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Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

12 September 1988

MEXICO'S EVOLVING DEBT STRATEGY

Summary

Mexico's President-elect, Carlos Salinas, has sent a strong signal that his administration will take a tougher stance with the international banking community when he takes over in December. Blaming the debt burden for stunting economic growth, he has vowed to drive a hard bargain with bankers in debt negotiations and has warned that he will suspend interest payments if the alternative is economic stagnation. Mexican officials probably hope the strong showing in the July elections by the leftist opposition--which favors a suspension of debt service payments--will give them some leverage with bankers. We doubt, however, that Salinas would follow through on threats of a moratorium given Brazil's failed attempt to force bankers to forgive a portion of their debt and the risk of losing short-term trade credits.

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A Drain on the Economy

Repaying foreign debt remains a significant impediment to Mexico's economic growth despite several rounds of debt restructuring since 1983 and concessions on the interest rate charged by commercial banks. Interest payments on the foreign debt as a share of GDP have doubled since the early 1970s to the equivalent of almost 6 percent of GDP. Public sector debt service payments still consume more than one-third of the foreign exchange earned from exports of goods and services each year.

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Mexican officials argue that bankers' refusal to lend Mexico new money has made the country a net exporter of capital to industrialized countries. In repaying principal and interest, Mexico has transferred abroad $44 billion in net resources since its initial debt crisis, equal to almost 5 percent of its GDP and more than one-fourth of its goods and services exports. In order to generate sufficient foreign exchange, the country has reduced imports and produced trade surpluses totaling $56 billion over the last six years, equivalent to 5.9 percent of its GDP for that period.

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Debt Swap Schemes

Past efforts to lighten the foreign debt service burden have borne little fruit. Mexico's debt-for-bond swap succeeded in exchanging only $3.7 billion in debt for $2.6 billion in bonds, canceling just $1 billion of Mexico's $100 billion foreign debt and shaving off less than $100 million in interest payments from the $8 billion annual bill. Before their suspension last year, exchanges of Mexican public sector debt for equity in Mexican companies also had only a limited impact on outstanding debt, reducing it by $1.8 billion. Secretary of Programing and Budget Pedro Aspe estimates the creation of pesos in exchange for the loans added 30 percentage points to the inflation rate because it substantially increased Mexico's narrow money supply. (See Appendix).

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Salinas´ Plans

Frustration over disappointing results from the debt-for-bond swaps and growing social discontent over deteriorating living standards have led to harsher public statements by Mexican officials on debt repayments. Even before the ruling party suffered unprecedented electoral losses in July, government officials were threatening that they would unilaterally cut Mexico's interest payments if bankers refused to provide easier terms or to participate in new financial schemes. Although Salinas currently prefers to negotiate a deal with bankers, he has appealed to popular nationalist sentiments by declaring his unwillingness to see economic growth choked by foreign debt payments. 25X1

Domestic political pressures are likely to propel Salinas to seek another round of debt renegotiations early in his administration. We believe he will try to gain concessions from creditors in part to appease domestic critics who argue his anti-inflation austerity policies better serve US than Mexican interests. In our view, Salinas probably believes he will lose nothing by advocating a harder line with creditors, and he might gain some leverage over bankers by pointing to leftists' demands for a suspension of debt service payments. 25X1

We believe Mexico City's negotiating position is still evolving, but its key demand probably will be for a substantial foreign reduction in interest and principal payments in return for implementing domestic austerity measures and for staying current on obligations. Aiming to cut interest payments in half, the new administration probably will propose reducing the interest rate, adding interest payments due to outstanding loans, or making interest payments in pesos. Mexican officials also want to

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slash principal repayments and are likely to press creditors to stretch out the payback timeframe, possibly to as much as 40-50 years, with a 10-15 year grace period. 25X1

Mexico's eroding current account balance could strengthen the argument of those Mexican officials who believe that attempting to chip away the annual interest bill through a debt-for-bond swap is a waste of time. Soft oil prices, sluggish export growth, rising imports, and higher interest payments already have slashed the current account surplus for the first half of this year to $200 million, compared with $2.8 billion during the same period last year, and may push the current account into a small deficit by yearend. If the situation continues, Mexican officials might ask the IMF, the World Bank, and commercial lenders for new loans. 25X1

Bankers are likely to be skeptical about Mexico's refinancing needs, and their reluctance to participate in Mexico's debt initiatives or lend new money probably will pose threats to Salinas' plans. Even if Mexico City provides a partial guarantee of interest payments for another debt-for-bond swap, we doubt that many bankers will be willing to go along. Nearly all the major banks will continue to balk at writing down their loans, and many regional banks are likely to view the swap simply as an exchange of one kind of risk for another. 25X1

Implications for the United States

Salinas' determination to make creditors match Mexico's economic sacrifices portends a drawn-out struggle with bankers. To offset potential political damage at home, where he is widely perceived as sympathetic to US interests, Salinas may lash out rhetorically at the United States for failing to help relieve Mexico's debt service burden. However, the inability of Brazil to force bankers to forgive a portion of the debt by using confrontational tactics, as well as the risk of losing short-term trade credits, probably will keep Salinas from taking a radical step such as a suspension of debt payments. 25X1

Should public disaffection increase as a result of stalled debt negotiations and a further downturn in the economy, Salinas is likely to try to deflect domestic political pressure by assuming an activist stance against US policies in Central America and elsewhere in the region. An anti-US foreign policy direction would have few negative domestic consequences and could placate Salinas' more strident leftist critics. 25X1

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APPENDIX

Mexico City unveiled a **debt-for-bond swap** in December 1987 that aimed to exchange up to $10 billion in 20-year Mexican bonds for $20 billion in public sector debts. To attract banks, Mexico City offered to pay a higher interest rate on the bonds' semi-annual payments than on currently outstanding loans. As collateral for the principal payment on its bonds, Mexican officials proposed to purchase a 20-year US Treasury zero coupon bond, sold at a deep discount because it pays interest only at maturity.

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Both the total number of bids and the discounts offered by bankers fell short of the government's expectations. Of the $6.7 billion in bids submitted, Mexican officials decided they could accept only half, with an average discount of 68 percent of face value, in order to reduce their annual interest bill and proclaim the deal a success. According to the Embassy, the largest number of acceptable bids came from Japan, followed by the United States and Canada. Most of the major European banks shunned the swap.

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Following the precedents set by Brazil and Chile, Mexico inaugurated a **debt-to-equity conversion** program in April 1986. Until its suspension in October 1987, only public sector debt could be traded for equity investment in Mexico. Foreign companies could redeem Mexican government debt purchased on the secondary market at 50 to 60 percent of face value at a higher conversion rate from the Ministry of Finance. The government conversion rate, which ranged from 75 to 100 percent of face value, depended on the priority of the investment. Investments in export industries and state firms up for sale received the highest rates. Critics within the government argued that the program was subsidizing foreign investments that were already planned.

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Table 1

Mexico: Balance of Payments

Billion US$

	1982	1983	1984	1985	1986	1987	1988*
Trade balance	6.8	13.8	12.9	8.5	4.6	8.4	4.6
Exports f.o.b.	21.2	22.3	24.2	21.7	16.0	20.7	21.2
of which:							
Crude oil	15.6	14.8	15.0	13.3	5.6	7.9	6.5
Imports f.o.b.	14.4	8.6	11.3	13.2	11.4	12.2	16.6
Services, net	-13.3	-8.6	-9.1	-8.2	-6.7	-5.2	-5.6
of which:							
Interest payments	13.4	10.5	12.2	10.2	8.3	8.1	8.9
Tourism, net	0.6	1.2	1.3	1.1	1.2	1.5	1.7
In-bond plants	0.9	0.8	1.2	1.3	1.3	1.6	1.8
Transfers, net	0.3	0.3	0.4	1.0	0.5	0.7	0.6
Current account balance	-6.2	5.4	4.2	1.2	-1.7	3.9	-.4

*Projected
Note: Figures may not add up due to rounding

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