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The Mexican Crisis: No Mountain Too High?

As a prelude to the overall review of the debt crisis and the debt strategy in later chapters, this chapter takes an in-depth look at the handling of the crisis in Mexico. Although Mexico was not the first indebted economy to erupt, nor the largest, nor the one with the most serious economic or financial problems, the 1982 Mexican crisis was the one that alerted the IMF and the world to the possibility of a systemic collapse: a crisis that could spread to many other countries and threaten the stability of the international financial system. Moreover, the Fund's response to Mexico in 1982 introduced important innovations in the speed of negotiations, the role of structural elements in the policy adjustment program, the assembling of official financing packages, and—most important—relations between the Fund and private sector creditors. This story also illustrates the always complex relationships between the Fund and its major creditor members. A successful resolution of Mexico's financial difficulties was economically and politically crucial for the United States, but the extent of Mexican indebtedness put the solution out of the bilateral reach of the U.S. authorities. The challenge for the Fund was to balance the interests of all of the affected countries, whether debtor or creditor, in circumstances that were critically important to its largest member and principal creditor.

In the middle of August, the pace of work at the IMF normally loses some of its usual freneticism. The Executive Board takes an informal recess while Executive Directors, the Managing Director, and a good portion of the staff go on annual holidays. In 1982, however, the dog days had come early, as the Annual Meetings had been moved forward by a few weeks to accommodate an Islamic holiday.[1] To prepare for the meetings, which were to be in Toronto, Ontario (Canada), the first week in September, the Managing Director (Jacques de Larosière) had returned from a brief holiday in time to chair a full schedule of Board meetings starting August 9. When the telephone rang on August 12, much of the staff was in place, but no one could have suspected that life in the Fund was about to become more frenzied and intense than at any time since U.S. President Richard Nixon had suspended convertibility of the dollar on another August evening 11 years before.

[1]See the discussion at EBM/81/144 (November 18, 1981). The holy day Eid-ul-adja, the date of which is governed by the lunar calendar, fell on September 28, 1982.

Smoldering Embers, 1979–81

There was ample reason to fear a crisis in Mexico, but also ample reason to calm one's fears. The government, first under President Luis Echeverría and later under his successor, José López-Portillo, had been borrowing large amounts in foreign currencies (mostly U.S. dollars) from commercial markets since the early 1970s. From 1973 to 1981, the external debt of the public sector in Mexico had grown at an average annual rate of more than 30 percent, from $4 billion to $43 billion. The mountain was high, and the path steep, but a challenge is not necessarily an obstacle. Was this borrowing a problem, or was it part of a sustainable strategy for economic growth?

Mexico in the early 1980s was no longer the agricultural economy that it had been just a few years before: it had become a power in the international oil market at a time when the price of oil was at an all-time high and was widely projected to rise still further. Consequently, the government's ability to service its debt was now growing at such a rate that the portion of export receipts absorbed by debt service had fallen from a peak of 68 percent in 1979 to 36 percent in 1981. Output had been growing by 8½ percent a year for the past three years, and in spite of the government's adherence to a fixed exchange rate when inflation was running at more than 25 percent a year, the current account deficit appeared financeable, averaging about 4½ percent of GDP.[2]

The Mexican authorities clearly viewed prospects as rosy and as unblemished by the large stock of debt.[3] From 1979 on, once the magnitude of Mexico's oil reserves had become known, government officials regarded the country's growth prospects as no longer subject in practice to a balance of payments constraint. Ariel Buira, then Alternate Executive Director for Mexico in the IMF, noted with satisfaction in January 1979 that

> the resources arising from the oil exports will allow Mexico to overcome the two constraints that in the last two decades had limited its growth rate to around 6½ per cent to 7 per cent per annum. As the rate of domestic savings rises substantially, and the foreign exchange bottleneck disappears, the ceiling which in the past these factors imposed on the rate of growth of the economy will be removed.[4]

Borrowing against future oil revenues to finance investments in productive physical capital was not just good politics, it was sound economics—if the future revenues were secure, and if the investments were productive.

The ability of the IMF staff to sort through the thicket of information and forecasts was hampered in 1980 and 1981 by gaps in what should have been regular surveillance discussions with the authorities. In 1977–79, following an exchange

[2]"Mexico—Recent Economic Developments," SM/83/86 (May 17, 1983), pp. 4 (output and prices), 57 (current account), and 69 (debt service).

[3]The official view did not go unchallenged within the government, but the optimists prevailed. See Kapur, Lewis, and Webb (1997, pp. 602–3) for an account of a battle in 1981 between the ministries of planning (bullish on borrowing) and finance (bearish), which the planning officials won.

[4]Minutes of EBM/79/1 (January 3, 1979), p. 7.

crisis during the 1976 presidential election year, Mexico had implemented a Fund-supported adjustment program under the Extended Fund Facility (EFF). Although the program was certainly successful,[5] it was followed by a period when the authorities did not appear eager to pursue close relations with the Fund. An Article IV consultation mission, led by Walter Robichek (Director of the Western Hemisphere Department), concluded that notwithstanding the success of the program, Mexico needed to make further adjustments; in particular, public sector spending was rising excessively (at a rate exceeding 30 percent a year over the previous three years), pushing up inflation without making more than a "dent" in the unemployment problem. The Executive Board, in concluding the consultation in March 1980, agreed with these concerns but "commended the authorities for their success in reactivating the economy."[6] Nonetheless, two years would elapse before the government would again agree to host a Fund mission.[7]

The external environment began to sour in the first half of 1981, as a sharp increase in short-term interest rates in the United States and other major countries was followed by a softening of demand for oil and the beginning of what would become a disastrous downward slide in the price of Mexico's principal export. The national oil company, Pemex, and the Ministry of National Properties and Industrial Development (SEPAFIN) attempted for a time to avoid cutting export prices in line with the market, apparently on the belief that the comparatively high quality of Mexican oil would ensure a continued market.[8] Instead, Mexico's share of a shrinking market declined, the volume of oil exports for the year was more than 25 percent below projection, and public sector external borrowing jumped to a record $18.3 billion.[9]

Even more ominous than the amount of borrowing in 1981 was its maturity profile. More than half of the new debt was in short-term credits, as the lending banks were beginning to show reluctance to make longer-term commitments; a particularly large hump in repayments now loomed in August 1982. In the meantime, Mexican residents began to accelerate the shift in bank deposits out of the country; by the end of the year, private sector claims on foreign banks totaled an estimated $10 billion.[10] By November 1981, as a Fund mission finally prepared to go to Mexico City for discussions under Article IV, it was clear that all of the preconditions for an economic crisis were present.

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[5]SDR 518 million (140 percent of quota, and approximately $600 million) was originally made available under the three-year program, later augmented by SDR 100 million. Only one drawing was made, however, for SDR 100 million in February 1977. Owing in part to the adjustment program and in part to the development of oil reserves, Mexico was then able to meet its external financing requirements through commercial banks. For further descriptions and analysis of the program, see de Vries (1985), pp. 377–80, and Guitián and Lindgren (1978).

[6]"Mexico—Staff Report for the 1979 Article IV Consultation," SM/80/24 (January 24, 1980), p. 17, and minutes of EBM/80/34 (March 3, 1980), p. 29.

[7]An informal staff visit, without a report being issued to the Executive Board, took place in July 1980.

[8]For accounts of this episode and its consequences, see Kraft (1984), pp. 34–35; Zedillo (1985), p. 313; and Bailey and Cohen (1987), p. 53.

[9]"Mexico—Staff Report for the 1982 Article IV Consultation," SM/82/121 (June 25, 1982), p. 10.

[10]Ibid.

Mounting Concerns: The 1981–82 Consultations

The 1981 consultations were not easy to complete, partly owing to the long interval since the previous meetings, and partly because the government was still preparing the 1982 budget when the mission arrived. After two weeks in Mexico City, the team returned to Washington and reported that it would be necessary to go back in January after the budget had been approved by congress. This they did, but the grounds for pessimism were not diminishing. The mission concluded that the prospects for fiscal adjustment were limited, the outlook for economic activity was poor, the exchange rate (which was fixed against the U.S. dollar) was inconsistent with a price level that was inflating more rapidly all the time, and debt service was likely to rise sharply. A presidential election would be held in July 1982, and not until a new administration took office in December were tough actions likely to be taken.

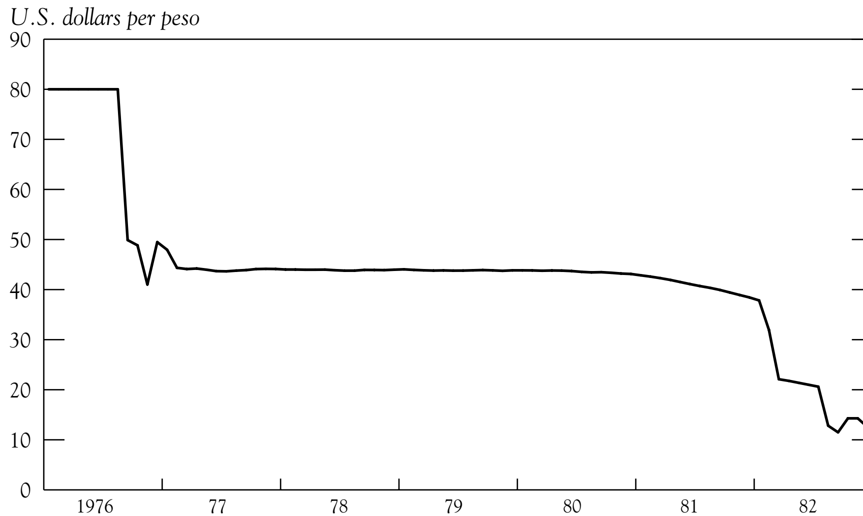
The mission report, however, did not go to the Executive Board right away, because a series of developments caused it to be updated several times. On February 17, 1982, the Mexican authorities announced that the central bank was temporarily withdrawing from the foreign exchange markets and would let the peso find its own level; within a week, the value of the peso in relation to the dollar had fallen by more than 40 percent (Figure 7.1). At the same time, to support the central bank's reentry into the market to stabilize the peso, Mexico drew down its reserve tranche at the Fund: the first use of Fund resources by Mexico in five years.

In mid-March, two senior officials were dispatched to Washington to explain to the Fund staff the measures that were being taken to control the economy. No sooner did they arrive than they were recalled to Mexico for what turned out to be a major shake-up in the leadership. The two officials were among the best that Mexico had yet produced: Jesús Silva Herzog was now to become finance minister (Secretary of Finance), a post that he would hold through more than four years of extraordinary pressure and that would make him one of the most renowned and respected officials in the developing world; and Miguel Mancera was to become governor (Director General) of the central bank (Banco de Mexico, or Bank of Mexico), a post that he would hold—with one interruption, discussed below—until 1997, and through which he would oversee Mexico's struggle to return to financial normalcy. But they began their day in the sun blinded by a fait accompli that marked a serious setback to the adjustment program: the day after their appointments, the government announced the authorization of large wage awards, averaging about 20 percent, which wiped out much of the benefit of February's devaluation and made an acceleration of inflation all but inevitable.

In April 1982, as worries over inflation deepened, capital flight escalated and the financial position of both the public and private sectors continued to deteriorate. Mexico's largest conglomerate, the Alfa Industrial Group, defaulted on the principal payments due on $2.3 billion in debts to foreign banks, in part because of the pressure on its balance sheet from the February devaluation.[11] A stabilization pro-

[11]"The Debt Burden on Alfa of Mexico," *New York Times*, May 10, 1982, pp. D1, D5.

Figure 7.1. Mexico: Exchange Rate, 1976–82



gram—drawn up at the insistence of Silva Herzog—was announced on April 20, promising that the fiscal deficit would be reduced by 3 percent of GDP over the remainder of the year through expenditure control and revenue enhancements, but the specific measures to be taken were left open.[12] Meanwhile, official reserves were sliding precipitously, and at the end of the month the Bank of Mexico drew $800 million overnight on its swap line with the U.S. Federal Reserve to meet its month-end liquidity requirements. Within days, the IMF sent its team back to Mexico City to follow up on the consultation discussions that had apparently been concluded in January, and both Silva Herzog and Mancera flew secretly to Washington to explain developments directly to the Managing Director.[13] At this stage, the Fund's main concern was over the inconsistency between the policy of trying to keep the peso from depreciating against the dollar and the policy of propping up aggregate demand through wage increases and other expenditures that could be financed only through inflation. The Managing Director and the staff knew that the books could be balanced only through continued recourse to external borrowing, but no one could foresee how rapidly the availability of such funds would shrivel up.

[12]"Mexico—Economic Adjustment Program for 1982," EBD/82/99 (April 26, 1982).

[13]Silva Herzog made regular, though highly secret, visits to Washington throughout the period between his appointment in March 1982 and the onset of the crisis in August. On each such visit, he met with officials from the IMF, the World Bank, the U.S. Treasury, and the Federal Reserve. Paul A. Volcker (then Federal Reserve chairman) recalled that the standard advice to the minister was for Mexico to apply for a Fund program and reform the domestic economy, but that the advice was routinely rejected on the grounds that any such action would have to await the inauguration of a new president. See Volcker and Gyohten (1992), p. 199. As discussed below (p. 289), although the Federal Reserve allowed Mexico to make end-month overnight drawings against its swap lines throughout the second quarter of 1982 for window-dressing purposes, no longer-term drawings were allowed until Mexico agreed to seek a Fund arrangement in early August.

A final version of the staff report on Mexico was prepared in the first part of June. The government by this time was making plans for further spending cuts, but neither the authorities nor the Fund staff was under any illusion that the planned cuts would be sufficient to restore even a semblance of balance to reserves without additional measures. Either the exchange rate would have to be allowed to depreciate further or tough domestic measures would have to be taken. In an election year neither option seemed politically viable. At the end of June, a syndicate of commercial banks agreed to lend an additional $2.5 billion to the Mexican government, bringing the total of international bank loans to $9.6 billion for the first half of the year.

Attitudes began to shift in July 1982, as the commercial banks displayed increasing reluctance to lend to Mexico: spreads over the standard London interbank offer rate (LIBOR) were widening, and syndicates were taking longer to form.[14] Although export volumes were growing reasonably well in spite of the second "dip" in the U.S. recession, revenues were still disappointing because of the continuing slump in oil prices. The only signs of brightness on the horizon were that the Federal Reserve was easing up on U.S. monetary policy enough to bring interest rates down a little (by about 1 percentage point on three-month U.S. treasury bills from April to July)[15] and that Mexican elections on July 4 had produced a president-elect who seemed committed to financial stability. Miguel de la Madrid, however, would not assume office for another five months, and neither a major economic contraction nor a program with the IMF would be the finale that López-Portillo hoped to have for his presidency.

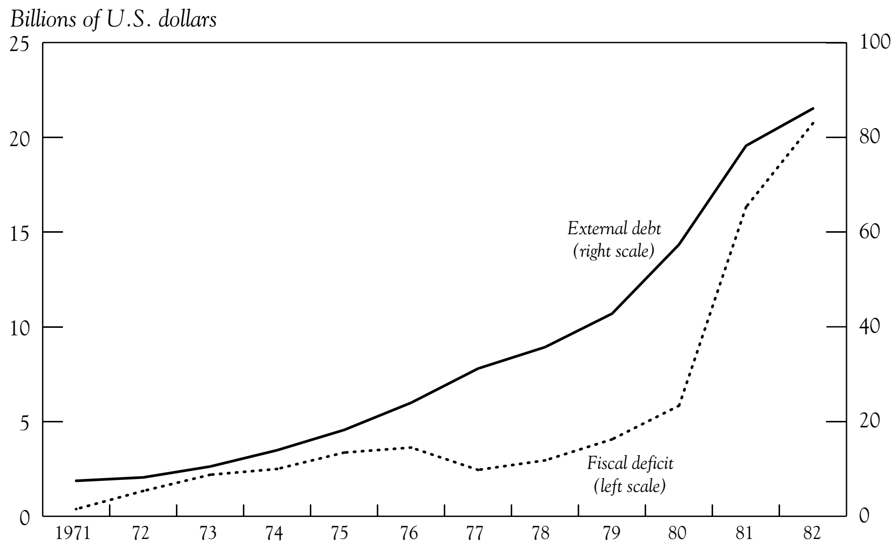
Caught between the obvious need to take further action and the desire to avoid a Fund program, the Mexican authorities explored the possibility of gaining some form of public approbation from the IMF that would enable them to improve their access to bank loans. On July 8, just before leaving on vacation, the Managing Director gave the staff team the go-ahead to explore with the authorities the idea of negotiating a policy program independently of any request to draw on Fund resources. If the proposed policy actions were strong enough to justify Fund financial support but could in fact be supported by bank loans instead, so much the better. The Fund, however, could not in any circumstances give its seal of approval to a weaker program just because its own money would not be put at stake.[16]

[14]Edwards (1986) documents the sudden rise in interest rate spreads and notes that it is "somewhat puzzling" (p. 583) that it did not occur months earlier.

[15]This episode has been the subject of much controversy. Kraft (1984, p. 8) and Lissakers (1991, pp. 205–206) attribute the easing in part to concerns over the effects that high interest rates were having on the cost of servicing Mexico's floating-rate external debt; but contemporaneous accounts generally give the dominant weight to domestic considerations. Volcker (in Volcker and Gyohten, 1992, pp. 179–180, and in interviews with the author) has argued that the easing in policy was unrelated to Latin America and could not have affected it very much in any case. It may also be noted that neither Volcker nor Anthony Solomon—the two most internationalist members of the Federal Open Market Committee—was the driving force behind the shift.

[16]Memorandum for files by Nigel Carter (Personal Assistant to the Managing Director), July 12, 1982; in IMF/RD Western Hemisphere Department file "Mexico—General Correspondence July–November 1982)" (Accession 87/19, Box 2, Section 94). This proposal—developed at a meeting between de Larosière and Robichek—was the prototype for what would become known by 1984 as "enhanced surveillance" (see Chapter 9).

Figure 7.2. Mexico: Fiscal Deficit and External Debt, 1971–82



Sources: IMF, *IFS*; and World Bank, *World Development Indicators*.

On July 16, 1982, the Executive Board met to conclude the Article IV consultations: the first Board meeting on Mexico since March 1980. The gap in consultations prompted quite a little grumbling, reflecting concerns over the effectiveness of surveillance. Those concerns would become more acute later, when the full scope of the crisis could be viewed with hindsight; for the moment, the complaints came primarily from Christopher Taylor (Alternate—United Kingdom) and Douglas I.S. Shaw (Temporary Alternate—Canada), both of whom argued that major developing countries should be given as much and as frequent attention as the major industrial countries.

More generally, several Directors were worried about the buildup of external debt (Figure 7.2). Costa P. Caranicas (Alternate—Greece) noted that Mexico had the world's largest external debt and that the staff was projecting what he termed a "staggering" magnitude of new borrowing during 1982. International banks were becoming uneasy about the situation, and if they should withdraw from additional financing, Mexico could be forced to undertake a harsh adjustment. Tom de Vries (Netherlands) noted that the staff report had not expressed a clear view on whether the debt position was sustainable. The promised cut in the fiscal deficit—from nearly 15 percent of GDP to less than 12 percent within eight months—was substantial and yet insufficient. No doubt having reflected on the similar problems that his own country had faced after experiencing a major expansion of natural gas exports in the 1970s, de Vries observed that while in general it was perfectly sensible to finance capital investment by external borrowing, such a policy would appreciate the exchange rate and thus squeeze the country's traditional

export sectors. Taylor added that much of the more recent borrowing carried very short maturities; a rephasing of the maturity structure, in his view, would have to be given a high priority.[17]

Notwithstanding these expressions of concern over the buildup of external debt, none of the discussion on July 16 suggested that a debt crisis was imminent.[18] Mexico's Executive Director, Ariel Buira, observed that the country had a good external credit rating and that he expected banks to continue to support the government's financing requirements. In sum, everyone involved knew that Mexico faced major financial difficulties that required a serious commitment to reduce the fiscal deficit and thereby sharply diminish reliance on external borrowing. Everyone knew that such a commitment could not become credible at least until de la Madrid assumed the presidency in December. But this knowledge was covered by an assumption—or a hope—that commercial financing would continue to be available until the necessary policy adjustments could be made.

The Board's complacency in July reflected the muted nature of the staff's warnings. For more than two years, the staff had been expressing concerns over the debt buildup by Mexico, albeit obliquely and without portending a *debt* crisis per se. In the January 1980 report on the 1979 consultations, the staff warned that "official external borrowing on the scale now being envisaged" could "lead to a level of domestic spending incompatible with the intended deceleration in the rate of domestic inflation." In November 1981, the mission concluded that borrowing had been used to support domestic consumption and had led to a widening of the current account balance; and that in "light of the above a major reorientation of public sector financial policies is needed." Finally, the June 1982 report noted that the "willingness of foreign lenders to extend credits to Mexico undoubtedly will depend on whether progress is being made toward a lower and more sustainable public sector financing requirement." As these passages indicate, the staff's emphasis was always on the need for policy adjustment as a prerequisite for financial stability. Projecting whether and when commercial lenders might decide to withdraw if adjustment fell short was outside the scope of the reports.[19]

[17]Minutes of EBM/82/100 (July 16, 1982), pp. 7 (de Vries), 11–12 (Caranicas), and 15 (Taylor).

[18]The July 16 meeting was chaired by the Deputy Managing Director, William B. Dale, because de Larosière was in Europe, where he had attended the monthly meeting of BIS governors in Basel, Switzerland. Several of the central bankers present in Basel reportedly expressed concerns about the ability of banks to survive defaults in Eastern Europe or Latin America. The sense of that discussion was reported to Dale on July 15, but the report did not specifically mention Mexico. Minutes of EBM/82/103 (August 9, 1982), p. 3; cable from Aldo Guetta (Director of the Paris Office) to the Acting Managing Director (July 15, 1982), in IMF/CF (I 300 "Bank for International Settlements 1979–1982").

[19]See "Mexico—Staff Report for the 1979 Article IV Consultation," SM/80/24 (January 24, 1980), p. 18; staff translation of the final statement presented to the authorities during the 1982 Article IV consultation discussions (November 27, 1981), p. 2 (attached to a December 2, 1981 memorandum from Beza to management, in IMF/RD Western Hemisphere Department file "Mexico, January 1981–December 1981" (Accession 84/70, Box 2, Section 74); and "Mexico—Staff Report for the 1982 Article IV Consultation," SM/82/121 (June 25, 1982), p. 18. Throughout the period leading up to the crisis, the staff and management of the World Bank were generally more optimistic about Mexico's prospects than the Fund; see Urzúa (1997), pp. 73–75.

Was it reasonable to expect banks to keep lending, when Mexico's financial imbalances were so evident? Certainly it was in the banks' collective interest to roll over the principal on existing loans, although the degree to which it was in their interest to make additional loans would have been more controversial. What was more difficult to foresee and was largely overlooked at the time was that the riskiness of loans to Mexico had become great enough that each individual bank had an interest in demanding repayment now, as long as it could do so ahead of any general stampede. This conflict between the individual and the collective interest was by this time a quietly but rapidly burning wick. An explosion was already inevitable.

The Crisis Erupts: August 1982

One week after the July Board meeting, Silva Herzog, once again in Washington, informed William Dale, then Acting Managing Director, that the financial situation was continuing to worsen and asked that the IMF send a mission to Mexico at once. No mention was made of a possible financial arrangement with the Fund. The minister was primarily interested in consulting closely on proposed policy adjustments, perhaps with an eye toward the sort of monitoring arrangement that had been discussed a few weeks earlier. But by the time Sterie T. Beza (Deputy Director, Western Hemisphere Department) and his team arrived in Mexico City at the beginning of August, the authorities, on instructions from President López-Portillo, were prepared to begin negotiations for a three-year arrangement under the EFF.

Discussions began on a hectic pace that was greatly accelerated in comparison with the Fund's usual practice and that prefigured the intense and telescoped negotiations that followed the Mexican and Asian financial crises in the 1990s. Beza's mission spent one week in Mexico City, gathering the detailed information that would be needed for the negotiations soon to follow. The authorities, aware of how quickly their ability to manage the debt portfolio was unraveling, hoped to complete work with the staff and win preliminary approval from the Fund's management by the end of August, and Beza was prepared to do everything possible to meet what must surely have seemed to be an impossible deadline.

Even before the week was out, two emergency measures had to be taken. On August 4, the Bank of Mexico drew $700 million on its swap line with the Federal Reserve; in contrast to the overnight drawings that had been made in the preceding months, this drawing carried a three-month maturity. Then, on August 5, a dual exchange market was introduced in an effort to isolate speculative capital flows within a market in which the exchange rate would float freely. This grudging and partial recognition of the ongoing fall in the market value of the peso (see Figure 7.1) could do no more than briefly delay the collapse of the policy regime. It might temporarily stem capital flight, but it would do nothing to revive and may even have helped to kill the already comatose financing from commercial lenders abroad.

Beza formally reported back to management on Monday, August 9, and was given the green light to prepare rapidly for a negotiating mission that would start the following Monday, August 16. If agreement could be reached on a comprehensive set of policies to control public expenditure, Mexico—which had no outstanding drawings from the Fund other than the reserve tranche purchase mentioned above—would qualify for maximum access under the EFF, which over three years would total SDR 3.6 billion, or the equivalent of 450 percent of Mexico's Fund quota. In addition, Mexican officials had requested authorization to draw the equivalent of 100 percent of their quota (SDR 800 million) under the Compensatory Financing Facility (CFF). Though a smaller amount, that money could be made available immediately upon approval by the Executive Board, perhaps as early as October.

Even this ambitious plan proved to be too slow to cope with the events that ensued that very week. On Wednesday, August 11, Silva Herzog concluded that Mexico could no longer contain the problem by negotiating only with commercial creditors. His principal debt negotiator, José Angel Gurría Treviño, informed him that banks were refusing to roll over the principal payments that were due next Monday, and the Bank of Mexico did not have sufficient reserves to meet them. If Mexico defaulted on those payments, the lending banks would be subjected to heavy pressure from regulators (who could require them to write down the value of their loan portfolio, not just to Mexico but to other countries as well), depositors, and shareholders. Mexico faced a simple choice: default or obtain outside assistance. Because the amounts involved were large enough to threaten the stability of the financial systems of the major creditor countries, there was a good chance of getting help.

On Thursday, August 12, Silva Herzog decided on several actions that would have to be carried out before the weekend. First, he ordered the exchange markets closed. Banks were authorized to purchase foreign exchange from the Bank of Mexico at a fixed rate (69.5 pesos per U.S. dollar) that was less favorable than the prevailing market rate (around 75), and dollar-denominated deposits were to be payable only in pesos, with balances converted at the official rate. Second, he had a letter sent to creditors informing them that Mexico was unable to pay the principal that would become due on Monday. Third, he telephoned de Larosière, Federal Reserve Chairman Paul Volcker,[20] and U.S. Treasury Secretary Donald Regan, and informed them of the actions he was taking. Fourth, accompanied by Gurría, Mancera, and other officials, he flew to Washington to make the case in person.[21]

Containing the Crisis: The First Weekend

It was Friday the 13th, but it was a pleasant sunny morning as Silva Herzog and his team went to the IMF for a nine o'clock meeting with de Larosière and the

[20]The Federal Reserve staff, at least, seems to have anticipated the crisis to some extent. As recounted in Volcker and Gyohten (1992), p. 200, Volcker had been alerted by his office on Monday that Mexico was imminently going to be unable to meet its payments to banks, a call that prompted him to return prematurely to Washington from a fishing holiday in Wyoming just before the crisis broke.

[21]See Kraft (1984), p. 2, for a description of Silva Herzog's initial actions.

Fund's Mexican team in the Managing Director's office.[22] De Larosière told them that the Fund was prepared to help them as much as possible, but first Mexico would have to find a way to avoid defaulting on its debts. Only if the government stayed current on its interest payments and reached agreement with its creditors regarding the scheduling of principal payments could the Fund be expected to have the requisite support for a substantial financial arrangement. More fundamentally, solving the problem would require adopting a severe adjustment program. The Managing Director suggested that the program would have to be designed by the Mexican authorities themselves and would have to meet their own political as well as economic requirements; the transition in the presidency would complicate matters, as the program would have to be endorsed by both the outgoing and the incoming administrations.

Silva Herzog assured the Managing Director that he had the authority to speak for both leaders and that President-Elect de la Madrid would name a representative to participate fully in the negotiations.[23] This assurance was in fact a bit of bluster: the current president was far from convinced that Mexico should undertake the commitments that such a program would entail, and there would be substantial opposition in the cabinet. All the more important, then, that the program be homegrown and not be seen as imposed from outside.

While the Fund staff continued to prepare for the previously scheduled negotiating mission, Silva Herzog spent the rest of that Friday and the weekend lining up U.S. official support for emergency funding. As has been documented elsewhere, that effort was nearly toppled by U.S. officials who insisted that Mexico should pay a high price for the rescue. To some extent, that position was motivated by a desire to design the deal so as to promote unrelated domestic or foreign policy objectives.[24] In addition, the U.S. administration's position was driven both by the need to win the approval of the U.S. Congress and by an innate Bagehot-like con-

[22]If Silva Herzog read his horoscope in the *Washington Post* that morning, he would have learned that "Your bargaining position is stronger than might be apparent on surface. . . . Your financial potential can be more fully exploited today." De Larosière was told to "Be prepared for revisions, rewrites. You are capable of building on a more solid structure. Individual who shares interests might 'lecture' you."

[23]Notwithstanding the interregnum, the Mexican negotiating team exemplified the country's unusual tradition of continuity in government under the ruling Partido Revolucionario Institucional (PRI). Silva Herzog had been appointed by López-Portillo in part because he was a close associate of incoming President de la Madrid; he later became ambassador to Spain and then to the United States under the two presidents who succeeded de la Madrid. The chief representative appointed by de la Madrid in the fall of 1982 was the head of his transition team, a Harvard-trained economist named Carlos Salinas de Gortari. Salinas became Minister of Budget and Planning in the new administration and in 1988 was elected to succeed de la Madrid as president. His assistant in the 1982 negotiations was Pedro Aspe Armella, with a Ph.D. from MIT. Aspe eventually became Secretary (Minister) of Planning under de la Madrid and Secretary of Finance under Salinas.

[24]See Kraft (1984), Bailey and Cohen (1987), and Leeds and Thompson (1987). The three books tell a generally consistent story, but they do not always agree on the details. The account here is based primarily on interviews with Mexican and U.S. officials who participated in the meetings.

viction that assistance to countries in economic difficulty had to be expensive to be effective.[25]

A key element in the package was an agreement that the United States would make an advance payment for imports of Mexican oil for its strategic reserve stockpile. In a meeting on Friday that occasionally became tumultuous and that lasted through much of the night, the U.S. negotiators offered terms that the Mexican representatives felt were far too expensive: in return for an immediate $1 billion payment, Mexico would agree to deliver oil later with a much higher market value, a gap that yielded an implicit interest rate of around 18 percent (which Paul Volcker would later describe as "egregiously high");[26] and would pay an up-front $100 million fee. At lunchtime on Sunday, with the U.S. treasury still insisting on these terms, Silva Herzog telephoned López-Portillo from the Mexican embassy for instructions and was told that if he could not get better terms, he had to reject the offer. The president saw the two countries as mutually dependent on resolving the crisis, and if the United States did not see the need for flexibility, then "Rome" would burn.

At this stage, Silva Herzog saw little choice but to call off the negotiations, return home, and order the Mexican banks closed as of Monday morning. Before he could leave, however, he received a telephone call at the embassy from the Deputy Secretary of the U.S. Treasury, Richard T. (Tim) McNamar. McNamar had managed to reach Secretary Regan, who was playing golf with President Reagan, and had persuaded him that insistence on the existing terms would cause negotiations to collapse and thereby pose an immediate threat to the international financial system. Regan authorized him to negotiate more flexible terms, and McNamar now persuaded Silva Herzog to stay for one more meeting. Having been meeting not only with the Mexican authorities but with officials from several U.S. agencies almost nonstop since Friday afternoon, and having had almost no sleep, McNamar no longer trusted himself to lead the negotiations. Volcker took over for the final discussions and negotiated a halving of the up-front fee and a reduction in the interest rate. Though the cost was still high, these adjustments were enough to win an agreement. Mexico would receive $1 billion from the U.S. Energy Department[27] on August 24, and—most important from the Mexicans' perspective—the possibility of completing other parts of the package on more favorable terms would be kept alive.

Two other arrangements with the United States were settled before Silva Herzog left for home Sunday night. First, the Commodity Credit Corporation (an agency of the Department of Agriculture) provided slightly more than $1 billion in guarantees for credits for food imports.[28] Second, the U.S. Treasury drew on the

[25] Walter Bagehot's classic 1873 treatise, *Lombard Street,* is generally credited as the origin of the doctrine that a central bank, acting as lender of last resort in a currency crisis, should lend freely to banks but only at a penalty rate.

[26] Volcker and Gyohten (1992), p. 201.

[27] To add to the unprecedented complexity of the package, since the Energy Department did not have an appropriation of funds large enough to provide this payment, the money was actually provided by the Defense Department in a transaction coordinated by the Treasury.

[28] See U.S. Department of Agriculture, Press Release 1014–82 (August 20, 1982) and FAS Report PR-158–82 (September 17, 1982). These guarantees covered loans by the U.S. private sector (primarily commercial banks) to Mexican importers of U.S. food products (mainly maize).

Table 7.1. Financial Assistance to Mexico, August–December 1982

Source	Type	Date	Amount (Millions of U.S. dollars)[a]
United States			
Federal Reserve swap lines	90-day credit	August 4	700
	BIS-linked, short-term	August 28	325
Strategic petroleum reserve	advance payment for imports	August 24	1,000
Department of Agriculture	credit guarantees	August 15	1,000
Treasury (Exchange Stabilization Fund)	line of credit:	August 15	
	commitment		1,000
	drawn	(repaid August 24)	(825)
	BIS-linked credit	August 28	600
Bank for International Settlements[b]	short-term credit	August 28	925
Other bilateral (France, Israel, Spain)	swap lines	August	550
IMF	first credit tranche (immediate)	December 23	220
	extended arrangement (three-year commitment)		3,750
	initial drawing		(110)
World Bank			
Inter-American Development Bank			
Commercial banks	medium-term concerted lending	December 23	5,000

[a]IMF assistance denominated in SDRs; amounts converted to dollars at market exchange rate.
[b]Non-U.S. G-10 central banks, plus those of Switzerland and Spain.

Exchange Stabilization Fund to establish a new temporary currency swap line for $1 billion. Mexico immediately withdrew $825 million on the swap line, which was repaid on August 24 using the proceeds from the advance oil payment.[29]

The immediately available resources from the United States (see Table 7.1) would enable the Mexican government to meet the interest payments due to banks and other commercial creditors on Monday, but bigger money would be needed soon if default was to be averted before Fund resources could be made available. After hearing Silva Herzog's story on Friday morning, at a ten o'clock meeting at the Federal Reserve headquarters a few blocks south of the IMF, Volcker got on the telephone to try to arrange an emergency meeting of the Deputies of the Group of Ten (G-10) central bank governors, under the aegis of the Bank for International Settlements (BIS) in Basel, Switzerland. This being mid-August, his task was not easy. He reached Fritz Leutwiler, President of the BIS, and asked him if the BIS could lend $1.5 billion to Mexico. Leutwiler was prepared to listen to the case, and

[29]*Federal Reserve Bulletin* (December 1982), p. 742.

he immediately called his senior staff back from vacations so that a meeting could be held on Monday. Volcker called Gordon Richardson, governor of the Bank of England; Richardson was on holiday, but he returned to work straightaway, and from that moment he would play the leading role in organizing European support for the rescue package. London was the major center for coordinating European bank loans to Latin America, and British banks had the highest exposure in Europe. Richardson instinctively recognized the magnitude of the crisis and the importance of global cooperation, and in any event the Bank of England could not have helped but play this role.

Volcker and Leutwiler both tried to telephone Haruo Mayekawa, governor of the Bank of Japan. He also was on holiday, but when his deputy, Takeshi Ohta, relayed the message to him, he returned at once to Tokyo and then flew to Basel. Japanese banks had the second highest exposure to Mexico after those in the United States. Both the Bank of Tokyo and the Industrial Bank of Japan would be threatened by a Mexican default, and the Bank of Japan was perhaps even more sensitive than the U.S. Federal Reserve to the possible systemic effects of a major portfolio writedown.

Between phone calls that Friday, Volcker found time to have a second meeting (over lunch) with Silva Herzog[30] and to meet twice with de Larosière. Though perhaps not a troika one would normally have thought to harness together, these three men would now meet and talk almost constantly over the next several months and together would assume the leadership of this most extraordinary rescue effort.

Bridge Loan from the BIS

As soon as the meetings with U.S. officials were concluded Sunday afternoon, Silva Herzog (who, himself, would have to return to Mexico City to direct the negotiations with the IMF) asked two of his associates—Ariel Buira and Alfredo Phillips (Mancera's international deputy at the Bank of Mexico)—to catch a plane that evening to Basel for meetings at the BIS. Neither man had anticipated having to go abroad so suddenly, but within two hours they managed to gather together a change of clothing, buy plane tickets, and catch the overnight flight from Dulles Airport to Paris.

The BIS credit package was a key element in the effort to provide enough emergency financing to the Mexican government to cover the period until IMF resources would become available. Arranging this package was complicated, because it was outside the usual business practice of the BIS. In normal times, BIS loans are made in secrecy to central banks, using funds on deposit from central banks, for the purpose of short-term reserve management. What was now being contemplated was for the BIS to coordinate a loan by a group of central banks to the Bank of

[30]Volcker later wrote that he and Silva Herzog had lunch at the Fed so frequently that year that Silva Herzog "indelibly" associated him with the lemon meringue pie that he (Volcker) always had for dessert; see Volcker and Gyohten (1992), p. 199.

Mexico; publicity would be an integral part of the operation, as the loan was intended not only to provide resources but to demonstrate an international commitment to helping Mexico work its way out of the crisis. The only real precedent for such concerted central bank action was the series of loans to Hungary that had been arranged earlier in the year (Chapter 8).[31] That lone precedent now proved to be extremely useful, as the lessons that had been learned in the spring could be applied directly to this new case, thereby enabling the BIS to act with an alacrity that was indispensable in the crisis at hand.

The first step toward arranging such a loan was to determine a basis for sharing the loan among the participating central banks. The work in Basel therefore began with a technical meeting of the BIS staff with the staff of the G-10 central banks, primarily to estimate the level of loan exposure to Mexico by commercial banks in each country. The available data were poor. Some countries had quite up-to-date estimates, while others lagged by several months. More fundamentally, allowance had to be made for the distortions produced by the use of foreign branches for making international loans; for example, if the New York branch of a Tokyo bank lent to Mexico, balance of payments data would treat it as a U.S. bank loan, but the underlying exposure should be allocated to Japan.

Once the background work was completed, the central bank deputies (i.e., the principal alternates to the governors of the participating central banks) met with the BIS management and the Mexican representatives on Wednesday, August 18, to determine the feasibility and appropriate terms of the requested loan. The G-10 central banks were all represented, along with the Swiss National Bank. (The Bank of Spain was also invited and would join in the lending operation, but they were unable to recall their staff from vacation in time to participate in the initial meetings.)

Volcker had suggested a loan of $1.5 billion, and his deputy at the meeting, Henry Wallich, indicated that the Federal Reserve and the U.S. Treasury Department were prepared to finance half of that amount. The starting point for the discussion thus was a request for $750 million from the BIS, backed by the other participating central banks. That amount was quickly raised from the G-10, and when the Bank of Spain offered an additional $175 million, the total was raised $1.85 billion ($925 million each from the United States and the BIS), which became the final agreed figure.[32]

[31]In 1977, the BIS had given similar publicity to a concerted loan to the Bank of England. That loan, however, was a medium-term credit designed to support a gradual and orderly reduction in the use of the pound sterling as a reserve currency. It was approved in January 1977, one week after the United Kingdom's request for an IMF stand-by arrangement was approved by the Executive Board; though conditional on compliance with the Fund program, the BIS loan served to complement the stand-by financing, not to provide a bridge to it. See de Vries (1985), pp. 475–76; and the 1976–77 *Annual Report* of the BIS, p. 144.

[32]Of the U.S. portion, $600 million would come from the Treasury's Exchange Stabilization Fund, and $325 million from a special swap line established by the Federal Reserve. These arrangements were formally linked to the BIS loan through cross-payment clauses, which provided that all payments would be shared equally between the United States and the BIS. During this same period, other short-term official financing was being made available separately, including swap lines with France, Israel, and Spain.

From the beginning, it was understood that a condition for the BIS loan was that Mexico should be actively negotiating with the Fund for an EFF arrangement. The two loans (from the United States and the BIS) would each be disbursed in three tranches, assuming that negotiations with the IMF were completed according to the anticipated schedule: the first immediately upon final agreement between the Banco de Mexico and the BIS together with the Federal Reserve, a second in mid-November, and a third in mid-December.[33] As the IMF's resources came on board, the BIS would get its money back; the $1.85 billion would not be in addition to the EFF money, but it would bring it forward (see Table 7.1).

Another condition to be resolved concerned the collateralization of the loan. In its usual short-term lending, the BIS accepts a central bank's gold reserves as collateral, but the Bank of Mexico's gold reserves amounted to less than half the size of the proposed loan. What Mexico did have was oil reserves, and the Deputies agreed that the revenues from future sales of oil could be pledged to secure the loan. A joint BIS–Federal Reserve mission then went to Mexico City to quickly negotiate the details of that pledge, and the first tranche of the loan was disbursed and publicly announced on August 28.[34]

First Agreement with the Commercial Banks

While the BIS was arranging this bridging operation and the IMF team was in Mexico City gathering information for the program negotiations, the commercial bank creditors were also scrambling to coordinate a response to the crisis. Mexico had made the payments due on August 16, but a protracted and coordinated effort would be required to ensure that the principal outstanding would be maintained and even raised so that Mexico could continue to meet interest payments as they came due. There were more than 500 banks with substantial loans to the Mexican government. Although many of these banks had small amounts outstanding, the sum of the small amounts was substantial enough to be of major concern to Mexico and the larger creditors, as well as to bank regulators and to the IMF. No plan could be successful unless it kept the small banks in the game.

During the initial crisis weekend in Washington, Silva Herzog had telephoned as many of the major bank chairmen as he could reach from his room at the Watergate Hotel. From those calls emerged the idea of holding a meeting with creditors as soon as possible. On Tuesday, August 17, he sent out more than 100 telexes to Mexico's main private and official creditors, and to the IMF, inviting them to a meeting in New York on Friday the 20th, to discuss Mexico's credit requirements and its plans for adjusting policies. The meeting would be at the Federal Reserve Bank of New York, hosted by the Bank's president, Anthony Solomon.

[33]1982–83 *Annual Report* of the BIS, p. 165.

[34]The principal negotiating parties were Remi Grós, Manager of the Banking Department at the BIS; F.-E. Klein, Legal Advisor at the BIS; Michael Bradfield, General Counsel at the Board of Governors of the Federal Reserve System; and Mancera. The loan agreement was formally approved by the governors of the BIS at a meeting in Toronto on September 5.

A large meeting was needed in order to inform and involve as many banks as possible, but it was already clear that a smaller group would need to take charge of relations with Mexico. Solomon therefore also arranged a small working dinner for Thursday evening at the Federal Reserve Bank. Buira and Phillips flew into New York from Switzerland, where they had been representing Mexico at the BIS meetings. Silva Herzog came up from Mexico. Volcker, his international deputy, Edwin M. Truman, and McNamar came up from Washington. All of those present were worried that the large and diverse group of banks that would be represented the next day would find it difficult to act decisively on the Mexican request. To deal with that concern, the group devised what would become the standard modus operandi for the debt strategy of the 1980s, in which the banks would establish a small coordinating committee, comprising senior officials from the largest creditors.

Early the next morning, August 20, at a meeting between Silva Herzog and the chairmen of four major New York banks—Walter Wriston of Citibank, Willard Butcher of Chase Manhattan, John McGillicuddy of Manufacturers Hanover, and Donald Platten of Chemical Bank—the idea of a coordinating committee was agreed upon. Over breakfast, Silva Herzog stressed that Mexico believed that it could stay current on its interest payments and that it would do everything possible to do so, but that he had to ask the banks to roll over the principal, of which perhaps another $1 billion would be coming due within a week. He asked for an extension of maturities of one or two years, but the bankers balked; Wriston, in particular, argued that the problem would appear unmanageable if payments were delayed for that long. The group agreed in principle to postpone principal payments for 90 days.

That same Friday morning, representatives of 115 commercial banks gathered at ten o'clock in the auditorium at the New York Fed. The IMF was represented by Robichek and by Manuel Guitián (Senior Advisor in the Exchange and Trade Relations Department). Silva Herzog explained the general adjustment measures that Mexico was prepared to take, and he related the assistance that had been assembled from official creditors. The government would stay current on its outstanding bonds, trade credits, and officially guaranteed export credits, and he did not expect to have to request a rescheduling of official bilateral credits from the Paris Club. Mexico expected support from the Fund, but Silva Herzog also needed help from the banks. He asked for a "purely temporary" 90-day rollover of principal on banks loans, and he promised that all banks would be treated uniformly.

Silva Herzog's candor, and his willingness to work with the banks in a cooperative spirit, had a salubrious effect. Many of the bankers may have come to the meeting prepared for a confrontation, and all must have been looking primarily for a way to get their money out as fast as possible. Now most of them saw that the problem could be contained if they all cooperated, even if that meant *increasing* their exposure in the short run. Much work would remain before new loan agreements could be drafted and signed, and the smaller banks knew that it was in their interests not to participate, as long as the large banks were prepared to raise their own exposure. Nonetheless, the meeting ended with a general oral commitment to try to work out the requested rollover.

That same morning, 14 of the largest bank creditors, based in 8 different countries on 3 continents, adopted the proposal that had been devised over breakfast, to establish an advisory committee to negotiate new loan agreements *ad referendum* on behalf of all banks holding syndicated loans to the country, organize participation in financing those agreements, and serve as liaison with the country and with official agencies including the Fund.[35] Although officially there were three cochairs of the committee, the driving force was William Rhodes, a senior vice president of Citibank. Rhodes was relatively unknown outside his own turf at the time, but he had rushed back to New York from his Canadian vacation when the crisis hit, had taken charge of the process, and would stay at the helm for more than a decade—not just on Mexico, but on the other major Latin American debtors as well.

As noted in the introduction to this chapter, it had been common practice for bankers to visit the IMF to talk about general economic developments in countries where they were lending, but lending decisions by banks and financial arrangements with the Fund had always been strictly independent. Indeed, for several years the staff of the IMF had been concerned about the tendency of many countries to borrow too freely from the banks, taking advantage of the lendable funds accumulating in international banks in the aftermath of the sharp increases in oil prices (the so-called petrodollars) and of interest rates that were generally negative in real terms. A standard performance criterion in financial programs was a limit on foreign borrowing, including borrowing from banks.

These relationships would now change, as both sides recognized the extent of their interdependence in finding a solution to the debt crisis that had engulfed them. The banks needed the Fund's expertise in country analysis and the Fund's leverage in dealing with borrowing countries; the Fund needed the banks' resources to help cover the borrowers' financing requirements, and it needed the banks' cooperation if a systemic financial crisis was to be avoided.[36] Borrowing countries were seeking help both from banks and from the Fund, and effective communication between the two was in their interest as well, as long as the essential confidentiality and mutual trust on which the Fund's relations with member countries depends could be preserved.

In August 1982, it was still unusual (though by no means unprecedented) that Robichek and Guitián would not just attend the large meeting with 115 bankers, but also participate in the committee meeting that followed it. As the strategy

[35]These committees did not have formal names, and they were variously known as "steering," "coordinating," or "advisory" committees. The term "Advisory Committee" is used here for the sake of consistency. The number of banks in the Mexican committee later dropped from 14 to 13, when the one Mexican bank on the committee, the Banco Nacional de Mexico, was nationalized on September 1, 1982. For more detail on the nature of the committees, see Lomax (1986), Chapter 6.

[36]Also see Chapter 6, pp. 275–76. For a thorough discussion of the weakness of country risk analysis by commercial banks in the period leading up to the debt crisis, see Lissakers (1991), pp. 94–110. For a banker's view of the need for a strengthened role for the Fund, see de Vries and Porzecanski (1983).

evolved over the next few years, however, Fund staff would participate in many meetings of the bank committees, bankers would become frequent visitors to Fund headquarters, and the Fund would play a very active role in solidifying bank participation in loan agreements.[37]

Negotiating the Program: August–November 1982

First Mission

Silva Herzog returned to Mexico that weekend, and throughout the following week—the last week of August—he and Mancera engaged in intensive negotiations with Beza over the policy adjustments on which the use of Fund resources would be made contingent. Both sides were largely in agreement on the nature of the required adjustment, but they started out far apart in assessing the magnitude that could reasonably be expected. Most significantly, while everybody knew that the authorities had to find a way to cut expenditures by enough to reduce the fiscal deficit sharply from its then-current rate of about 15 percent of GDP, the Fund staff insisted that a 1983 deficit of much more than 6 percent of GDP could not be financed, while the authorities insisted that the deficit could not be reduced much below 10 percent of GDP by 1983 without having ruinous effects on the economy. Each side understood that both of these arguments were correct and that a compromise had to be reached quickly.

As August drew to a close, the negotiators decided that a retreat from the heat and pressure of Mexico City might help create the right atmosphere for reaching agreement on a draft Letter of Intent for the proposed program. Accordingly, Silva Herzog took Mancera on his motorcycle to the coastal resort of Oaxtepec, and Beza and his team drove over more conventionally by automobile. Over the weekend, the two sides hammered out a compromise, the essential feature of which was allowance for more external financing than the IMF team had thought was reasonable to expect. Up to that point, the negotiating position of the IMF staff had been that commercial banks could not be expected to significantly raise their exposure to Mexico. Relaxing that assumption would enable the government to finance a larger fiscal deficit without resorting to inflationary domestic finance. The agreement reached in principle at Oaxtepec was that the program would be predicated on an assumed $5 billion in external finance, of which $3.5 billion would have to come from commercial lenders. That program would still require cutting the fiscal deficit at least to a ceiling of 8 percent of GDP.[38]

[37]In the case at hand, a team of bankers—the Economic Subcommittee of the banks' Advisory Committee—was in Mexico City throughout the late-August Fund mission, gathering much of the same information as the IMF, but they were unable to meet with Beza or his staff team.

[38]Draft memorandum from Beza to the Managing Director, dated September 3, 1982, and conveyed in that form to the Managing Director in Toronto the following day; in IMF/RD Managing Director file "Annual Meeting—1982 (Briefs)" (Accession 84/21, Box 1, Section 168).

Driving back to Mexico City at the end of the weekend, everyone knew it would be a tough job selling the program to the banks, to President-Elect de la Madrid, and especially to outgoing President López-Portillo. The president had often staked his own reputation on maintaining the parity of the peso. He who devalues the currency devalues himself, he had famously said; he would defend the peso like a dog. For the moment, however, it looked as if López-Portillo might have finally recognized the inevitability of the economic forces that he faced. None of the negotiators could have known that their efforts would be undermined by midweek. On Monday and Tuesday, Buira drafted a Letter of Intent based on the Oaxtepec understandings and gave it to Silva Herzog. The Secretary then told Buira that there had been no reason to hurry, because everything was going to change tomorrow.

At two o'clock Wednesday afternoon, September 1, the members of the IMF team were working on their reactions to the draft Letter. In the background they could hear López-Portillo on television, delivering his annual State of the Union (*Informe*) address. As the president delivered the early part of the speech, there was no hint of any major policy shift. The telephone then rang; it was their department head, Walter Robichek, calling from Toronto, where preparations for the IMF–World Bank Annual Meetings were under way. An advance copy of the *Informe* had been leaked to reporters and other participants there, and Robichek could scarcely believe what he was reading: the president was nationalizing the banks, introducing exchange controls, and blaming foreign creditors—including the IMF—for the country's economic crisis. Minutes after Robichek relayed this information, the team heard the president delivering the same message on television. The draft Letter of Intent lay still-born on the table.

The Mexican negotiating team was now in disarray. Mancera—who was on record as a strong opponent of exchange controls—was dismissed as central bank governor and replaced by Carlos Tello, an opponent of the policy reforms to which both sides had so nearly agreed. When Buira went back to his office at the Bank of Mexico after the president's speech, he found his way barred by army troops who had surrounded the building. Silva Herzog offered to resign, feeling that he lacked political support for the policies he knew were needed, but López-Portillo rejected his request. Beza, too, was ready to give up and go home, but when Silva Herzog told him he was not resigning and asked him to keep negotiating, he agreed to stay for another two days to assess the new situation.

Toronto

On Friday, Silva Herzog and Beza flew together to Toronto while the rest of the mission returned to Washington. Mexico, of course, was on the minds of virtually all of the thousands of bankers, bureaucrats, and politicians who were converging on Toronto from around the world that first weekend in September, and for the next week the focus of attention would be on this financial and convention center on the northern shore of Lake Ontario. The first task for de Larosière and Beza was to deflect Tim McNamar's frenzied insistence—at a midnight meeting that

same Friday night—that the Fund should agree to lend money to Mexico immediately. McNamar feared that without quick and decisive action, a wave of defaults by several developing countries would destroy the banking system and throw the world economy into depression. De Larosière took a more temperate view, if only because he knew that the Fund could not lend to Mexico until an economic program had been negotiated and a complete financial package had been secured.[39]

Negotiations resumed at 8:15 Sunday morning, as de Larosière, Beza, and other IMF staff met at the Sheraton Center with Silva Herzog, Gurría, and Phillips to discuss how to respond to the political setback. Silva Herzog acknowledged the problem, but he emphasized that he did not want to abandon ship and that he wanted to move the process forward as best they could. He was authorized by the president to reach agreement with the Fund and to report back as soon as possible. De Larosière responded that the Fund was willing to act quickly, but the Mexican authorities needed a strategy, and there had to be agreement on a solid program. Drafting a new Letter of Intent during the Toronto meetings was probably not feasible, but perhaps they could agree on some general principles and prepare an aide-mémoire that Silva Herzog could take back to the president. The critical issue, all agreed, was the need for a commitment to reduce the fiscal deficit in 1983. Other issues such as the newly imposed exchange controls were only symptoms of the underlying fiscal problem.[40]

Conditions became only more chaotic as the week progressed. While the Fund staff and the Mexican authorities worked on the aide-mémoire in Toronto, a highly artificial exchange regime was being implemented in Mexico. Two separate fixed exchange rates went into effect on Monday morning, both of which entailed substantial subsidies that would place additional pressure on the fiscal budget, accelerate capital flight, and push transactions into the burgeoning parallel market near the U.S. border. By the end of the day, the extent and impact of the flight were as clear in Toronto as in Tijuana; that night, around 2 o'clock, Volcker telephoned Wriston to ensure that the CHIPS system for clearing cross-border interbank settlements would be protected in the event of a default on interbank claims.

By the next morning—Tuesday, September 7—there was indeed a panic in the interbank market. International banks were refusing to roll over lines of credit to Mexican banks. Unless calm could somehow be restored, the Mexican banks would have no choice but to default, and the whole interbank market could collapse overnight with incalculable consequences for financial markets. Throughout this Black Tuesday, Volcker, Leutwiler, Sam Y. Cross of the Federal Reserve Bank of New York, and Brian Quinn of the Bank of England all worked the telephones to persuade banks to maintain the level of interbank credits. A substantial portion of the BIS loan that had just been approved was parceled out to repay portions of

[39]This constraint on the Fund's capacity to respond to a crisis became increasingly unsettling in the 1990s. For a comparison of the response to Mexico in 1982 with the responses to Mexico in 1995 and Korea in 1997, see Boughton (2000).

[40]File minute on the meeting; in IMF/RD Western Hemisphere Department file "Mexico—General Correspondence (July–November 1982)" (Accession 87/19, Box 2, Section 94).

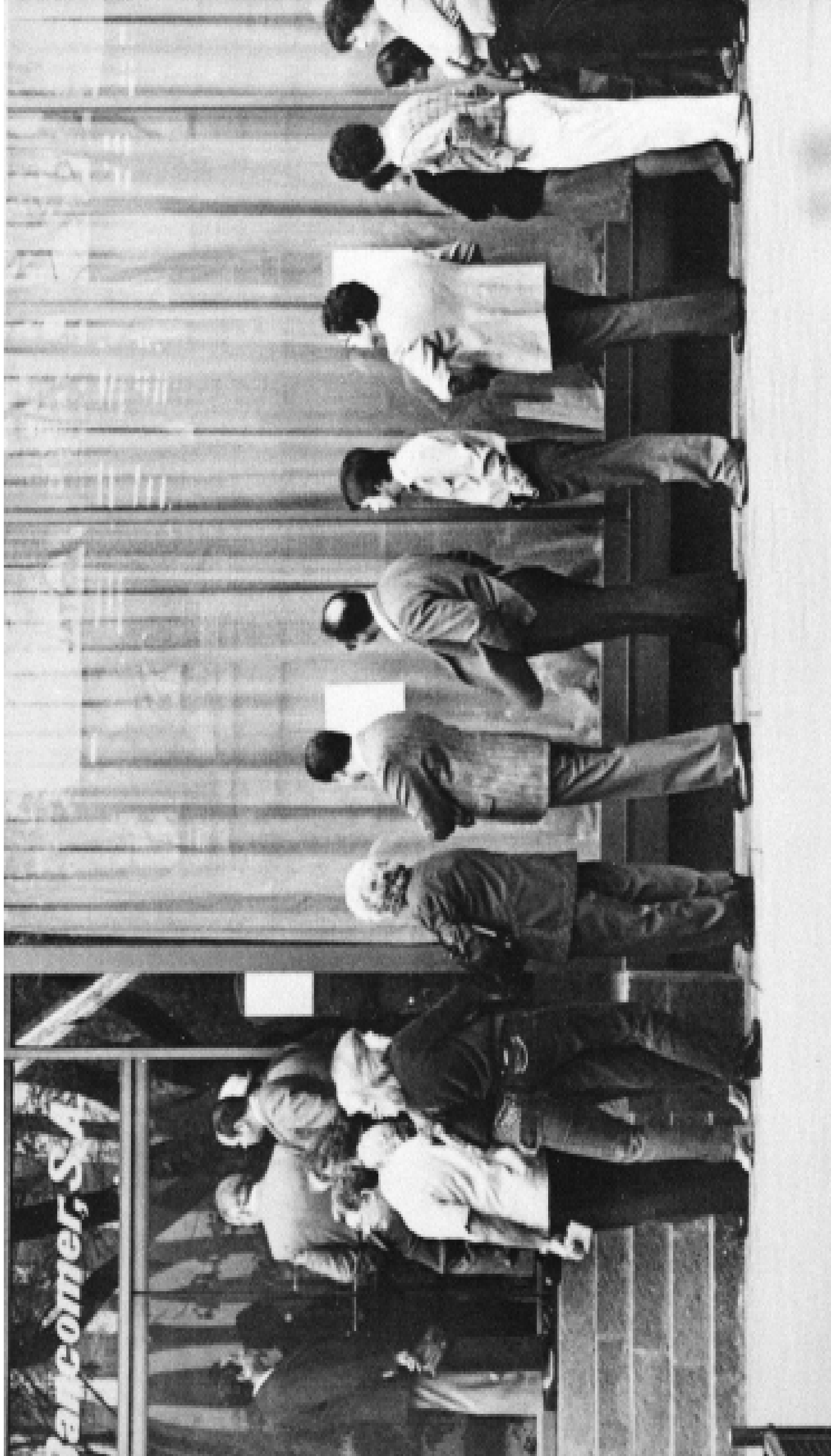
the outstanding claims, and the banks—knowing they could not get paid that day in any case—agreed to preserve the rest. By nightfall, the banking system had squeaked by without a default—and without a systemic collapse.

Early Wednesday morning, September 8, the aide-mémoire was approved by de Larosière and delivered to Silva Herzog. Avoiding specific numbers or other program details, it specified, inter alia, that the public sector deficit should be cut by more than half in proportion to GDP in 1983; that subsidies should be reduced; that wage policy should be consistent with a reduction in inflation; that interest rates should be allowed to rise by enough to encourage residents to keep their savings in domestic banks; and that exchange rate policy should help restore international competitiveness. Within that structure, it was hoped there would be room for the authorities to design a program that they could sell both at home and abroad.

Silva Herzog, weighed down by enormous pressure from all sides, was beginning to feel seriously ill. He telephoned his wife in Mexico City, hoping for a quiet respite before a late-morning meeting with U.S. officials, only to discover that Tello had just announced a new set of exchange controls and other measures that were completely at odds with the program that Silva Herzog was going to have to prepare. If the president was allowing the Bank of Mexico to shift policy in that direction while asking him to negotiate on his behalf in the opposite direction, what credibility could he, Silva Herzog, have?

With little hope left, Silva Herzog went to his meeting with the U.S. team. Everyone involved from Washington was there: Volcker and Truman from the Federal Reserve; and Regan, Beryl Sprinkel (Under Secretary for Monetary Affairs), and McNamar from the Treasury. To whom should we be talking, they wanted to know; did he still represent the president? All that Silva Herzog could tell them was that there was no viable alternative to assuming that he did. He was going home tomorrow, he would give López-Portillo an ultimatum, and if he failed, he would resign. The declaration was dramatic, all the more because of Silva Herzog's obvious exhaustion and dejection. Regan urged him not to resign, as would others in the course of the next two days. It was a critical moment for Mexico and for the international financial system, and Silva Herzog's resignation would have left a huge vacuum in the circle of power and influence.

The Toronto meetings wound down on Thursday with no real resolution of the Mexican crisis. Then on Friday there came a false dawn that temporarily calmed the financial markets. In the second stage of the drawn-out transition that characterizes the Mexican presidency, the election of de la Madrid was confirmed by congress. Perhaps more important for the short term, Silva Herzog announced that he would stay on as Secretary of Finance. He had met with López-Portillo on returning to Mexico City, and he believed that he had convinced the president that unless they reached agreements soon with both the banks and the IMF, Mexico would be unable to import even basic foods before the end of his term in office. De Larosière by this time had gone fishing with friends in a remote region in Ontario, but he had asked Silva Herzog to call him there as soon as he knew whether the negotiations could resume. For the moment, it seemed possible to relax.



Uncertainty reigns in Mexico after the government nationalizes private banks

Conclusion of Negotiations

Silva Herzog's illness proved to be serious. He was taken to the hospital the next day to be operated on for appendicitis and would be out of action for most of the rest of the month. Meanwhile, the IMF negotiating team returned to Mexico City on September 23 to try once again to get agreement on a program that could be supported by Fund resources. Unfortunately, the falseness of the dawn was now revealed in that the more radical forces, led by Tello, continued to block efforts to cut the deficit and rationalize the foreign exchange regime. Throughout the first half of October, rumors surfaced that a Letter of Intent was on the verge of being signed. In reality, Silva Herzog—now back at work—was still caught between the two camps and lacked political support for an effective program. Negotiations broke down once again, and both sides agreed to shift the scene back to Washington.

On October 22, Silva Herzog and his negotiating team arrived in Washington for two days of meetings with U.S. and Fund officials. The breakdown in negotiations was creating multiple problems for them, because the second tranche of the BIS loan was dependent on satisfactory progress vis-à-vis the Fund program. The Managing Director was still pushing for a 1983 fiscal deficit target of no more than 8 percent of GDP, and the authorities were still searching for a way to avoid that big a reduction in the first year. Other items on the agenda included the Fund's insistence on prior actions such as a rise in the heavily subsidized price of gasoline, on a commitment to undertake structural measures such as elimination of the dual exchange rate system, on establishment of a timetable for eliminating payments arrears, and on acceptance of the program by both the outgoing and the incoming administration; and the authorities' request for front-loading of the funds that would be available under the program.[41]

The Washington meetings produced no major breakthroughs, though they did reveal enough common ground and enough flexibility to warrant resumption of negotiations in the field. Silva Herzog reportedly attempted to persuade both Volcker and Rhodes to apply pressure on the Fund to ease up on their demands, but without success.[42] He met with de Larosière and his staff, twice in formal meetings and twice over lunch. On the surface, he went home empty-handed, but the meetings had persuaded the Fund to be a bit more optimistic about other external financing that might be available in 1983. When Beza boarded a plane for Mexico City at Dulles Airport a few days later, he was authorized to negotiate on the assumption that Mexico would get $2 billion in official credits in 1983, plus $5 billion in new medium-term credits from commercial banks. If that much financing could actually be put on the table—and that was a big "if"—then the fiscal demands on the Mexican government could indeed be relaxed.

[41]The request was to draw the equivalent of 450 percent of quota over three years, which would normally be made available in roughly even quarterly installments; that is, 150 percent of quota a year, as long as the performance criteria were met or were explicitly waived by the Executive Board. There was scope, however, for making a larger proportion available in the first year or two if the case was determined to be exceptional.

[42]Kraft (1984), p. 45.

The improved outlook for external financing was partially offset by the need to drop the request for a CFF drawing equal to Mexico's quota. As noted above (p. 290), this amount—SDR 800 million, or approximately $880 million—could have been made available immediately upon approval by the Executive Board in December. The difficulty was that the CFF request would have been justified on the grounds that export revenues had been depressed by the decline in oil prices. If Mexico drew on that basis, other oil-exporting countries would also have been eligible, and the Fund's liquidity position could have been severely squeezed. At an informal meeting between Executive Directors and the Managing Director on August 23, Mohamed Finaish, the Executive Director for Libya, had indicated that oil exporters would indeed plan to make such requests.[43] Consequently, Mexico eventually dropped its own request and the issue was dropped.[44] By November, therefore, Mexico was requesting only the EFF arrangement, to be phased over three years.

While the mission was in Mexico, de Larosière turned his attention to ensuring that the external financing would be there when it was needed. He was not worried about the official portion, but how could the Fund be sure that the commercial banks, especially the large number of smaller banks who had lent to Mexico, would not use the availability of official resources to try to get their own money out? The standard arrangement, under which the program would simply project the likely availability of external financing and treat that amount as an assumption underlying the program, would not work in this case. De Larosière therefore became convinced by the end of October that a more active policy of bringing the banks into the process was required.

During the first week in November, de Larosière consulted with Volcker, Solomon, and Richardson, among others, about the possibility of his meeting with bankers to impress upon them the necessity of their providing the requisite support for Mexico. As a result of these discussions, de Larosière invited representatives of 17 major banks to meet with him in the boardroom of the Federal Reserve Bank of New York on November 16.[45] To stress the importance of participation by non-American banks, Richardson separately invited a small group of mostly European and Japanese bankers to meet privately with de Larosière at the Bank of England the following week.

The program finally was falling into place. On November 8, Beza telephoned the Managing Director from Mexico to tell him that he had reached agreement with both administrations and the central bank on the draft Letter of Intent and

[43]File minute on the meeting, in IMF/RD Managing Director file "Mexico—1982" (Accession 85/231, Box 6, file 3, Section 177).

[44]The issue of under what circumstances a country could draw on the CFF to compensate for a decline in oil export revenues continued to plague the Executive Board throughout the 1980s. See Chapter 15.

[45]Because the meeting would deal with Argentina as well as Mexico, the invitees included all banks that were represented on the Advisory Committees for either country. Of these, seven were U.S. banks; Canada, France, Germany, and Switzerland were each represented by two banks; and Japan and the United Kingdom by one each.

that a technical Memorandum of Agreement was being finalized. Two days later, Silva Herzog and Tello signed the Letter and—in what was then an unusual move, intended to demonstrate the country's commitment to the program—released it to the press.[46] As the key compromise, the fiscal deficit was to be reduced (from the latest estimate for 1982, 16½ percent) to 8½ percent of GDP in 1983. Now full attention could be turned to securing a commitment from the banks.

Commitment from Commercial Banks: November–December 1982

On November 9, de Larosière addressed the fourth annual International Monetary Conference—a gathering of the leading international bankers—in Philadelphia. Using the occasion to alert banks to the role they would be asked to play in resolving the crisis, he emphasized the need for closer cooperation. "Avenues for collaboration between the Fund and the banks are being actively considered . . . the banks will have to maintain adequate net financing flows for those countries that have adopted strong adjustment measures . . . *all* of the banks must be involved . . ." (emphasis in the original text). With this speech, the Managing Director was dropping a fairly broad hint of the need for concerted lending, but the audience seems to have interpreted it more as a call for cooperation and a promise of IMF involvement. As the *Washington Post* noted the next day, participants at the conference had been discussing the desirability of the IMF "cofinancing" bank loans to developing countries; the reference by de Larosière to "collaboration" was thus seen as a possible endorsement of that approach, under which the banks would have been firmly in the driver's seat.[47]

Advisory Committee

Then came the key meeting with the major banks in New York, at 4:30 Tuesday afternoon, November 16.[48] De Larosière began his presentation by outlining the policy mistakes that had brought Mexico to the brink: sharp increases in public sector spending over several years, financed in large measure by foreign commercial borrowing. These policies were to be reversed in conjunction with the EFF program to which the Fund and the authorities had just agreed, but that program could not succeed without the full cooperation of the banks. He then came to the bottom line. In 1983, Mexico was expected to have a current account deficit of

[46]The Letter of Intent and the detailed Technical Memorandum of Understanding were published in full in the newsmagazine *Proceso*. For a report in the Mexican press welcoming the agreement, see the stories and editorials in *Excelsior,* November 11, 1982.

[47]Article by Hobart Rowen, *Washington Post,* November 10, 1982, p. D9.

[48]The following summary is based on de Larosière's speaking notes for the meeting, plus a file memorandum dated November 18, 1982, by Irwin D. Sandberg of the Federal Reserve Bank of New York; in IMF/RD Managing Director file "Mexico—1982" (Accession 85/231, Box 9, Section 177).

$4¼ billion, inclusive of some $10 billion in interest payments due to commercial banks on public sector debt alone. To this deficit would be added $2½ billion in required repayments on short-term official loans, notably those arranged in August by the BIS. Furthermore, official reserves would need to be rebuilt; that added another $1½ billion as the minimum increase that would permit normal functioning of the financial system, for a total financing requirement estimated at $8¼ billion.

The IMF was prepared to provide the maximum financing allowable under the rules of access: $1.3 billion in 1983, with equivalent amounts to be provided in 1984 and 1985. That would leave a gap of $7 billion to be financed by others. Of that, only $2 billion was expected to come from official bilateral sources, principally as credits for export cover.[49] The banks, therefore, would have to raise their exposure to Mexico by $5 billion, or the program would not add up. Finally, de Larosière dropped the bombshell: the $5 billion increase in bank exposure in 1983 was so crucial to the program that he could not take the EFF to the Executive Board until he had agreement from the banks to provide that amount. The required reduction in the fiscal deficit—by 8 percent of GDP in one year—was unprecedented; nothing more could be expected, and there was simply no choice.

De Larosière concluded his presentation by asking for a written commitment for $5 billion in "new money" for 1983, and additional commitments on three other points. First, the banks were asked to continue to roll over existing short-term credits. Second, they would need to reach agreement with the Mexican authorities on a rescheduling of intermediate and long-term debt. Third, they would need to "clean up" $1½ billion in private sector interest arrears that would be outstanding by the end of 1982. Executive Board consideration of the EFF was tentatively scheduled for December 23, but if written commitments were not in hand by December 15, the meeting would have to be postponed.

The pressure put on the banks by the Managing Director was unprecedented, and it sent shock waves through the banking community. When the shock was absorbed, however, it became clear that cooperation was in everyone's interest. The fundamental advantage to the banks as a group was that the package would enable them to get a net reflow of dollars from Mexico. As de Larosière had indicated, the Mexican public sector would owe about $10 billion in interest payments during 1983. Without a fully financed adjustment program, the chances were virtually nil that Mexico would be able to make those payments. De Larosière's arithmetic implied that Mexico would pay approximately $5 billion in interest to banks in 1983, while the remainder would be rolled over into new principle. Thus, by raising exposure by $5 billion, the banks would receive a similar amount in net reflows that they otherwise could not get. Furthermore, if the Managing Director had been prepared to follow standard practice and take the program to the Board without any prior commitment regarding private financing, the Advisory Committee would have had a far tougher job—perhaps an impossible task—raising the $5 billion be-

[49]On a net basis, taking into account the repayment of short-term credits mentioned earlier, this projection implied that official bilateral exposure would decline by about $550 million in 1983.

cause of the free-rider problem they would have faced. Each individual bank that was small enough not to threaten the agreement by itself had an interest in trying to get its money back as rapidly as possible. Only if those banks could be convinced that withdrawal was impossible could the cost to each bank in terms of increased exposure be kept to a reasonable level.

In the discussion that followed de Larosière's presentation, Rhodes and other bankers expressed three main concerns about the Managing Director's demands. First, they felt that the authorities could do more to solve the problem of private sector arrears to banks. In some cases, companies that could afford to meet their interest payments were being blocked by regulations prohibiting them from using foreign exchange for that purpose. Furthermore, much of the private sector debt was held by small banks whose participation in a new-money package would be contingent on a solution being found to this problem. If there was any significant attrition by small banks, the required increase in exposure by the remainder would be that much larger; if the burden could not be spread evenly across all creditor banks, securing a commitment by the remainder would be far more difficult. De Larosière recognized the dilemma, and although he was reluctant to put the IMF in the middle of the effort to settle private sector arrears, he promised to speak to the Mexican officials about it.

A second concern of the banks was what they perceived as the unequal burden between official and private creditors. Even assuming that official creditors did raise their exposure through $2 billion in export credits in 1983, their net exposure would decline, since they would be getting $2½ billion in repayments, as mentioned above (p. 307). Allowing for Fund drawings and the relatively small amounts expected from multilateral development banks, official credits would rise by about $1 billion, compared with $5 billion from commercial banks. Or, as Rhodes put it at the meeting, it looked as if the main effect of the EFF arrangement was to enable Mexico to repay its official creditors.

Third, banks were concerned about the attitude of the regulatory agencies: would they be penalized for increasing the outstanding balances of such risky loans? Solomon responded on behalf of the Federal Reserve, saying that loans made in support of a Fund-supported adjustment program would not be subjected to regulatory criticism. That same evening, Paul Volcker would be addressing bankers at the annual meeting of the New England Council (in a speech whose timing had been carefully coordinated with de Larosière's presentation) and would make this same point.[50] These assurances set the tone for similar responses by regulators in Europe and Japan in the weeks to come.

[50]"From the standpoint of the banks themselves, such restructuring and the provision of some additional credit, alongside and dependent upon agreed IMF programs, will in some instances be the most effective and prudent means available to enhance the creditworthiness of borrowing countries and thus protect their own interests. In such cases, where new loans facilitate the adjustment process and enable a country to strengthen its economy and service its international debt in an orderly manner, new credits should not be subject to supervisory criticism." Volcker (1982), p. 17.

Other Creditor Banks

Following the New York meeting, the Advisory Committee agreed to roll over Mexico's short-term principal payments for another 90 days. There were, however, more than 500 other creditor banks whose participation in concerted lending had to be secured before the Fund program could be approved, and only four weeks remained before the deadline. On Monday, November 21, de Larosière flew to London for a meeting and dinner the following day at the Bank of England.[51] Richardson had invited the bankers whose prestige and influence would be essential. It was a small group of bank chairmen, but with a global reach: Jeremy Morse of Lloyd's, Wilfried Guth of Deutsche Bank, Jean-Yves Haberer of Paribas, Franz Lutolf of Swiss Bank, Yusuke Kashiwagi of the Bank of Tokyo, and Lewis Preston of Morgan Guaranty.[52] Richardson, de Larosière, and Leutwiler made up the official contingent.[53]

The major issue for the major banks at this stage was how to structure the package so as to obtain participation by the maximum number of smaller banks. De Larosière's initial plan was to ask each creditor bank to increase its exposure to Mexico by 9 percent; this target would leave enough of a margin that even if a number of smaller banks declined, the $5 billion target could still be attained. If there was too much attrition, the large banks would have to make up the difference. Throughout the evening in London, the bankers impressed upon the Managing Director that they could not be expected to cover such deficiencies. The arithmetic was plain, and if the small banks knew they were expendable, they would certainly flee.

One conclusion that emerged from the London gathering was an understanding of the need for an active involvement by national regulatory authorities. As noted above, Volcker and Solomon had clarified the position of the Federal Reserve on November 16: sovereign lending that helped fill a country's financing gap in conjunction with an IMF program would not be considered problem loans. Although certainly helpful, this passive approach—even if shared by all of the G-10 central banks—would not be sufficient. The bankers therefore requested the assistance of the IMF in persuading national authorities to actively encourage banks in their territories to participate fully.

On November 23, Rhodes called de Larosière (who was in transit from London to Geneva to address a ministerial meeting of the GATT) requesting to meet with him on Mexico, along with the other two cochairmen of the Advisory Committee, as soon as possible on his return to Washington. De Larosière agreed, and a meeting was held in his office on November 30, the evening before de la Madrid's

[51]Based on the Managing Director's travel file, in IMF/RD (Accession 86/34, Box 16, Section 208), plus interviews with several participants.

[52]Kashiwagi, Lutolf, and Preston had also been at the November 16 meeting in New York.

[53]A rare feature of this gathering was the absence of Paul Volcker. Volcker's involvement in the development of the debt strategy was so pervasive in 1982 that a decade later, several participants at the Bank of England dinner mistakenly recalled to the author that Volcker had been there as well.

inauguration as president. There were two interrelated issues to be settled: how much banks could reasonably be asked to raise their exposure via the new-money package, and how close they would have to get to the $5 billion requirement before the Managing Director could safely propose approval of the program to the Executive Board. On the first question, although de Larosière preferred the safety margin that a 9 percent increase would provide, he was persuaded that a lower figure—though not so low as the 5 percent increase suggested by Rhodes—would be necessary to bring enough pressure on reluctant creditors. The group thus settled on the obvious compromise, 7 percent. At that rate, more than 500 banks would have to participate: only the very smallest creditors could be let off the hook.[54]

The second issue—the cutoff point for going forward—was equally risky. A late-December deadline was essential if Mexico's financing needs were to be met, but it posed a dilemma. The bank agreement could not be signed and delivered until the entire $5 billion had been pledged, and it would almost certainly be impossible to reach that figure in less than a month. De Larosière therefore devised the idea of setting a threshold on the basis of which one could be reasonably confident that the full amount would be reached within a matter of weeks. He proposed the idea to the bankers and suggested that 95 percent would constitute what he called a "critical mass."[55] The banks obviously liked the idea but wanted a much lower figure, on the order of 70 percent. Eventually they settled on 90 percent, and de Larosière agreed to propose acceptance of the EFF if the banks could get signed agreements totaling $4.5 billion by December 23.[56]

With this agreement between the Advisory Committee and the Managing Director on the financing required to support the Fund program, and the new administration installed in Mexico, the next requirement was a detailed agreement on the financing proposal between the Advisory Committee and the Mexican authorities. To that end, Gurría flew to New York on December 1, where he spent the next week negotiating specific terms. Four days later, Silva Herzog and Mancera[57] flew to Washington to meet with de Larosière and then on to New York, where the agreement with the major banks was finalized on December 8. The terms were harsh for Mexico and highly profitable for the banks, but that was a

[54]The establishment of a cutoff point, below which banks whose exposure was less than an agreed minimum absolute level would be excused from participating in a "new money" or concerted loan, became known as the *de minimis* principle.

[55]The term "critical mass" quickly became an accepted part of the lexicon of the debt strategy, with the specific meaning of a level of commitments from bank creditors that would provide reasonable assurance that the full amount of a syndicated loan would be forthcoming within a few weeks or months. Previously, de Larosière had used the phrase in other contexts. For example, in the January 1982 speech cited at the beginning of Chapter 6, he used "critical mass" to describe the "quantum of resources the *Fund* must be able to offer to members, when a program justifies it, to make its conditional financing an attractive proposition and to help unlock access by such members to other sources of external finance." (Op. cit., p. 7; emphasis added.)

[56]Statement by the Managing Director at EBM/82/167 (December 23, 1982), p. 4; and background interviews.

[57]On December 1, President de la Madrid had retained Silva Herzog as Secretary of Finance and had rehired Mancera as Director General of the Bank of Mexico.

price the Mexican government was willing to pay to extricate itself without a default.[58]

To complete the bank agreement required the participation of some 500 additional banks, and only two weeks remained before the Executive Board was to consider the EFF request. During those two weeks, all of the major participants worked virtually nonstop to persuade as many banks as possible to agree to raise their exposure by 7 percent.[59] De Larosière and Dale undertook to keep the authorities of the major creditor countries (the G-10, Switzerland, Spain, and several Middle Eastern countries) informed and to develop with them a uniform position that the concerted lending agreement would be treated favorably for regulatory purposes. The national authorities in turn undertook to persuade banks or at least to inform them of the favorable light in which the agreement was seen. In the end, the total on December 23 fell slightly short of the arbitrarily defined critical mass, with $4.32 billion in signed pledges, but enough other agreements were in the pipeline that de Larosière decided to proceed.

Role of the Fund

As detailed below, over the next few months the program would be approved and the bank loan agreement would be completed. Before leaving this subject, however, one should ask: What did the IMF achieve by insisting on the concerted-lending package, and at what cost? The case for this dramatic innovation rests on the argument that the package was in the interests of both Mexico and her bank creditors but that it nonetheless could not have been achieved—or could have been achieved only at a higher cost—in the absence of outside intervention. The first part of this case is straightforward; the second is more complex.

Because Mexico lacked the foreign exchange to meet its current external debt obligations, a rescheduling or similar agreement with creditor banks was necessary to prevent default. Avoiding default was in Mexico's interest because it preserved both trade and financial flows. It was in the banks' interest because default—compared with the position following an agreement—would have raised the current book value of outstanding credits (including unpaid interest) and lowered the expected return on them.[60] It was also in the interest of creditor countries, especially the United

[58]The concerted-lending agreement was contracted at a spread of 2⅛ percent over LIBOR or similar rates, plus substantial fees. Rowen (1983) calculated—using estimates made by Karin Lissakers of the Carnegie Endowment for International Peace—that the rescheduling and concerted-lending agreements together would cost Mexico some $800 million in fees and increased spreads; he quoted Lissakers as regarding the terms as "outrageous." In a speech on March 7, 1983, just after the bank deal was finalized, Martin Feldstein, chairman of the U.S. Council of Economic Advisers, noted that the banks were charging "substantial risk premiums," a practice that he predicted would be "self-defeating" because it would raise the "risk of nonpayment" (Feldstein, 1983, p. 6). Although Feldstein did not mention it, the U.S. government had also exacted a high price for the official credits extended in August 1982 (see above, pp. 291–92).

[59]The base date for calculating exposure had been set as August 23, 1982.

States, for whom a bilateral bailout would have been economically and politically risky and, in the absence of policy improvements in Mexico, probably quite fruitless. A coordinated multilateral solution was obviously superior but appeared to be out of reach without the involvement of an established international financial institution.

The primary explanation for the difficulty in reaching a globally optimal solution without outside intervention is that there was a sharp split in interests *within* the banking community. Figure 7.3 illustrates the key role played by small banks in the Mexican agreement.[61] While the 25 largest creditors would provide for just over $2 billion of the $5 billion required by raising their exposure by the specified 7 percent, the next $2 billion would take another 75 banks, and the final $1 billion would require pulling in more than 400 additional banks. Furthermore, as a general rule, the banks with smaller exposure (and thus smaller required commitments) were not just smaller banks; they also had smaller exposure relative to their own size and thus would have been better positioned to cut their losses and run if the prospects of program success were judged to be poor.[62] One goal of the concerted-lending package was to raise the stakes for those small banks by making success depend on their participation. Every bank with significant exposure would face a linkage between its decision to participate and the likelihood of program success; the free-rider problem[63] was thereby greatly diminished.[64]

The two alternatives to officially sponsored concerted lending (other than default) would have been sanctions against nonparticipating banks or voluntary rescheduling agreements with a limited number of large banks. Any bank whose credits to Mexico were small enough not to affect the viability of the package would have an interest not to participate, unless some form of sanction could be imposed. Because contractual obligations required debtors to treat all creditors alike, a default on payments to nonparticipating banks would have made it impos-

[60]This statement appears to presume that the only alternative is a complete default, but the comparison of expected returns holds true even if allowance is made for a commensurate partial default. From a static financial perspective, there is no practical distinction between a partial default and concerted lending: in each case, creditors are forced to accept a rise in exposure. If, however, concerted lending in conjunction with a program of policy adjustment succeeds in raising the borrower's ability to pay, then it also raises the expected rate of return on outstanding credits. Nor does the conclusion depend on the red-herring argument that the country be illiquid but not insolvent. Given the uncertainty surrounding the valuation of future output and foreign exchange revenues, neither concept is empirically relevant for this problem. The only required assumptions are that the country be unable (not just unwilling) to meet its current debt-servicing obligations and that policy adjustment be facilitated by the avoidance of default. See Arora (1993) for a review of the literature on these issues, and Chapter 12, below, for further discussion.

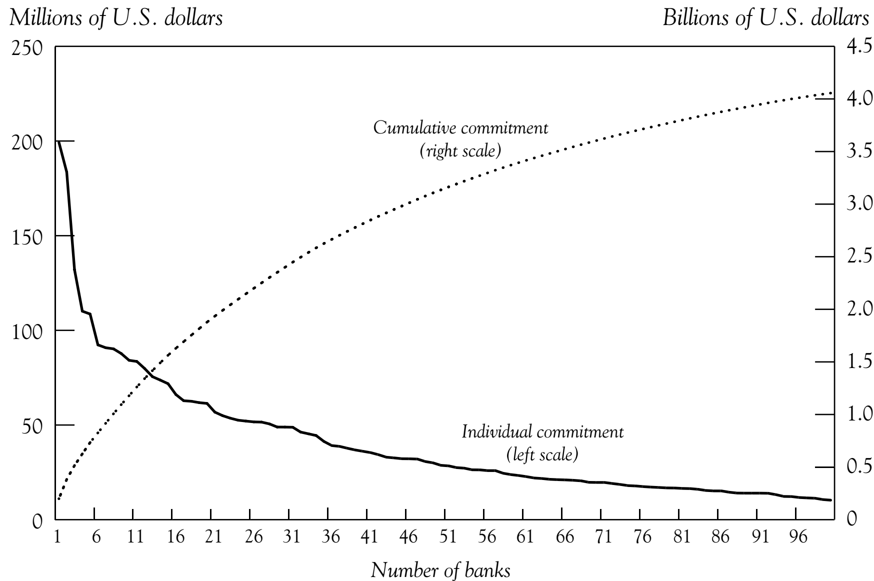
[61]Data are from the credit agreement between Mexico and the commercial banks, dated March 3, 1983; in IMF/RD Western Hemisphere Department file "Mexico—Credit Arrangements with Citibank, 1983" (Accession 85/231, Box 9, Section 177).

[62]See Sachs and Huizinga (1987) for an analysis of 1986 data on exposure to developing countries by size of bank.

[63]See Sachs (1984), Krugman (1985), and Caskey (1989) for discussions of the conditions under which the presence of large numbers of small creditors can inhibit market agreements.

[64]Of the 526 banks participating in the loan agreement, 28 made commitments of less than $100,000 (implying initial exposure of less than approximately $1.4 million).

Figure 7.3. Distribution of the 1983 Concerted Lending Agreement for Mexico
(Top 100 creditor banks)



sible for national regulatory authorities or the Fund to support the package. The large banks could have threatened to exclude dissidents from future syndications, but in the competitive environment of the early 1980s such threats would have lacked weight.[65] Sanctions therefore would have had to come from the official sector, and there is no reason to think official sanctions would have been preferable in any way to the zero-margin concerted-lending package concept that was used instead.

The other alternative, under which only those banks whose exposure was too large to be withdrawn would have rescheduled their loans, would have required those banks to raise their exposure by a much larger percentage than in the concerted-lending package. Not only would that approach have induced considerable brinkmanship as banks at every level tried to leave the larger banks holding the bag; the resulting exposure levels would have made it far more difficult for regulatory agencies to treat the new loans as "performing."

Though concerted lending may have been necessary in the Mexican case, it did not come without cost. The banks had entangled themselves in the debt crisis over a number of years by failing to adequately analyze country credit risks and by failing to recognize the more general risks associated with sovereign lending. Encour-

[65]For discussions of relations between large and small banks in sovereign lending, and the problems associated with sanctions on holdouts, see Lipson (1985) and Fernandez and Kaaret (1992). For a review of the literature on the problems associated with heterogeneous commercial lenders, see Eaton and Fernandez (1995). Lissakers (1991) describes banking practices with regard to sovereign lending in the 1970s and 1980s.

aged by regulatory agencies and national authorities to "recycle" resources from surplus to deficit countries in the developing world, many banks had responded excessively and incautiously. Now, to help avoid a default, the IMF was providing assurances to the banks that the borrower's economic policies were being adjusted in ways that, inter alia, would improve the prospects that the banks could be repaid.[66] If the IMF were to put itself in a position whereby such assurances could become a *general* requirement for bank lending to developing countries, the institution's independence and neutrality could be threatened and the banks would face a serious moral hazard problem. Furthermore, if the programs failed to resolve the debt crisis within a reasonable time, the return to voluntary lending could be unduly delayed. Although the Fund recognized and discussed these dangers, it was unable to avoid them while responding to the initial crisis. For the moment, longer-run concerns were pushed to the back burner.[67]

Approval of the EFF Program: December 1982

On December 23, the Executive Board unanimously approved Mexico's request for an extended arrangement under the EFF totaling SDR 3,410.6 million ($3.75 billion).[68] Little of the discussion by the Board indicated reservations about the program. Jacques de Groote (Belgium) expressed concern that key elements of the program were insufficiently spelled out, and he concluded that what was before the Board "was not a program so much as a list of intentions."[69] Although he was prepared to approve the requested drawings, he (and other Directors) cautioned that frequent reviews would be required to ensure that intentions with regard to the level of fiscal borrowing and wage moderation were made concrete over the coming months. A number of Directors also indicated skepticism regarding the program's underlying assumption that oil prices would not fall further in 1983; without such an outcome, the required fiscal adjustment could not be realized. More generally, however, there was a very broad recognition by Directors that Mexico was committing itself to as much fiscal and wage adjustment as could reasonably be expected and that the Fund's support of that effort was both appropriate and essential to the success of the program.

[66]For example, the Managing Director's cable to the Advisory Committee on December 1, 1982, concluded that "the program should make possible a lowering of pressures on prices while at the same time permitting a reduction in the reliance on external financing, making provision for a reasonable volume of credit to the private sector, and ensuring a rebuilding of foreign reserves"; IMF/CF (C/Mexico/150.1 "Fund Relations with Commercial Banks, 1982–1983").

[67]For the limitations that were soon put on the procedure, see the discussion of the 1983 Uruguay program, in Chapter 9 (pp. 408–09).

[68]Mexico's quota at the time was SDR 802.5 million, and the Fund's holdings of pesos amounted to 100 percent of quota (i.e., there were no outstanding drawings other than the reserve tranche). On this date, the Board also approved an immediate purchase of the first credit tranche, SDR 200.625 million; that purchase plus the full amount of the EFF arrangement would have brought total drawings (other than the reserve tranche) to 450 percent of quota.

[69]Minutes of EBM/82/168 (December 23, 1982), p. 4.

The Board meeting was also an occasion for Directors to reflect on the more general issues raised by the Mexican situation. Directors generally supported the Managing Director's initiatives vis-à-vis commercial banks, though with the caveat that these procedures should be considered as exceptional and should not be generalized. Some concerns were expressed that the World Bank had not been involved in the assessment of Mexico's plans. In particular, it was standard practice for proposed EFF arrangements to include an assessment by the Bank of the country's public investment plans (see Chapter 15). That practice had not been followed in this case, because Mexico had been trying to "graduate" from Bank financing, and the Bank had not been actively involved while the program was being put together. The staff assured Directors that the authorities intended to ask the Bank to review their investment plans as soon as the new administration was established. Finally, a number of Directors questioned whether Fund surveillance had been adequately pursued in this case. Had the two-year gap in consultations made it more difficult for the staff to assess developments in Mexico, and could the crisis have been foreseen under better procedures? As Bruno de Maulde (France) phrased it, the "so-called surveillance process had obviously failed to produce adequate warnings,"[70] and the Board would have to take up the problem again in the context of a general review of surveillance (on which, see Chapter 2).

Completing the Package: January–March 1983

Approval of the EFF arrangement was not the end of the process: financing of the bank package had to be completed, official support had to be secured, and Mexico had to implement the policy program.

On December 23, 1982 (when the EFF arrangement was approved), just over $4.3 billion (86 percent of the required $5 billion) in new money from commercial banks had been pledged. Neither the banks' Advisory Committee nor the Mexican negotiators felt confident that they could bring in the remainder without help from governments and regulators, so they turned to the IMF for help. For the next two months, both de Larosière and Dale worked hard to ensure that the authorities in all creditor countries were helping to bring in as much bank financing as was needed. Maintaining the principle of uniform treatment was a critical element: if the banks in one country or region believed that they would end up shouldering more than their share of the load, they would likely pull out and bring down the house of cards.

The banks' reluctance to pledge new money was geographically widespread, with major difficulties evident in France, Japan, Switzerland, and the United Kingdom, and in U.S. banks outside the principal money markets. The position of the Japanese banks was especially sensitive in this regard. The Japanese banking sector—with its strong presence in the New York market—had the second largest

[70]Minutes of EBM/82/167 (December 23, 1982), p. 12.

exposure to Mexico, in dollar terms and in number of banks, after the United States. By mid-January, very little had been pledged from Japan, and the management of the IMF became convinced that the $5 billion total could not be reached unless they could turn that situation around. Cables and telephone calls to the Ministry of Finance and the Bank of Japan were cordially received but seemed to have had little effect.

The stalemate was effectively broken during the Interim Committee meeting in Washington in February 1983. In the margins of that meeting, the Mexican authorities met with the IMF staff and a number of senior bankers from Japan. The bankers were in a delicate position, because they were being increasingly criticized at home and could not necessarily count on the support of their own boards of directors for any concessions they might make in Washington. The once-profitable loans they had made to Mexico had turned sour, and it was not obvious at the time that patience would be the winning strategy. In New York, Washington, and Mexico City, the Japanese position was widely misunderstood. There never was any serious risk that the Japanese banks would refuse to participate, once other banks were also willing to commit. Agreements to that effect apparently had been reached between the principal bankers and the Japanese authorities at a very early stage. The main concern in Tokyo was that they had to be sure they would not be left holding the bag: that *all* banks, including the small U.S. and European banks, would be sharing the risk. They feared that if the Japanese banks, with their huge exposure, committed too early, the free riders would be back in the saddle. By the time of the Interim Committee meeting, the efforts of the IMF staff and the Mexican authorities to ensure wide participation had paid off enough that the Japanese bankers could take home some reasonably firm assurances. Much work remained, but at least everyone now understood how to get the job done.

For much of the rest of February, Gurría—accompanied by bankers from the Advisory Committee—circumnavigated the globe to line up reluctant banks and official creditors, especially in the Middle East and Japan. On the 24th, having enough confidence that the $5 billion package would soon be completed, the Committee banks extended Mexico a loan of $434 million to serve as a bridge. Three days later, with all but a handful of small banks uncommitted, they set the signing ceremony for March 3 in New York. Not until March 15, however, would the magic figure of $5 billion finally be reached, as the last 7 of 526 creditor banks signed on.[71]

Meanwhile, the IMF conducted the first review of the adjustment program, with a mission starting on March 7, headed by Joaquín Pujol (Chief of the Mexico/Latin Caribbean Division, Western Hemisphere Department). One concern of the mission team was that oil prices had slipped further since the program had been devised. They determined, however, that the fiscal effect of that slippage on export receipts had been more than offset by the effects on outlays from a 2 percentage

[71]An unknown number of other small creditor banks never did sign on, but a few of the large banks made additional commitments to make up the difference.

point drop in interest rates. The mission also met with their counterparts from the World Bank, who were in Mexico City reviewing the investment program that the Bank was supporting. Overall, the situation seemed well in hand in March of 1983: the program was on track, and the initial phase of the debt crisis had passed.

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