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FOREIGN DEBT: THE MEXICAN EXPERIENCE

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On February 4, 1990, Mexico and its creditors signed an international debt accord that was both hailed and assailed. In a letter to the International Monetary Fund, the Finance Minister of Mexico, Pedro Aspe, estimated that the deal would save Mexico almost $4 billion a year through 1994. At the same time, Jeremy Morse, chairman of Lloyds Bank, and Kit McMahon, chairman of Midland Bank estimated that the package would "save the country less than $1 billion in external interest payments each year."[1] The significant difference in these numbers for the first accord completed under the so-called Brady initiative (proposed on March 10, 1989) reflect alternative estimates about the benefits of the complex plan. The agreement included interest rate reduction, principal reduction, new money, and partial guarantees from the Japanese, World Bank, and IMF.

Although this article briefly discusses the Brady Initiative and the political economy of the Mexican rescheduling agreement, its major focus is on previous Mexican debt rescheduling efforts going back to the 1820s. As we shall see, many of the proposals which are currently in vogue have been tried in the past. A historical perspective is helpful in examining the prospects for a "definitive" settlement of the debt. In particular, we shall see that excessive euphoria about the success of any single plan is unwarranted and detracts from a long-term concerted effort to resolve both a debt and development problem.

I. THE DEBT CRISIS IN HISTORICAL PERSPECTIVE

For analytical purposes, we can consider four epochs in international lending and rescheduling over the last 160 years.[2] The first epoch began in the 1820s and ended in the 1870s with Britain as the leader in lending; the second overlapped in part with the first and ran from the 1860s with both Britain and France and then Germany taking an active part in the loan market until the onset of the first World War; the third covers the interwar period, when the U.S. was a major lender, up to the post-World War II resolution of debt problems; the fourth runs from the 1970s to the current debt negotiations.

With respect to the lending and borrowing process, two common patterns emerge. On the supply side, the cycles of lending are related to the degree to which banks could float bonds among the public or were flush with deposits. Inadequate analysis by banks and bondholders of the long-term prospects for repayment by debtors appears to be the rule -- rather than the exception.

On the debtors' side, be they U.S. states, European countries, or Latin Americans, the desire

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[1] **Financial Times**, February 1, 1990, p. 5.

[2] This section draws on my article "Interpreting the History of Mexico's External Debt Crises" in Barry Eichengreen and Peter Lindert, eds., **The International Debt Crisis in Historical Perspective** (Cambridge: MIT Press, 1989).

to secure foreign funds as an alternative to raising domestic revenue has often proved to be the Devil's temptation. In the Mexican case, the discovery of large oil reserves at various times only whetted the government's appetite for foreign loans as Mexico was seen to be a more attractive investment site.

Let us examine some of the striking parallels to the current problems facing Mexico.

A. Epoch 1: 1820 to 1880s

The first epoch of lending to Latin America -- and to Mexico in particular -- began with its independence from Spain in 1821 after 11 years of revolutionary turmoil. In 1824, Mexico contracted its first bond loan of 3.2 million pounds (16 million dollars) through the London financial house of Goldschmidt and Company. Mexico received only $6 million of this amount in cash, the rest being lost to discounting of the bonds, money withheld for bond servicing, and commissions. Another bond loan issue for the same amount was contracted in London the following year.

By 1827, however, Mexico stopped coupon payments on the bonds. The banks and bondholders found themselves thrown into negotiations with successive Mexican governments over the resolution of the defaults. It was not until an era of relative peace and a strong government under President Porfirio Díaz in 1885 that Mexico's leaders worked out a comprehensive scheme of financial readjustment to settle these early foreign loans.

Mexico took a first step toward settling its debts in the early 1820s by discussing a secret plan to repurchase its bonds at their depressed price (owing to the political unrest in the country). It then intended to sell them at the inflated price resulting from the artificially "increased" demand. Such a repurchase idea has been considered with respect to the bank loans in the current era. Mexico--as well as other debtors--have often been accused of using part of the new funds they have received to purchase their discounted debt on the secondary market rather than to service debt at its face value.

Negotiations continued throughout the 1830s until Mexico agreed to capitalize overdue interest on the initial loans through the issuance of new bonds. After servicing the new bonds for only a year, Mexico again defaulted on its debt.

In a novel twist on debt-equity swaps, shortly after the Mexico-Texas war the Mexican government sought to adjust its debt while securing support for its effort to regain and maintain its Northern territories. It proposed that British bondholders be given land in Texas, Sonora, the Californias and elsewhere. This proposal garnered little support among London bondholders: they were not interested in obtaining questionable territory; and they were not eager to emigrate to Mexico.

In an example of issue-linkage to trade, in 1857 Mexico agreed to a treaty calling for a $15 million loan from the U.S. in exchange for Mexican trade concessions. But dissension with the U.S.

Government led disagreement over the treaty and in the end the Americans disavowed it. Similarly, in the 1980s, the U.S. actively pressed Mexico to join the GATT and open its markets.

In 1867, after the French-imposed Emperor Maximilian was overthrown, Benito Juárez returned to power. Taking an aggressive stance with Mexico's creditors, Juárez repudiated Maximilian's loans and disavowed the international character of Mexico's Convention debt obligations. Going farther, in 1868, Mexico began to repurchase its foreign bonds at heavily discounted prices (about 20% of their original value).

In 1873, the bondholders tried to pressure Mexico by blocking a railway bond flotation on the London stock exchange. While this effort failed, it apparently generated enough uncertainty among Mexican officials to induce Lerdo to open negotiations with the bondholders. But Díaz revolted against the government, arguing that Lerdo has "sacrificed Mexico's best interests."[3]

Díaz's ascension to the Presidency in 1877 marked a new era in Mexican history known as the Porfiriato. After preliminary efforts to resolve the debt overhang failed, in 1884 Díaz instructed a newly formed commission to prepare a comprehensive plan of financial readjustment, including a bond adjustment proposal. In June 1886, an agreement was reached based on this proposal.

Overall, the bondholders did not fare badly considering the constant defaults, repudiations, conversions, and rescheduling agreements. The holders of the London debt bonds were able to recover all of their principal in 1888 with interest averaging 2.3% a year on the 1824 bond issues, and 1.1% on the 1825 bond issues.[4] By this time, however, most holders of the original debt had long sold their bonds to speculators and thus had already borne the cost of the extended negotiations.

B. Epoch 2: 1880s to the Default of 1913

Following the 1886 settlement, in 1888 Díaz floated a 10.5 million pound bond issue to German capitalists. This began a new period of foreign borrowing. Over the next few years, Mexico secured additional loans connected to railroad construction and general revenue expenditures. Although Mexican credit worsened for some time, as in the late 1970s, the discovery of oil in 1901 set off a major period of borrowing at improved terms. By 1910, 4% bonds were marketed almost at par.

Such propitious circumstances were short-lived. In May 1911, Díaz was overthrown by a revolution led by Francisco Madero. The immediate financial effect was a massive outflow of capital from Mexico. Madero was forced to seek a $10 million short-term loan from American

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[3] Michael Meyer and William Sherman, **The Course of Mexican History** (New York: Oxford University Press, 1987), p. 410.

[4] Edgar Turlington, **Mexico and Her Foreign Creditors** (New York: Columbia University Press, 1930), p. 6.

bankers in 1911 and a second loan for the same amount in 1912. Despite many efforts, no resolution of the revolution-induced default took place during this second epoch.

C. Epoch 3: 1920s to 1940s

Renewed efforts after the first World War led to the conclusion of an agreement between Mexico and its bankers in September 1922. Although the accord provided for rescheduling of about $700,000 in principal and interest payments, it did not provide for an additional inflow of new money -- a key objective of President Obregón. The accord quickly unravelled as de la Huerta, the Mexican Finance Minister who had negotiated the agreement, led an armed revolt against President Obregón. By June 1924, Mexico announced a suspension of the freshly negotiated agreement. The government was experiencing a sharp decline in oil tax revenues as a result of growing foreign competition and the exhaustion of easily accessible wells.

By the end of 1927, paralleling the recent role of the IMF, the bankers sent a committee of experts to Mexico to examine its economic problems in greater detail before additional adjustments would be made. The ensuing depression did not, however, contribute to financial solvency. After initially failing to ratify a new debt agreement negotiated in 1930, the Mexican Congress passed a law in 1932 declaring the accord to be invalid. This default remained in force under President Cárdenas from 1934 to 1940.

Discussion of the bond debt resumed only in 1942. The resulting agreement was highly favorable to Mexico as the U.S. government took an active interest in the talks. The context of World War II was clearly fundamental in creating this auspicious climate for the Mexicans as the U.S. agreed to Export-Import bank assistance to Mexico, a trade agreement, and various other credits and collaboration accords. The debt agreement called for major interest rate concessions, in some cases with agreement to pay 0.1% of the original value on interest arrears! Overall, taking into account provisions for debt resumption and repayment of a portion of the principal amount, it has been estimated that a debt of over $500 million was eliminated for slightly less than $50 million.[5]

II. MEXICAN DEBT RESCHEDULING IN THE 1980S

More than 30 years passed before bankers had forgotten Mexico's earlier debt problems. In the current case, although the majority of its debt has been held directly on the books of banks rather than among the bondholding public at large, the parallels to past debt negotiations continue.

Mexico began to borrow heavily in the late 1970s driven by its oil boom. By 1981, however, falling oil prices dimmed the lights on the party: in that year alone, Mexico's foreign debt grew from

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[5] William Wynne, **State Insolvency and Foreign Bondholders**, Vol 2. New Haven: Yale University Press, 1951), pp. 97-99 and 106.

$55 billion to $80 billion.[6] With massive capital outflow putting pressure on the peso, Mexican authorities devalued the currency by about 30% in February of 1982. Despite this action, Mexico was unable to staunch its loss of reserves and was forced into the now famous August 1982 financial crisis.

Although space limitations preclude an extensive discussion of debt negotiations after this crisis, some highlights are worth mentioning. In August 1982, Finance Minister Jesús Silva Herzog met with US government officials in an effort to secure funds. He managed to secure a commitment for about $3 billion from the U.S. including $1 billion in commodity credits, $1 billion as prepayment for Mexican oil, and about $1 billion as an emergency bridge loan. Mexico subsequently agreed to an IMF program on the 10th of November; significantly, the IMF loan was contingent on the banks' participation in a jumbo loan of $5 billion in new money to Mexico to prevent their being repaid at the IMF's expense. By December 2, 1982, Mexico and the banks reached an agreement on the new money.[7]

In April 1983, new Mexican efforts to reschedule its debt ended with a major agreement negotiated in September 1984 (signed March 1985). During 1983, Mexico successfully met its IMF targets, repaid its bridge loan, and managed to secure a major public sector rescheduling of almost $19 billion. Moreover, by December, the banks agreed to an additional $3.8 billion in new funds on more lenient terms than the previous year.

In 1984, Mexico began efforts to secure a longer rescheduling of its debts. By September of that year, it secured a preliminary agreement for a long-term rescheduling of about $50 billion with maturities of 14 years and no rescheduling fees. But bankers were wary of signing until Mexico and the IMF agreed on the targets for the third year of its IMF accord. After a good faith payment on a portion of the principal of its $5 billion loan and new budget cuts in February 1985, Mexico managed to reach agreement with the IMF on March 25, 1985. Soon thereafter, the agreement with the banks was initialled with over 550 banks participating in the multiyear rescheduling.

From mid-1985 until the March 1987 signing of a $6 billion commercial bank package, Mexico faced severe problems. A divisive election in July 1985 put pressure on the ruling party's (PRI) ability to control dissent; the Mexico City earthquake in September 1985 proved financially, physically, and politically costly; and the dramatic decline in oil prices in January of 1986 forced Mexico to seek large new loans.

By late September 1985, Mexico raised its estimated needs for new loans from $2-3 billion

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[6] Joseph Kraft, **The Mexican Rescue** (New York: Group of Thirty, 1984.

[7] For details on this period, see Kraft, 1984 and Vinod Aggarwal, **International Debt Threat: Bargaining Among Creditors and Debtors in the 1980s** (Berkeley: Institute of International Studies, 1987).

to almost $5 billion. Capital flight worsened toward the end of the year and was further aggravated by the sharp fall of oil prices in mid-January of 1986. In June 1986, the peso fell over 30% in one week while negotiations dragged on with the banks and the IMF. In late July, the IMF provided a relatively softer package calling for additional loans if oil prices continued to fall. Shortly after this agreement, negotiations began with the commercial bankers on their contributions (approximately $6 billion of the total $12 billion package). In the meantime, the U.S. pressed other central banks and the lead commercial banks to come up with a $1.6 billion short term bridge loan to tide over Mexico. Although this effort proved successful, many banks continued to balk at the large $6 billion commitment.

Although banks missed an initial September 30 deadline, pressure on chairmen of the commercial banks from Paul Volcker of the Federal Reserve, de Larosière of the IMF, and Barber Conable of the World Bank encouraged the tentative October 1 agreement. Most significantly, Mexico secured a promise for up to $1.7 billion linked to changes in its economic performance, and an additional $720 million for the same purpose from the IMF. Soon thereafter, Mexico and the banks agreed to roll over an additional $11 billion in private sector debts. The actual raising of funds proved difficult: The final agreement was not signed until April 3, 1987.[8]

[8] **Economist**, April 11, 1987, p. 84.

III. THE BRADY PLAN AND BEYOND

Debtor countries have found it increasingly difficult to comply with IMF-prescribed adjustment packages tied to new rescheduling efforts. With two or three exceptions, every debtor has either stagnated or declined in GNP terms. Mexico, for example, has a GNP which is 16% lower per person than it was in 1982.[9] While some countries such as Peru have linked debt servicing to export receipts, the subsequent cutoff of new funds and trade credits simply sent the Peruvian economy into a tailspin from which it has yet to emerge. With respect to capital flows, in 1988, banks lent only $ 6 billion but extracted $ 26 billion in interest.[10]

Reflecting fears of an uncontrollable crisis, we have seen two major efforts by the U.S. to cope with debt on a more global basis. The so-called Baker plan, first discussed in 1985, has given way to the Brady plan. The Baker plan failed to meet its objectives of getting banks to resume voluntary lending to those developing countries following adjustment plans. It simply continued a case-by-case treatment of debtors without providing for real debt reduction.

In March 1989, an enthusiastic response by debtors and banks greeted a plan proposed by Secretary of the Treasury James Brady. This initiative encouraged the idea that some form of debt reduction, whether in principal or interest, is required at this stage. In sum, Brady advocates reducing old debt while simultaneously providing new money.

The Brady plan significantly departs from the Baker plan in its recognition of the need for debt reduction. Yet it still does not go far enough in terms of a write-down of the debt. A case-by-case approach prevents free-riding debtors from escaping needed adjustment. But the Brady plan does not sufficiently reward countries undertaking major adjustment efforts.

In the recent Mexican rescheduling accord, finally signed on the 5th of February of this year, banks were presented with three distinct options with respect to 48.5 billion dollars of Mexican debt (about half of what it owes). Two involved the exchange of debt for bonds. Under the third, banks were to grant new loans to Mexico equalling 25% of their exposure over four years.

In the actual event, 49% of banks opted for interest rate reduction bonds at 6.25%; 41% chose principal reduction bonds worth 35% off their face value; and only 10% chose the new money option. Although the Mexicans and international financial officials have talked up the benefits of the deal, claiming it will save Mexico from 4 to 5 billion dollars a year on average from 1990 to 1994, all is not rosy.

The deal has allowed hundreds of banks to cut all ties with Mexico -- leaving only a handful of banks as potential lenders. At the same time, small changes in interest rates or oil prices, can once

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[9] **Economist** February 11, 1989, p. 86.

[10] **Ibid**., February 11, 1989, p. 83.

again throw Mexico back into crisis. The banks' exit pushes international agencies, Western governments, and taxpayers to the forefront of the problem. But international institutions do not have the resources to finance Mexico and other big debtor nations. Thus governments will increasingly have to take up the slack, even as banks benefit from tax credits. For example, the new Mexican bonds are valued at 65 cents to the original dollar whereas the open market value of the debt was about half this amount.

Some policymakers recognize the danger to U.S. security if political instability grows south of the border. In an effort to forestall such problems, the U.S. has often given Mexico direct help outside the multilateral apparatus based upon the IMF and the World Bank. But at this point, the U.S. (and other creditor) governments need to apply greater pressure on the banks to reduce their claims on Mexico.

In my view, the failure of policymakers to fully recognize the close interconnections between various issues such as security, immigration, and trade has been a serious obstacle in debt negotiations. As an example, consider the debt-trade link.

First, developing countries desperately need to receive additional funds, a need which the Europeans in particular have failed to recognize. Without hard currency, developing countries are increasingly unable to import consumer goods to maintain social stability. Moreover, a decline in the import of capital goods has impaired their ability to export enough to service their debt. The resulting contraction in export markets represents a high cost for producers in the industrialized countries.

A second element of the debt-trade link is the increasing import competition from developing countries. This competition leads to protectionist demands by domestic producers as they are forced to cope with an influx of low-priced and often subsidized goods. Without debt reduction, this problem will only worsen. Developing countries will continue to use all the means available to them -- including many indirect violations of the GATT -- as banks continue to pressure them to service their debts.

CONCLUSION

As this article has attempted to show, the problem of debt-rescheduling is hardly a novel one. Nor are "new" ideas to "solve" the debt crisis very original. One clear lesson that emerges from an examination of Mexican debt negotiations is that debt resolution is a lengthy process. In addition, the instability engendered by debt negotiations -- not only in Mexico but also in most other debtor countries -- should be a warning to creditor governments.

To date, the debt crisis has been extremely costly for debtors and business groups in the developed countries. In retrospect, it is evident that the initial programs for debt repayment have often been both unrealistic and inappropriate for fostering domestic recovery and growth.

This problem arises from the banks' political success in setting the agenda for negotiations. As a result, both producers in the developed countries and debtors have greatly suffered. Before 1982, banks made huge profits in the developing countries. Now they are reluctant to continue funding developing countries and insist on repayment. The result is a double whammy for producers in the industrialized countries: declining export markets and increasing import competition.

These problems are likely to continue. Europe 1992 poses a potential threat to the developing countries. If European countries who compete most directly with the developing countries secure higher trade barriers, the more global objectives that Europe should have will fall by the wayside. "Fortress Europe" will lead not only to trade conflict with the U.S. but will also undermine Europe's traditionally strong role in the developing world. Moreover, as West Europeans increasingly seek investment opportunities in Eastern Europe, Latin Americans will find it more difficult to raise capital.

A more balanced resolution of the debt crisis requires additional concessions from the banks. Although developing countries must continue to put their house in order, in the absence of further debt reduction, the debtors' adjustment programs will come at too high a political cost. Without quick and decisive action by creditor governments, social unrest could return dictatorships to Latin America.