreement on other debtors and negotiations:

- The debt negotiating environment will almost certainly become more drawn-out and strained as debtors stall in their negotiations and demand similar treatment and as commercial creditors become increasingly reluctant to go along with such arrangements. We already see signs of this in Argentina, Venezuela, and the Philippines.
- Other debtor governments will come under increased pressure from their domestic constituency to get "as good a deal as Mexico." To the extent they are unable to do so, the Mexican agreement may paradoxically increase the strains on other debtors that continue to pay their debts without resorting to concession-gaining strategies.
- There will be an increased concentration of exposure to debtor LDCs by the largest international banks as more regional banks swap or write off their existing LDC debt and refuse to participate in future financing packages. These increases in involuntary lending will place the larger creditors in greater jeopardy.

[Redacted]

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Other LDC debtors believe their economic and political situations are similar to Mexico's and that they deserve equal treatment. In requesting relief they will cite a variety of reasons. In Latin America, some debtors—notably Argentina and Brazil—will cite prior economic reform efforts. The adverse effects of falling commodity prices will be used as justification by

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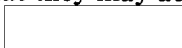
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Argentina and Venezuela in particular. All will argue the need for faster economic growth to justify debt concessions. In addition, Egypt and the Philippines may cite their special relationships with the United States.



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Despite the risks it has created, the agreement has shown a new flexibility on the part of the Fund—in the Mexico case, allowing larger budget deficits and tying further assistance to growth—that may encourage other recalcitrant debtors to stay within the case-by-case debt strategy and not go it alone as Peru has done. Nevertheless, should key debtors fail to receive what they consider to be equal treatment to that given Mexico, it is possible that they may adopt unilateral measures to limit their debt service payments.



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The Mexican Program

Major concessions of the Mexican-IMF letter of intent include:

- **The amount of new financing.** The agreement assumes more than \$12 billion in new money between now and the end of 1987, with half coming from commercial banks, according to financial press reporting. Mexico's preliminary financing package comprises the following:

	Million US \$		
Source	1986	1987	Total
Total	5,000	7,200	12,200
Commercial banks	2,500	3,500	6,000
World Bank	900	1,000	1,900
IMF	700	900	1,600
Inter-American Development Bank	200	200	400
International export credits	500	1,000	1,500
US farm credits	200	600	800

- **Tying additional loans to commodity prices.** A contingency fund has been created under the letter of intent to insulate Mexico from the further effects of declining oil prices. New money would be made available automatically if oil prices fall below \$9 per barrel for more than 90 days during the first nine months of the accord. Mexico will receive less financing if oil prices rise above \$14 per barrel.
- **An orientation toward growth.** The accord in effect replaces IMF's traditional policy of supporting austerity reforms with a new flexible approach that promotes efforts to foster longer term growth. The Fund agreed to let Mexico tailor an economic recovery program that allows real GDP growth of at least 3 percent starting in 1987. To assist

Mexico, the letter of intent established a \$500 million reserve to bolster domestic investment if the economy fails to recover by the first quarter of 1987.

- **The longer term creditor commitment.** Mexico can seek medium-term lending commitments from creditor banks beyond the 18 months covered by the IMF-supported program. In addition, the letter of intent reportedly allows Mexico to renew the IMF package automatically for another year at the end of the program.

Although most of the official funding has been approved for the package, Mexico's commercial creditors have yet to agree to provide the \$6 billion specified in the accord.

The IMF agreement fails to force Mexico to adopt a stringent austerity program, but Mexico City is promising to make a renewed effort to accelerate economic restructuring.

Mexico's strategy is to reduce government operating costs, encourage new capital inflows, and stimulate trade. Mexico reportedly will try to cut its budget deficit—projected to top 16 percent of GDP in 1986—primarily by increasing government revenues. Mexico has also promised to sell or close about 300 nonstrategic parastatals, although no formal timetable has been established. In addition, monetary policy will remain tight with interest rates higher than inflation in an attempt to reverse capital flight. Mexico will also encourage the entry of foreign investors, particularly those in export-oriented industries that provide modern technology, and meet GATT regulations as part of an expanded policy of opening its trade doors.

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Mexican-IMF Agreement: The Risks of Spillover

Mexico has been the center of attention in the debt arena since the beginning of 1986. After suffering a decline in export revenues and international reserves, an economic slowdown in 1985, and with little prospect for improvement in 1986, Mexican debt negotiators again turned to their international creditors for relief. After lengthy and often difficult talks, Mexico and the International Monetary Fund (IMF) signed on 22 July 1986 a letter of intent that offers the de la Madrid administration a less painful solution to its chronic economic problems.

We expect that other LDC debtors may use the Mexican-IMF agreement as a model for their future negotiations with creditors. Many of these debtors may put strong pressure on the IMF and commercial banks for similar concessions because they also face acute financial difficulties or believe that they deserve special consideration because of their strong economic adjustment efforts. In addition, some debtors—especially those countries that are more financially hard pressed or belligerent—could model alternative payment schemes after concessions granted in the Mexican agreement and take unilateral action to reduce debt payments instead of negotiating with creditors.

Candidates for Spillover

Mexico is not alone in being hard hit by export revenue losses resulting from stagnant or falling commodity prices and lower import demand in developed countries. Falling export earnings and rising debt service burdens are forcing many other LDCs to continue economic reforms and austerity-related cutbacks in spending—especially for investment—to maintain financial solvency and foreign exchange reserves. In turn, these developments are placing additional checks on growth and development among the key debtors. These adverse financial conditions are likely to continue over the next 18 months and may lead to increased demands from several other debtors for Mexican-type concessions.

Arguments for Relief

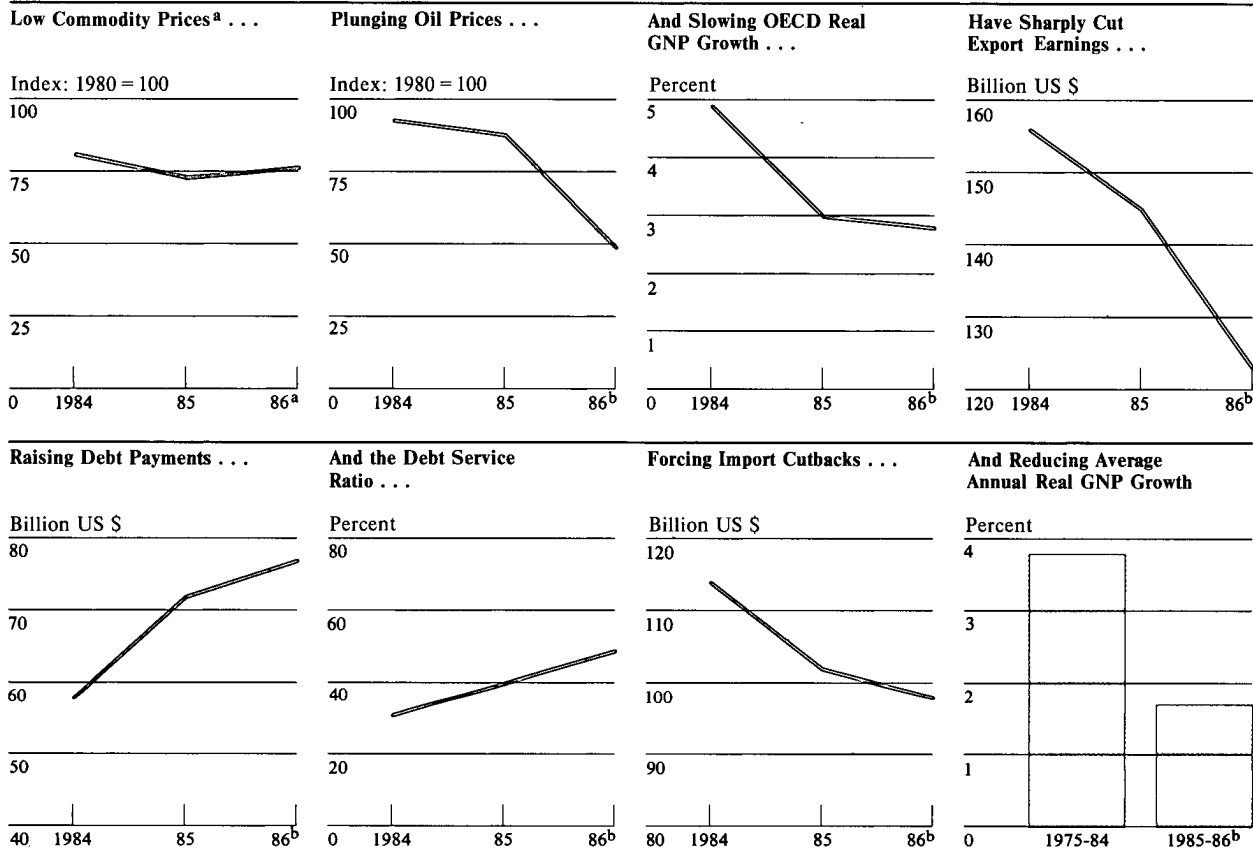
In our view, major LDC debtors will be likely to use at least one of the following arguments to support their demand for debt concessions:

- **Bleak trade outlook.** *Export revenues in key debtors have fallen sharply over the past two years because of low commodity prices, a 50-percent drop in oil prices, and slack import demand in developed countries. Slowing real GDP growth in OECD member states and continued oversupply conditions make a sustained commodity price recovery unlikely, especially for agricultural products. In addition, many debtors—frustrated by five years of economic austerity—are now more concerned with economic recovery than with debt service payments, and are determined to boost imports and real GDP growth. This combination of lower export revenues and the need for higher imports is setting the stage for growing financial gaps in many debtor countries.*
- **Prior economic reforms.** *A few key debtors, such as Brazil, have undertaken significant economic reform measures, including exchange rate devaluations and anti-inflation programs. They could demand lenient debt treatment as a reward for these efforts, given their adverse impact on real GDP growth and unemployment. They may also contrast their own efforts with Mexico's lack of progress toward economic adjustment.*
- **A special relationship with major creditors.** *Mexico is of special concern to the United States, given the closeness of economic and political ties between Mexico City and Washington and Mexico's proximity to the United States. But the United States has developed special relationships, based on economic, political, and military factors, with other countries such as Egypt and the Philippines. In addition, European and Japanese creditors have maintained close ties to debtors in their regions. We feel that some of these countries will vociferously argue that Mexico used its special relationship with the United States as leverage to obtain concessions and that they are entitled to similar relief from creditors for the same reason.*

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Figure 1
Key LDC Debtors: The Road to Financial Problems, 1975-86



^a Data for 1986 is for the first half.
^b Estimated.

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Latin American Debtors

We believe several Latin American countries are candidates for spillover. These debtors will base arguments for debt relief on current financial hardships, the need for renewed economic growth, and structural adjustment achievements. Moreover, some political leaders have a "populist" outlook and are likely to demand lenient debt-repayment terms to alleviate what they perceive as painful economic burdens on

their constituents. These countries have closely followed the Mexican talks and are already positioning themselves to demand similar concessions.

Larger Countries

Argentina. Argentina's year-old austerity program, the Austral Plan, sharply lowered the inflation rate, reduced the government budget deficit as a share of GDP, and set the stage for short-term industrial improvement. Even though the plan is beginning to

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unravel, Argentine officials will be quick to point out their progress on reform and argue that such efforts should be rewarded with debt concessions. [redacted]

On the payments side, falling prices and flooding in agricultural areas last fall could reduce 1986 export earnings by as much as \$1 billion. Buenos Aires has already cited the US decision to subsidize agricultural sales to the Soviet Union as wreaking further havoc with its foreign payments position. In addition, boosting real GDP growth is an announced government priority, and renewed import growth is a prerequisite to higher real-income levels. To realize these goals, we believe that Argentina will seek \$2-3 billion in new money over the next 18 months or concessions on interest payments to meet financial needs. [redacted]

The Mexican debt agreement with the IMF already is playing a role in Argentina's negotiating strategy. Buenos Aires delayed negotiations with the IMF and commercial banks until the details of the Mexican arrangement became clear. Press reports indicate that Argentina is seeking to link debt repayment terms to agricultural export prices. [redacted]

Brazil. With a \$102 billion foreign debt, massive debt service payments, and a high debt service ratio, Brazil also is a candidate for spillover, despite its strong current account position and substantial foreign exchange reserves. The Sarney administration has repeatedly argued that foreign creditors should give Brazil the easiest financing conditions in Latin America because of that country's superior economic adjustment achievements. Brasilia can cite elimination of a current account deficit that was \$16 billion in 1982, tax reform, and budget consolidation. More recently, the Cruzado Plan—Brazil's six-month-old austerity program—has slashed the rate of inflation, reduced interest rates, and set in motion market-oriented reforms that could strengthen Brazil's economy. However, government spending has not been curbed, savings have declined sharply, and new business investment continues to be sluggish—signs that inflationary expectations may not have been broken. [redacted]

Brazil's case for major concessions is not as strong as that of other Latin American debtors. Bolstered in part by higher coffee prices, export growth is likely to

resume this year after a slight decline in 1985. Real GDP growth also remains strong. Lower oil prices and greater domestic production will reduce petroleum imports, allowing for higher imports of raw materials and other industrial inputs. Finally, an agreement to restructure debt repayments for 1985 and 1986 has been concluded, and press reports indicate that negotiations toward a more comprehensive multiyear restructuring could begin before the end of 1986. [redacted]

Chile. Chile's financial situation is nearly as bad as Mexico's. Export earnings have stagnated since 1981—after a near tripling between 1975 and 1980—as lower prices (especially for copper) offset higher export volume. A worsening balance-of-payments situation and sharp increases in the level of foreign debt forced draconian import cuts. As a result, real GDP fell 14 percent in 1982 and has yet to recover completely to 1981 levels. Chile's debt situation is now so burdensome that principal payments must be rescheduled, and interest payments take up 40 percent of export earnings. [redacted]

At the same time, Chile's economic management team has carried out domestic reforms, including liberalization of trade and capital markets, exchange-rate devaluation, and efforts to stimulate private saving while maintaining fair treatment of foreign investment. These measures have been supported by strict adherence to IMF-supported austerity programs, supplemented by new loans and rescheduling agreements. These actions have allowed Chile to make interest payments and achieve some resurgence in economic growth over the past two years. [redacted]

Given its precarious financial situation and its economic reforms, Santiago probably feels it has a strong case for debt relief. Negotiations are scheduled to begin before the end of 1986, and US Embassy reports indicate that Chile will seek rescheduling of payments due through 1989 or 1990, and more than \$400 million in new funding during the period 1987-88. Given competent economic management in the face of adverse external factors, a perfect interest payment record, and full compliance with IMF and World Bank adjustment programs, we believe that Chile can lay a strong case for debt relief. The human

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rights issue, however, remains sensitive and could delay approval of new loans or other debt concessions, especially from official creditors. [redacted]

Venezuela. Venezuela is likely to argue for debt relief on grounds of a poor financial situation, the need to revive a stalled economy, and bank reluctance to provide new funds. Falling oil prices will cost Venezuela \$5-6 billion in export revenue in 1986, and we forecast a 2-percent decline in real GDP. As a result, Venezuela almost certainly will request a postponement of \$3.4 billion in principal payments due during 1987-89. [redacted]

banks will be extremely reluctant to provide new funds, insisting that Venezuela first draw on its \$13 billion in foreign exchange reserves. [redacted]

Venezuelan leaders have been carefully monitoring the Mexican debt negotiations. [redacted]

[redacted] Moreover, Caracas's unilateral and short-lived decision to pay private-sector debt with long-term, low-interest rate bonds angered creditors, and could complicate future debt negotiations. In our opinion, however, a rescheduling of public- and private-sector debt, coupled with the use of foreign exchange reserves, will be necessary to cover the loss of export revenue in the near term. [redacted]

Smaller Countries

Colombia. In our opinion Colombia probably will not press for concessions or rescheduling over the next 18 months. We forecast a sharp increase in export earnings in 1986 as a result of higher coffee prices. [redacted]

[redacted] it is unlikely Colombia will need to draw on all external funding that has been made available. A strenuous, IMF-monitored economic stabilization program has led to economic recovery; we forecast 4-percent real GDP growth this year, following increases averaging 2 percent per year between 1982 and 1985. Moreover, compared with other Latin American debtors, Colombian economic performance during the past four years has been excellent. [redacted]

Ecuador. The sharp drop in oil prices will slash Ecuador's export revenues by \$500-600 million in 1986 and increase the current account deficit to \$750 million. [redacted] In response, Quito has negotiated increased financial assistance—such as a \$200 million syndicated loan—and on 11 August announced new economic adjustment measures, including exchange-rate reform and deregulation of interest rates on savings and loan accounts at private banks. Given Ecuador's proven record of making economic reforms and its poor financial outlook, we believe Quito has a strong argument for further debt concessions. [redacted]

Peru. Peru's financial outlook has been clouded by a number of adverse factors, including persistently low commodity prices. While progress has been made toward curbing triple-digit inflation and boosting economic growth, these benefits are likely to be short lived. As a result, we believe that a case for debt concessions can be made. However, given Peru's hardline confrontational attitude toward debt repayment, the resultant de facto debt relief, and a near-complete lack of creditor confidence, Lima almost certainly will not obtain major debt concessions from commercial banks or the IMF unless it substantially moderates its debt repayment position. [redacted]

Core Four Central American Countries. Costa Rica, El Salvador, Guatemala, and Honduras—the Core Four Central American countries—may be candidates for spillover because of an increased debt burden and continuing economic stagnation. We expect total debt service to weigh heavily on these small economies, remaining near 40 percent of goods and services exports in 1986—after more than doubling between 1980 and 1985. In addition, we forecast only a slight increase in real GDP in 1986, which fell 5 percent between 1980 and 1985. Despite an expected improvement in the trade picture in 1986 because of higher coffee prices and lower petroleum imports, we expect most of these debtors to seek payment concessions and new financing to compensate for five years of eroding export earnings, the continued fall in per capita income, and the need to combat domestic insurgent threats. [redacted]

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Jamaica. In the Caribbean, Jamaica is in need of some special financial arrangement because of bauxite revenue losses and real GDP declines. Prime Minister Seaga, citing the need for growth after years of austerity, abandoned IMF guidelines in May. Because Jamaica's debt negotiations with the IMF and other creditors are currently at a difficult stage and the country is \$70 million in arrears to the Fund, Kingston almost certainly will not obtain major concessions or new financing in the near term. Seaga, however, may feel that his good relations with the United States and the potential for former Prime Minister Michael Manley to be reelected if the economy does not improve may enhance his chances for concessions. [redacted]

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[redacted] Manila probably believes that the severe political and economic problems faced by the new government put the Philippines in line for favorable treatment. Manila will cite the need—especially to Washington—to make resources available both to fight the insurgents and to make life better in the rural areas—a key source of insurgent support. With renewed economic growth a top government priority, Manila's approach is to seek the support of its foreign donors and creditors for a growth-oriented economic strategy that includes a multiyear debt rescheduling and tolerates a high government budget deficit. [redacted]

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Key Asian Debtors

In general, the potential for spillover is not as great in Asia as in Latin America. Most of the Asian countries have considerably stronger financial positions. Moreover, Asian debtors generally are less belligerent toward creditors and are more amenable to implementing measures to permit full servicing of debt obligations. [redacted]

Indonesia and Malaysia

Although they are in much stronger positions than the Latin American debtors, Indonesia and Malaysia also suffered economic and financial reverses during 1985 and 1986. Lower oil prices and, for Malaysia, a sharp decline in commodity prices have reduced export earnings for the two countries by \$4-6 billion each since 1984, and resulting import cutbacks have reduced the rate of real GDP growth. In addition, the decline of the US dollar has sharply raised debt servicing costs for both countries on the portion of foreign debt that is nondollar denominated. [redacted]

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The Philippines

The Philippines is a marked exception, however. There the financial and economic situation deteriorated in 1983, and the economy remained in recession through 1985. Since 1984, Philippine export earnings have been depressed by a sharp 40-percent drop in commodity prices, imports have been slashed, and real GDP has fallen more than 2 percent. Since President Aquino assumed power in February 1986, however, economic adjustment measures have been put into effect—tax measures have been passed, trade liberalization is under way, and reform of financial institutions has begun. We believe, however, that Manila will need to demonstrate that leftists do not dominate policymaking, that the Communist insurgency can be arrested, and that the new government can implement economic programs to restore the confidence of creditors and investors. [redacted]

We believe that, unless oil and commodity prices rebound sharply, these countries will need substantial amounts of new funding—\$2 billion per year for Malaysia and \$5 billion per year for Indonesia—to boost real GDP growth and absorb labor force increases. If these funds are not forthcoming, debt concessions modeled in part on those in the Mexican agreement could be requested. [redacted]

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Thailand

Thailand's economic outlook has brightened, following an economic slowdown in 1985. Exports have risen 19 percent in dollar terms over the first half of 1986, and lower oil prices have slashed Thailand's oil import bill. In addition, while the cost of servicing yen-denominated debt has risen—as a result of the depreciation of the US dollar—Bangkok is refinancing its

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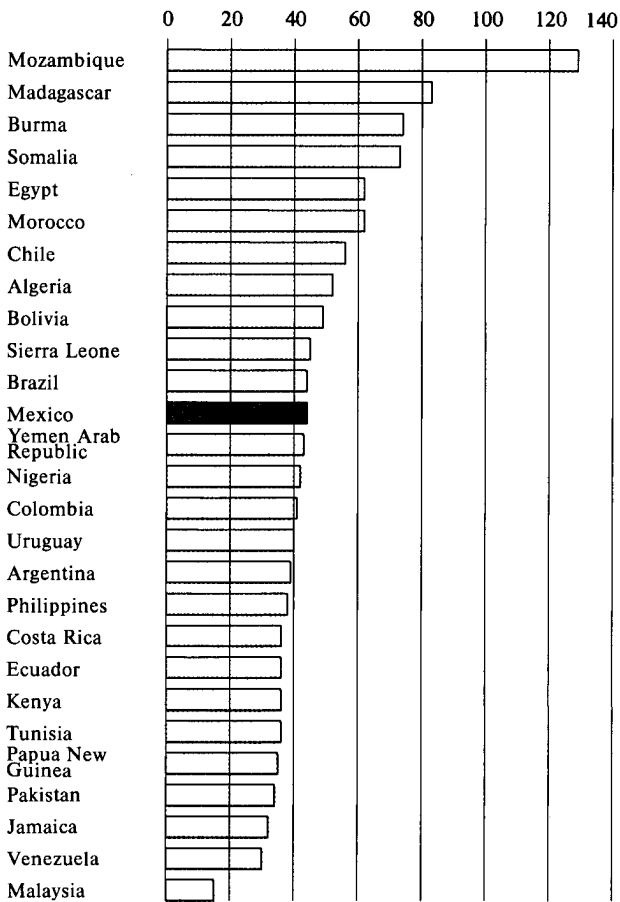
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[redacted]

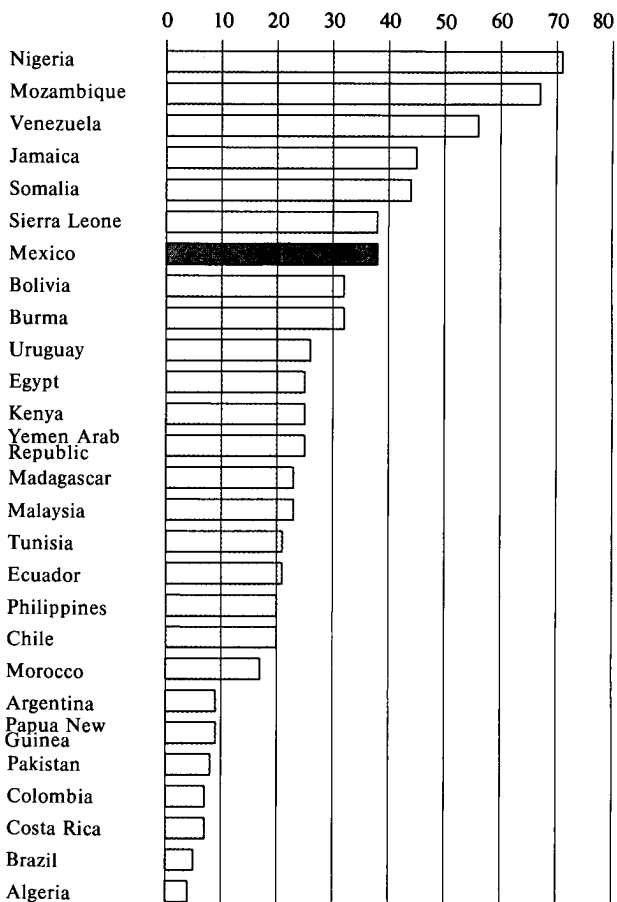
Figure 2
LDC Debtors: Trade and Financial Indicators

Percent

Debt Service Ratio, 1985



Exports: Percentage Decline From Peak Level^a



^a Dates of data range from 1984 to 1986, depending on country.

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dollar-denominated debt, and [redacted] overall debt servicing costs could be lower for 1986 than in 1985. We believe that, unless oil prices rise sharply, the chances for a Mexican-type debt agreement are remote. [redacted]

African and Middle Eastern Debtors

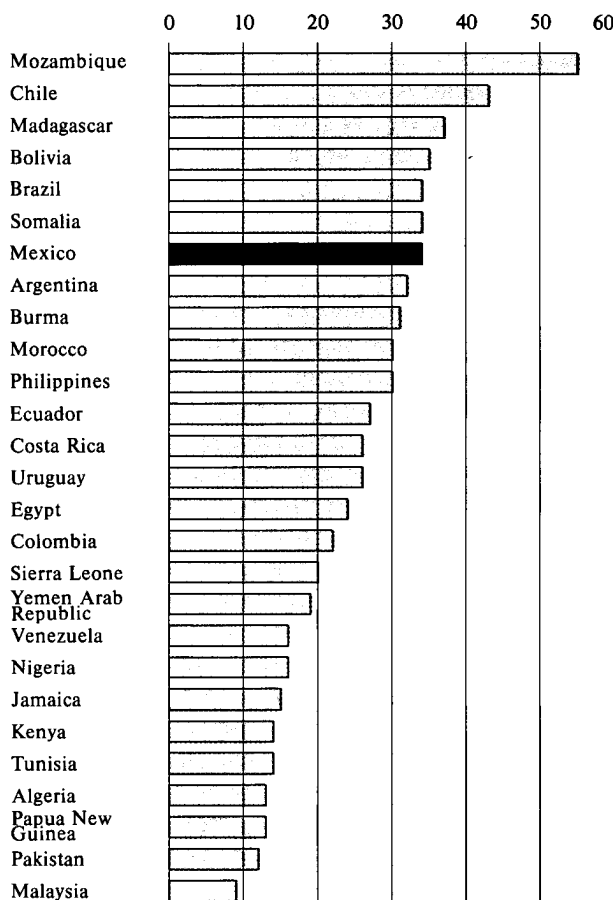
Egypt

Although there are several countries in these regions that are candidates for spillover, Egypt is the one of greatest concern. Export revenues have been devastated by lower oil prices and a sharp dropoff in worker

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Figure 2 (continued)

Interest Payments as a Percentage of Exports, 1985



remains unpalatable to Cairo because the strict financial and economic guidelines of a fund-supported program would almost certainly provoke political and social unrest. [redacted]

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Cairo will probably also point to a newly formulated program of economic reform as justification for debt relief. US Embassy reports indicate that the program is far reaching and comprehensive, but specific weaknesses remain in the areas of the budget deficit, credit expansion, and exchange-rate reform. Egypt has proved more adept at proposing reforms than at implementing them, which has created a credibility gap with commercial banks, creditor governments, and the IMF, and has delayed agreement on a new standby accord. [redacted]

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Finally, Cairo will continue to cite its special relationship with Washington as an argument for debt concessions. Egypt and the United States share concerns on several major military and political issues, and Cairo almost certainly assumes that the strong US commitment to supporting a moderate regime in Cairo will provide the leverage needed to win increased funding and debt rescheduling. [redacted]

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Nigeria

Elsewhere, Nigeria could argue that its financial situation is worse than Mexico's and that major debt relief is needed. Falling oil prices will slash export earnings as much as \$5 billion in 1986, and, despite initial moves such as a two-tiered exchange-rate system, political considerations will make meaningful austerity measures difficult. In addition, efforts to obtain an IMF agreement have been stalled by strong anti-IMF feeling within the government. [redacted]

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Nevertheless, Nigeria does not seem willing to press the issue of debt relief. Lagos is aware that past actions, such as the accumulation of large debt arrearages, have left creditors with a dim view of further lending. In addition, Nigeria does not demand the attention from creditors that the Latin American countries receive. Creditors appear split on offering new financing to Lagos, with most US banks viewing Nigeria as a poor credit risk, while European banks are still willing to make new loans because of their

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remittances, and we believe that, even with modest import cutbacks, Cairo will require substantial new funding to meet financial needs. Although US Embassy reports indicate that the Egyptians have recently met with IMF officials, a formal IMF agreement

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historical relationship with Africa [redacted] [redacted] These differences could make agreement on a package of debt concessions more difficult. [redacted]

Morocco and Tunisia

Morocco and Tunisia could be candidates for spillover, given their bleak financial condition, strategic location at the entrance to the Mediterranean, and shared concern with the United States over regional political matters. Export earnings have fallen because of declining demand for phosphate, and foreign exchange reserves for both countries are nearly exhausted. Cautious steps toward economic reform are now being taken to secure increased funding, but progress has been limited by fear that these measures will lead to a repeat of the bloody riots that followed the attempted imposition of austerity in 1984. [redacted]

Sub-Saharan Africa

A number of small countries in Sub-Saharan Africa—including Cameroon, Ghana, Ivory Coast, and Senegal—have implemented economic reform programs to rescue their battered economies, ensure continued external funding, and create a more favorable long-term environment for economic growth. These measures, however, have not been without opposition, and have potentially serious political and social implications because already poor countries are being called on for further sacrifice. As a result, these debtors may press for lenient debt treatment as a reward for their economic reform efforts. [redacted]

Risks of the Agreement

Increased Complexity

Creditor-debtor relations are likely to become more complicated in the wake of the Mexican package. Mexico is the first debtor to have commodity export prices explicitly linked to the terms of a new IMF agreement, thus setting the stage for other key debtors with narrow export bases to demand similar terms. For example, debtors such as Argentina and Malaysia could argue for linkage to a basket of commodity export prices, and Indonesia, Nigeria, and Venezuela

could demand terms linked to oil prices. Press reports confirm that Buenos Aires is already making such an argument. Similarly, some key debtors seem more inclined to link debt payments to GDP. For example, Brazilian Finance Minister Funaro stated in off-the-cuff remarks to the press on 28 July 1986 that Brazil needs to limit its debt service to 2.5 percent of GDP to support economic growth. Funaro and members of President Sarney's staff subsequently explained that reducing payments was a goal Brasilia wanted to negotiate with creditors and did not imply an intention to take unilateral action. [redacted]

Deterioration of Debt Negotiations

A major risk of the Mexican package is a deterioration in the conduct of debt negotiations. The Mexican package makes it politically more difficult for other debtors to continue paying without extracting concessions from creditors while continuing to keep tight reins on their respective economies. Therefore, we believe that debt-troubled countries will be less willing to operate under the old strategy where continued financing was contingent on an IMF-supported program. If a debtor fails to receive what it considers adequate financing or payment terms, or cannot find other orderly ways to reduce debt payments or at least link them to export performance, there is a greater possibility that the debtor would unilaterally act to curtail payments. While we believe the possibility of a debtors' cartel remains remote, there nevertheless is now a greater chance that LDC debtors may act jointly if they are not satisfied with creditors' responses to their plight. [redacted]

Debtor Networking

We expect the question of spillover will grow in importance as the future debt negotiations of major LDCs progress. Debtors are likely to increase contacts among themselves in an effort to receive comparable treatment from creditors—stepping up bilateral contacts, keeping each other informed of current negotiating strategies, and exchanging documentation.

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Alternative Payment Schemes

Although debtor demands for relief will probably be modeled after the Mexican financial package, alternative schemes have been proposed—and some have been implemented. It is possible that these proposals could surface again as debtor countries search for ways to ease their financial problems. Such past actions have included:

- **Tying payments to export revenues.** President Garcia announced on 28 July 1986 that Peru would restrict principal and interest payments on public debt to 10 percent of export revenues for another year, and that payments would be contingent upon creditor inflows meeting or exceeding Peru's payment levels. At the same time, Lima stated that new interest rate charges or refinancing terms must meet the 10-percent payment limit. Similarly, Nigeria announced on 31 December 1985 that it would limit debt payments to 30 percent of export revenues, covering roughly half the projected obligations due in 1986.
- **Issuing bonds to service debt.** Venezuela passed a new law on 7 July 1986 that provided for repayment of a portion of \$7 billion in private-sector debt in the form of 15-year, dollar-denominated government bonds carrying a 5-percent interest rate. Under this system, Venezuelan firms would buy bonds from the newly created exchange compensation fund in domestic currency and then turn the bonds over to foreign creditors as payment for outstanding debt. Criticism from creditors forced Caracas to

abolish the legislation in mid-August, and Venezuela will instead alter the prior private-debt scheme through executive decrees to change the exchange agreements, according to the US Embassy.

- **Domestic currency deposit schemes.** Mexican finance officials [redacted] drafted a plan where interest payments due to foreign creditors would instead be deposited in an escrow account at the Central Bank, according to press reports. These funds were to bear interest at the normal interbank rate set in London, but could not be transferred abroad as dollars until Mexico's foreign reserves increased substantially. Although the need to implement this plan has lessened with the signing of the IMF letter of intent, its presentation to creditors showed the severity of Mexico's threat to lower debt payments and signaled the end of its previously moderate approach to debt negotiations. [redacted]

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Creditors have generally responded harshly to unilateral attempts at reducing debt payments. Commercial creditors view such payment schemes as setting dangerous precedents and as obstacles to financial negotiations. When such unilateral actions are taken, banks first retaliate against an LDC—as they did with Peru, Nigeria, and Venezuela—by cutting back short-term trade financing. But they may also take more drastic steps; for example, banks threatened legal action against Venezuelan firms when the bond system was first announced. [redacted]

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Troubled debtors may use this network to time announcements of alternative payment schemes to maximize their effect. [redacted]

more willing to negotiate a mutually acceptable solution instead of maintaining its hardline position. [redacted]

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Creditor Response

[redacted] Only when Mexico decided to negotiate rather than take unilateral action did Venezuela become

There also is a danger that creditors, especially commercial banks, will become more opposed to negotiating with debtors if the Mexican-IMF accord becomes the standard. [redacted]

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[Redacted]

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We believe that commercial banks will remain hesitant to extend new longer term loans to most LDCs unless pressured to do so in conjunction with an IMF-supported program. In addition, creditors would be likely to face a substantial need for new funds if every major debtor is to receive a large Mexican-scale agreement. Also troubling is the fact that involuntary bank lending over the next few years will become more concentrated among the world's larger banks—increasing their risks and exposure—as US regional and smaller foreign banks largely opt out of large new money packages. Although most large money center banks are now in better financial shape after building up loan-loss reserves, lending to LDCs that are poor credit risks, as well as the possibility of unilateral payment stoppages or negotiated payment reductions, places these creditors—especially some large international banks—in greater jeopardy. [Redacted]

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Offsetting these increased risks is the fact that because the Fund will be perceived as having had a more flexible approach during negotiations—by allowing larger budget deficits and by tying further assistance to growth and oil prices—some recalcitrant debtors may be encouraged to stay within the case-by-case debt strategy and not follow Peru's example and go it alone. Nonetheless, should other key debtors fail to receive what they consider to be equal treatment, or at least softer payment terms, the spillover risks may become real, and it is possible that some debtors will even adopt unilateral measures to limit debt service payments. [Redacted]

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