

SECRET

Prime Minister (2)

13 September 1982

5

You asked for a ALAN WALTERS

PRIME MINISTER

Thank you very much for note from Alan on the Bank's Mexico figures Mex 14/9

BANK CLAIMS ON MEXICO AND OTHER DEVELOPING COUNTRIES

The Bank of England's memorandum (7 September) confirms in figures what we already knew. Broadly speaking, the British Bank's commitment is one-tenth of the total BIS commitments, although this varies somewhat from one country to another. And Mexico's and Venezuela's debt is short compared with that of Brazil.

An additional feature which the Bank memo does not highlight, is the concentration of this lending in the last year. For example, according to my sources in the World Bank, Mexico borrowed about 20 billion dollars in 1981, almost all of it from the world's banks. This was at a time when it was obvious that Portillo had adopted expansionist policies which were clearly worse than those which were pursued during the last two years or so of Echeverria's Presidency. The banks lent on the myth that oil was a substitute for sensible policies, in spite of the experience of countries such as Iran, Nigeria etc.

Mexico and the IMF

There is no doubt that if Mexico showed that she was going to adopt sensible policies (which can come only through an IMF reform package) doubts about solvency and liquidity would rapidly be allayed. The policies pursued by Portillo have been quite dreadful and are unlikely to improve; indeed I think they will get worse. Sr Tello, the Governor of the Central Bank appointed to succeed Sr Mansera, is a product of our own Cambridge school of Marxist economics. It was he who when a Director (and Assistant Director) in the Budget Office, urged that Mexico should repay her debt to the IMF and be free of the need to conform to the IMF's package. He is a strong proponent of a command-siege economy and expanding public spending. On the monetary and budgetary side therefore I suspect things will get considerably worse during the next three months or so.

Meanwhile it is the Mexican season for wage awards. There is an enormously inflated claim by the main trade unions in Mexico. It is designed to more than catch up with inflation. I cannot see how Portillo will deny this claim in his last year of office. This will

/then much

SECRET

SECRET

- 2 -

then much exacerbate the already serious unemployment problem and stimulate migration into the United States.

Madrid and Prospects of Reform

The hopes of the world financial community are pinned on Sr de la Madrid who will become President in early December. It is anticipated that he will be a much more sensible and prudent President than Portillo. It is worth reflecting, however, that the same thing was said about Portillo six years ago. Portillo had also been a sound Minister of Finance, but changed dramatically when he became President. Sr Madrid has been making all the right noises in his speeches, but it is worthwhile bearing in mind that when he was in the Budget Office he supported expansionist policies. It would be unwise to count too heavily on Sr de la Madrid as the reforming President.

The world's financial community appears to be hoping that the pendulum of Mexican politics will swing again into the hands of the traditional rich ruling class. It is hoped that Sr Madrid will pay attention to the industrialists in the private sector and follow the generally successful lines of policy which they have supported. I believe that the majority of opinion of the World Bank and IMF Latin American specialists is that Madrid will return to those sensible pre-Echeverria policies. But there is a substantial minority of very well informed old Mexican hands who believe that things have gone too far to return to the old nostrums.

In my judgement the evidence so far suggests that Mexico is likely not to repudiate its debts. Although it is unlikely that they will accept fully the IMF reform package, they will go far enough to give sufficient confidence that they mean business on reform. It is likely that they will press some very hard bargains on interim interest rate arrangements, and in that sense they will write off some of their market obligations. In other words, I judge the latent conservative forces to be still powerful enough to assert the need for sensible reform policies.

Repercussion Effects

It is likely, therefore, that Mexico will so frighten its creditors that it will extract from them a reduction in the debt in exchange /for avoiding

SECRET

for avoiding all the messy consequences of repudiation. It will be very important for other developing countries, as well as the basket cases in Eastern Europe, to see what Mexico can get away with.

There are various options that are being touted around. Perhaps the most persistent one is that either central banks or the IMF should buy the debt off the banks at a substantial discount, say 70% of its face value. Then this would be treated legally as an indebtedness to the central banks or the IMF. The discount would then compensate for the fact that the debt would be "re-scheduled" and the interest rates would be lower than market rates. Obviously the political and economic implications of these suggested solutions are both complicated and worrying.

The Liquidity Problem

This is all concerned with the solvency problem. On the other hand, the liquidity problem seems to be more or less well covered. The central banks do appear to have the banking system substantially supported to offset any short term run on deposits. I am convinced now that the Ambrosiano Luxembourg phenomenon was a small aberration and not typical of the general operations. More important, I believe that the markets are convinced of this also.

Conclusion

With the liquidity problem at least temporarily out of the way, there is an opportunity for an orderly re-scheduling of Mexico's debt. Mexico will press its advantages here and secure concessions on interest rates etc effectively to reduce its obligations. The Americans must take the lead in all these negotiations, US banks are far more committed than any other country's banking system. It may be that the American Government would want to go rather further than we would to cement its good relationships with the incoming Madrid administration. But I suspect there is little we can do about that. The Americans know that any weakness in dealing with the Mexicans is likely to be taken as a signal by the rest of the developing world to write down their indebtedness. It will be contagious. So there will be a natural check to their propensity to propitiate the new Mexican Government.

SECRET

- 4 -

Of the other candidates for "re-scheduling", I think little has changed since the discussion we had on 31 August. I heard that Peru seems to be in imminent danger of collapse. The indebtedness to the UK is, however, only about $\frac{1}{2}$ billion. I believe that Chile is safely out of the wood, and Venezuela and Brazil not far behind. However, it is most important that Mexico does not profit much from its profligacy "pour encourage les autres".

13 September 1982

ALAN WALTERS

(Dictated but not signed
by Alan Walters)

SECRET