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DIRECTORATE OF INTELLIGENCE

18 September 1986

Mexican IMF Agreement: The Risks of Spillover

Summary

On 22 July, Mexico and the IMF announced a ground-breaking agreement to deal with Mexico's debt problems. The agreement provides $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. While this accord appears to have diffused a volatile situation -- Mexico City reportedly planned to deposit the interest owed to its foreign creditors in an escrow-like account at the Central Bank until the foreign reserve position improved, in effect threatening to stop payment -- the precedents established in the accord could create new risks for the management of the LDC debt situation.

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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. 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 American, 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 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 relationship 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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This memorandum was prepared by [redacted] Economics Division, Office of Global Issues. Comments and queries are welcome and may be directed to the Chief, Economics Division, OGI, [redacted]

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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 this year. After suffering a decline in export revenues and international reserves, a continued recession in 1985, and little prospect for improvement this year, Mexican debt negotiators again turned to their international creditors for relief. After lengthy and often difficult talks, Mexico and the 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.

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We expect 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 either they also face acute financial difficulties or their belief that they deserve special consideration because of 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.

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CANDIDATES FOR SPILLOVER

Mexico is not alone in being hard hit by export revenue losses due to stagnant or falling commodity prices and lower import demand in developed countries. Falling export earnings and rising debt service

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[TEXT BOX 1]

THE MEXICAN PROGRAM

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

- The amount of new financing. The agreement assumes over $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
(Million US Dollars)

SOURCE	1986	1987	TOTAL
Commercial banks	$ 2,500	$ 3,500	$ 6,000
World Bank	900	1,000	1,900
IMF	700	900	1,600
InterAmerican Development Bank	200	200	400
International export credits	500	1,000	1,500
US farm credits	200	600	800
TOTAL	5,000	7,200	12,200

- 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 a barrel for more than 90 days during the first nine months of the accord. But Mexico will receive less financing if oil prices rise above $14 per barrel.

- An orientation toward growth. The accord in effect replaces the 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

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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 automatically renew the IMF package 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 laid out in the accord. 25X1

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. 25X1 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 this year -- 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 a expanded policy of opening its trade doors. 25X1

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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 in the key debtors. In our judgment, these adverse financial conditions will continue over the next 18 months, and may lead to increased demands for Mexican-type concessions from several other debtors.

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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.

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Larger Countries.

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

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[TEXT BOX 2]

ARGUMENTS FOR RELIEF

In our view, major LDC debtors will likely 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 due to low commodity prices, a 50 percent drop in oil prices, and slack import demand in developed countries. Slowing OECD real GDP growth 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. Key debtors in this category could demand lenient debt treatment as a reward for these efforts, given their adverse impact on real GDP growth and unemployment. They may also cite Mexico's lack of progress toward economic adjustment, in contrast to their own efforts.

- 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 physical 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 with debtors in their respective 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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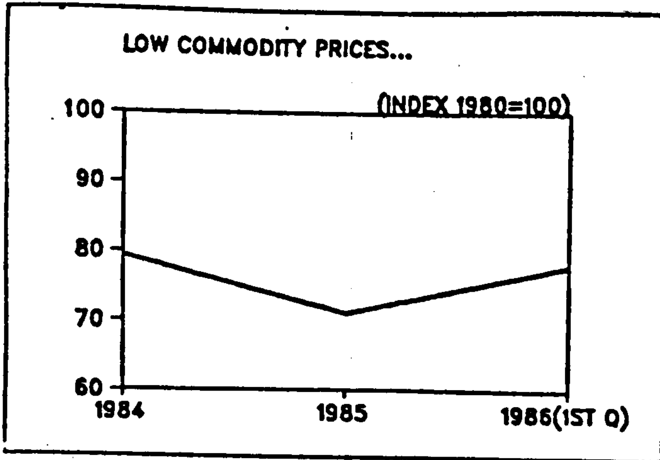

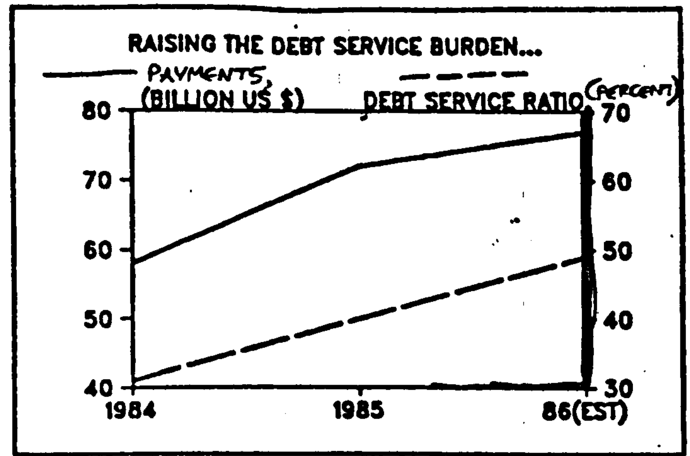

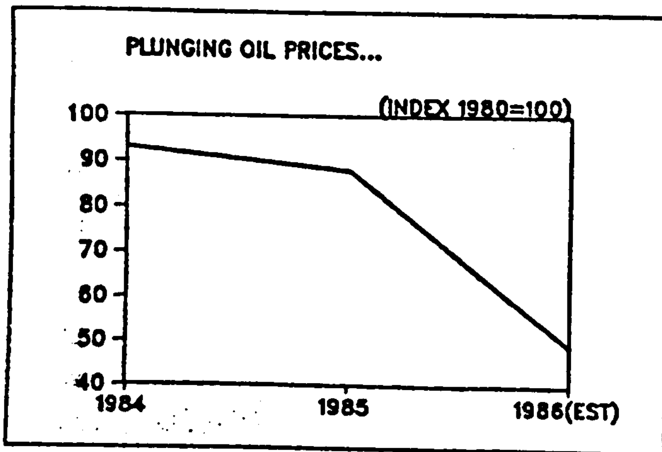

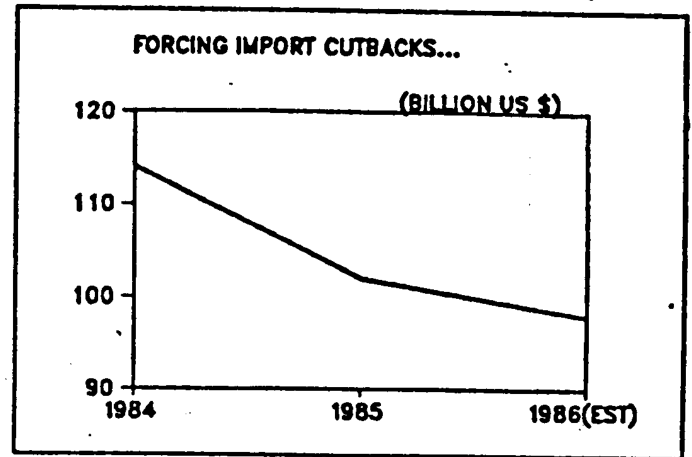

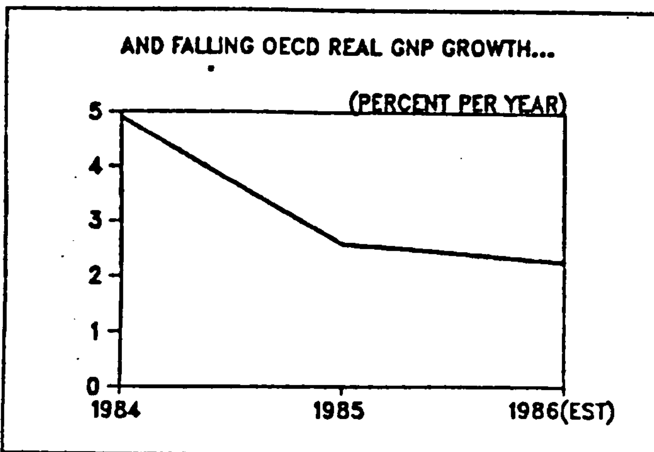

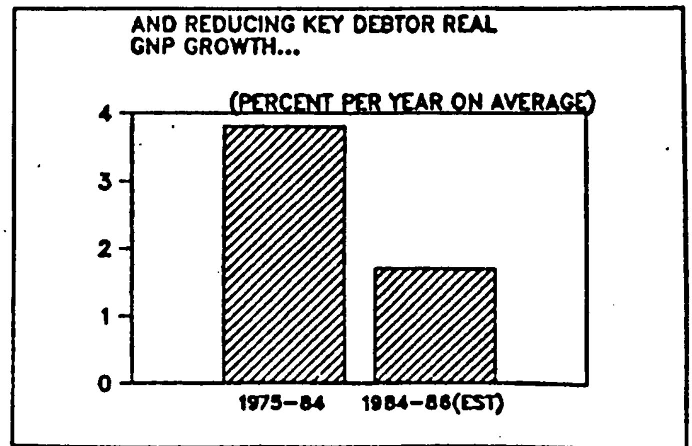

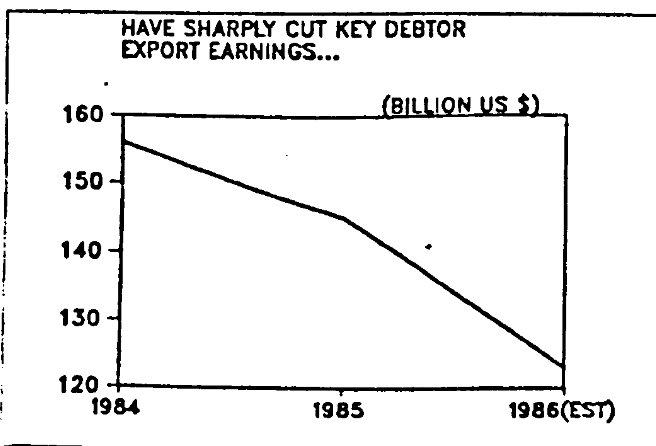

BUT MEXICO IS NOT THE ONLY COUNTRY HARD-HIT...

PERCENTAGE CHANGE 1984-86 [A]

	NONOIL COMMODITY PRICES	EXPORTS	DEBT SERVICE RATIO	IMPORTS	(REAL GNP)
ARGENTINA	-12	-10	22	-12	-4
EGYPT	-6	-23	2	-8	-2
MEXICO	1	-38	B [illegible]	1	-1
NIGERIA	-13	-42	33	-38	-4
PHILIPPINES	-40	-16	26	-20	-6
VENEZUELA	-7	-46	34	-11	-6

A. DEBT SERVICE RATIO CHANGE IS IN PERCENTAGE POINTS.
B. DEBT SERVICE RATIO HAS FALLEN DUE TO PAST DEBT RESCHEDULINGS.

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On the payments side, falling prices and flooding last fall in agricultural areas could reduce 1986 export earnings by as much as $1 billion. Buenos Aires already has cited the US decision to subsidize agricultural sales to the Soviet Union as wreaking further havoc with their foreign payments position. In addition, boosting real GDP growth is an announced government priority and renewed import growth must be a prerequisite to higher real income levels. To realize these goals, we believe that Argentina will seek $2 to $3 billion in new money over the next 18 months or concessions on interest payments to meet financial needs. 25X1

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, and press reports indicate that Argentina is seeking to link debt repayment terms to agricultural export prices. 25X1
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Brazil -- with a $102 billion foreign debt, massive debt service payments, and a high debt service ratio -- 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 $16 billion current account deficit since 1982, tax reform, and budget consolidation. More recently, the Cruzado plan -- Brazil's

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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 sharply declined, and new business investment continues to be sluggish -- signs that inflationary expectations may not have been broken. 25X1

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 1985-86 debt repayments has been concluded, and press reports indicate that negotiations toward a more comprehensive multi-year restructuring could begin before the end of this year. 25X1

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 completely recover 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. 25X1

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At the same time, Chile's economic management team has carried out essential 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.

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Given the precarious financial situation and its economic reforms, Santiago probably feels it has a strong case for debt relief. Embassy reports indicate that Chile will seek rescheduling of payments due through 1989 or 1990, and over $400 million in new funding during 1987-88. Negotiations are scheduled to begin in late September, but progress may not be made until details of the Mexican agreement are clear. 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 rights issue, however, remains sensitive and could delay approval of new loans or other debt concessions, especially from official creditors.

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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 this year, and we forecast a 2-percent

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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.

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Venezuelan leaders have been carefully monitoring the Mexican debt negotiations, and Caracas has been stalling its own negotiations in order to get equal treatment. Moreover, Caracas' 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. However, in our opinion 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.

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Smaller Countries.

In our opinion Colombia will not press for concessions or rescheduling over the next 18 months. We forecast a sharp increase in export earnings this year due to higher coffee prices, and a reliable source indicates that 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.

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The sharp drop in oil prices will slash Ecuador's export revenues by $500-600 million this year and increase the current account deficit to $750 million, according to Embassy sources. 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 poor financial outlook, we believe Quito has a strong argument for further debt concessions.

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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 hard line confrontational attitude toward debt repayment, the de-facto debt relief that has been its result, 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 position on debt repayment.

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The Core Four Central American countries -- Costa Rica, El Salvador, Guatemala, and Honduras -- may be candidates for spillover because of an increased debt burden and continuing economic stagnation. We expect total debt service to again weigh heavily on these small economies, remaining near 40 percent of goods and services exports -- after more

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SELECTED CARIBBEAN AND CENTRAL AMERICAN DEBTORS:
IMPACT OF DETERIORATING TERMS OF TRADE

(percentage changes 1984-86)

	Exports	Prices for Nonoil Commodity Exports	Debt Service Ratio*	Imports	Real GDP
Costa Rica	12	27	12	1	-2
El Salvador	-2	7	0	-1	-3
Guatemala	-3	17	13	-22	-8
Honduras	27	5	11	6	-1
Jamaica	-28	-8	38**	9	2
Mexico	-36	1	-10	1	-1

* Change in debt service ratio is in percentage points.
** 1984-85

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than doubling between 1980 and 1985. In addition, we forecast only a slight increase in real GDP this year, after falling 5 percent between 1980 and 1985. Despite an expected improvement in the trade picture this year due to 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.

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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. With debt negotiations with the IMF and other creditors currently at a difficult stage, and $70 million in arrears to the Fund, Kingston almost certainly will not obtain major concessions or new financing in the near future. Seaga, however, may feel that his good relations with the US government and the potential for Michael Manley's reelection if the economy doesn't improve may enhance his chances for concessions.

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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 these 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.

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The Philippines is a marked exception, however. There the financial and economic situation deteriorated in 1983, and the economy remained in recession though 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, however, economic adjustment measures have been put into effect -- tax measures have been passed, trade liberalization is underway, 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 in order to restore the confidence of creditors and investors.

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In these circumstances, while Finance Minister Ongpin has reportedly stated that Manila intends to pay all the country's debt -- even those that the current government suspects were diverted for personal use by the Marcos regime -- it may cite the alleged diversion of funds as an argument for debt relief. Manila probably believes that the severe political and economic problems faced by the new government puts the Philippines in line for favorable treatment. Manila will particularly cite the need -- especially to Washington -- to make resources available to fight the insurgents while making 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

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that includes a multi-year debt rescheduling and tolerates a high government budget deficit. 25X1

Although in much stronger positions, Indonesia and Malaysia have suffered economic and financial reverses during the past two years. Lower oil prices and, for Malaysia, a sharp decline in commodity prices have reduced export earnings for the two countries by $4-6 billion 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 non-dollar denominated. 25X1

We believe that 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 unless oil and commodity prices rebound sharply. If these funds are not forthcoming, debt concessions modeled in part on those in the Mexican agreement could be requested. 25X1

Thailand's economic outlook has brightened this year, following an economic slowdown in 1985. Exports have risen 19 percent in dollar terms over the first half of this year, and lower oil prices have slashed Thailand's oil import bill. In addition, while the cost of servicing yen-denominated debt has risen--due to the depreciation of the US dollar--Bangkok is refinancing its dollar-denominated debt, and Thai sources indicate that overall debt servicing costs could be lower this year than in 1985. Unless oil prices rise sharply, we believe that the chances for a Mexican-type debt agreement are remote. 25X1

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AFRICAN AND MIDDLE EAST DEBTORS

While there are several countries in these regions that are candidates for spillover, Egypt is of the greatest concern. Export revenues have been devastated by lower oil prices and a sharp drop off in worker remittances; even with modest import cutbacks, we believe Cairo will require substantial new funding to meet financial needs. Although Embassy reports indicate that the Egyptians have recently met with IMF officials, a formal IMF agreement remains unpalatable to Cairo as the strict financial and economic guidelines of a fund-supported program would almost certainly provoke political and social unrest. 25X1 25X1

Cairo will probably also point to a newly-formulated program of economic reform as justification for debt relief. 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 proven more adept at proposing reforms than at implementing them, which has created a credibility gap with commercial banks, creditor governments, and the IMF, delaying agreement on a new standby accord. 25X1

Finally, Egypt 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. 25X1

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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 this year, 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 blocked by strong anti-IMF feeling within the government. 25X1

Nevertheless, Nigeria does not seem willing to press the issue of debt relief. Lagos is aware that past actions -- such as 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 historical relationship with Africa 25X1 These difference could make agreement on a package of debt concessions more difficult. 25X1

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Morocco and Tunisia are in desperate financial straits and could be candidates for spillover, given their 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 in order to secure increased

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funding, but progress has been limited by fear that these measures will lead to a repeat of the bloody riots that followed the imposition of austerity two years ago.

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In Sub-Saharan Africa, a number of small countries -- 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. However, these measures 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.

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RISKS AND OPPORTUNITIES

Creditor-debtor relations likely will 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, 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, while Indonesia, Nigeria, and Venezuela could demand terms linked to oil prices. Press reports confirm Buenos Aires already is making such an argument. Similarly, some key debtors already 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

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[TEXT BOX 3]

ALTERNATIVE PAYMENT SCHEMES

While we believe debtor demands for relief will be modeled after the Mexican financial package, some alternative schemes have been proposed -- and implemented. Some of 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 this year.

- Issuing bonds to service debt. Venezuela passed a new law -- FOCOCAM -- 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 will 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, reportedly with the backing of President de la Madrid, 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 substantially increased. 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.

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Creditors have generally responded harshly to unilateral attempts at reducing debt payments. Commercial creditors view such payment schemes

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as setting dangerous precedents and as obstacles to financial negotiations, so they react accordingly. 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.

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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.

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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 and while continuing to keep tight reins on their respective economies. We, therefore, 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 it 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.

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We expect the question of spillover will grow in importance as the future debt negotiations of major LDCs progress. Debtors will likely 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. Troubled debtors may use this network to time

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announcements of alternative payment schemes to maximize their effect. For example, in Venezuela, the main impetus for the bond program was Caracas' understanding that Mexico was approaching confrontation with its creditors and the time was therefore propitious to also take a tough stance with banks

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Only when Mexico decided to negotiate rather than take unilateral action did Venezuela become more willing to negotiate a mutually acceptable solution instead of maintaining its hardline position.

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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. They view solutions that link debt payments to commodity prices or GDP growth as unacceptable because payment amounts are then subject to factors beyond their control and ability to plan 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 likely 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 will 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

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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.

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Offsetting these increased risks is the fact that the Fund will be perceived as having had a more flexible approach during negotiations -- by allowing larger budget deficits and tying further assistance to growth and oil prices -- may encourage some recalcitrant debtors 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.

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SUBJECT: Mexican IMF Agreement: The Risks of Spillover

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